An Overview of the Major Events and Regulation of the Securities and Futures Markets between 1997 and 2007

The sovereignty of Hong Kong was returned to China on 1 July 1997, and the Hong Kong Special Administrative Region (HKSAR) Government was established. The Basic Law of the HKSAR guarantees Hong Kong's ability to continue to provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre. The Securities and Futures Commission has been operating as the independent regulator of the securities and futures markets in Hong Kong effectively and efficiently since its establishment in 1989 and after the handover, and will continue to do so.

Today, Hong Kong is recognised as the premier fund raising centre of Mainland companies and as an international financial centre. One of the key factors of these successes is the existence of an appropriate regulatory environment which is on a par with the world's best standards and practices and is conducive to market growth and development.

The introduction of the Securities and Futures Ordinance (SFO) in 2003 was a key milestone in the process. The SFC spent a considerable amount of time and effort working with the Hong Kong Government to put together this important Ordinance, which marked the beginning of a new regulatory era. The SFO is largely based on international standards and it forms one of the cornerstones that set the regulatory environment in Hong Kong. Another major development which has enabled Hong Kong to have a modern market infrastructure is the successful demutualisation and merger of the exchanges and clearing houses which created Hong Kong Exchanges and Clearing Limited (HKEx) in 2000. The SFC played a key role in the establishment of the new exchange. The HKEx is now one of the world's leading exchanges with a market capitalisation of listed companies of HK$15 trillion as of the end May 2007, being the eighth largest in global ranking.

Many events that took place in Hong Kong, the Mainland, and globally in the past 10 years have shaped the way in which securities markets and regulations have evolved and, accordingly, the changing role of the SFC. In reflecting the changes,

the past decade can be largely divided into three periods. It should be noted, however, that as many of the events and changes have had long lasting implications for the market and its regulation, the demarcation between periods is not to be taken as absolute.

The three periods are:

- **First period (1997 – 1999) – Asian Financial Crisis and dealing with aftermath**
- **Second period (1999 – 2003) – Modernisation of the regulatory regime and market facilitation**
- **Third period (2003 -) – Market growth and Mainland opportunities**

A chart that provides a snapshot of the major events that took place in each of these periods and which played a role in shaping the Hong Kong securities market is attached to this paper.

First Period (1997 – 1999)
Asian Financial Crisis and dealing with aftermath

The Asian Financial Crisis in 1997-1998 ushered in a period of financial instability of the securities markets not only in Hong Kong but also in many other parts of Asia. But due to its resilience and with a determination to restore investor confidence, the Hong Kong market was able to emerge from the turmoil and became stronger in the process. Hong Kong also took the opportunity to commence a series of reforms of its securities regulatory regime, which paved the way for Hong Kong to further strengthen its status as an international financial centre.

During the **Asian Financial Crisis**, the sharp swings of the markets and some major corporate failures shook global financial stability and exposed regulatory problems. The highest priority at that time was to tackle regulatory gaps and market vulnerabilities.

In Hong Kong, the collapse of **CA Pacific** group in early 1998 caused substantial losses to thousands of investors. The failure exposed the regulatory gap in the supervision of share margin financing activities, which were not covered under the banking or securities legislation. The SFC acted promptly to protect the interests of the clients of CA Pacific and prevent contagion to the rest of market. Other share margin financiers responded to the SFC's concerns and found ways to strengthen their financial positions and manage the risks of their business. The SFC immediately worked with the Administration to develop a policy response, placing share margin financing activities under SFC's regulation.

During the crisis, aggressive speculators double played in the currency market and the securities market in Hong Kong. The severity of the speculative attack was unprecedented. To frustrate these speculative attacks, the HKSAR Government decided in August 1998 to step into the stock market and acquired considerable amount of shares. The Government later created a vehicle to divest the acquired shares, The **Tracker Fund** of Hong Kong, which was listed in 1999. The Tracker Fund was the first exchange-traded fund (ETF) authorised by the SFC, and was at the time the largest IPO in Asia ex-Japan.

Thereafter, the Government announced a comprehensive **30-point plan** to tighten market discipline, increase transparency, and restore order to the financial market. The SFC worked with the exchanges and various market stakeholders to introduce these measures covering short selling, system improvement, risk management, and inter-market surveillance. The SFC played an active role in the inter-agency monitoring process to ensure that the 30 measures were implemented successfully to maintain the overall financial stability and integrity of the markets.

Recognising the need to further enhance the competitiveness and stability of the securities and futures markets, the Government introduced a major **three-pronged market reform** in March 1999. The reform aimed to bring the regulatory regime in line with best international standards, facilitate market innovation and competition, and update the technology infrastructure to make Hong Kong one of the most efficient, convenient and cost effective places to conduct business. The three "prongs" were the modernisation of the securities legislation, demutualisation and listing of the stock and futures exchanges, and the enhancement of financial infrastructure. The fruits of these major projects were seen in the following years.

Second Period (1999-2003)
Modernisation of the regulatory regime and market facilitation

The three-pronged measures to reform the securities and futures markets were implemented in earnest in the years following the Asian Financial Crisis. The exchange company was listed in 2000 and the Securities and Futures Ordinance became effective in 2003. Significant progress was also made in financial infrastructure development through the implementation of newer generation trading *and clearing systems and improved networks.*

The stock and futures exchanges were demutualised and merged with the clearing houses in March 2000 in order to achieve economies of scale through reducing operation costs. The merged entity, **Hong Kong Exchanges and Clearing Limited** (HKEx), was listed in June. HKEx is a profit making organisation but has a statutory obligation to maintain an orderly, informed and fair market. Because of the demutualisation, the regulation of brokers previously directly supervised by the exchanges has become the responsibility of the SFC.

Perhaps the most significant regulatory development since the post-1987 market crash Securities Review Committee report – which recommended a wide range of reforms including the formation of the SFC - was the enactment of the **Securities and Futures Ordinance**. The SFO consolidated 10 pieces of legislation governing the securities and futures markets at the time, and brought the securities law in Hong Kong on a par with international standards. It was passed by the Legislative Council in 2002 and implemented in 2003 with a comprehensive body of subsidiary legislation.

The following are some of the key features of the SFO: (a) a new dual filing arrangement that ensures timely and accurate disclosure of information by listed companies and listing applicants. False or misleading disclosure made knowingly or recklessly is liable to prosecution; (b) insider dealing, market manipulation, dissemination of false and misleading information can be pursued either by prosecution or through a new Market Misconduct Tribunal. The Tribunal decides on cases using the less stringent civil standard of proof and may impose a range of deterrent sanctions; (c) a single licensing system that brings improved cost effectiveness to licensed market practitioners; (d) the SFC has greater flexibility in determining disciplinary sanctions against licensed practitioners' misconduct; (e) a new investor compensation scheme that offers improved protection for retail investors; and (f) a new regime for Automated Trading Services.

In 1999, the Stock Exchange of Hong Kong introduced the Growth Enterprise Market with a view to attracting technology related companies to raise funds in Hong Kong. At the beginning of the new millennium, over-stretched enthusiasm in technology stocks led to the eventual collapse of the technology stock bubble. This, together with the corporate and accounting scandals involving US companies including Enron Corporation and WorldCom, inspired global discussions on corporate governance and conduct issues. In Hong Kong, the Government began a review of the regulatory structure of the securities and futures markets, which eventually led to a proposal to give **statutory backing** to the more important listing requirements. Statutory backing will raise the quality of corporate disclosure and allow more effective enforcement against breaches. This exercise has made considerable progress in the following period.

The SFC also worked on areas which aimed at building Hong Kong up as a sustainable and conducive environment for market development. The SFC has issued authorisation codes and guidelines on ETFs, retail hedge funds, and real estate investment trusts (REITs). Hong Kong is one of the first jurisdictions in the world to allow retail hedge funds; the first hedge funds were approved for sale to the public in 2002.

Third Period (2003 -)
Market growth and Mainland opportunities

The modernisation of the securities regulation and market infrastructure placed Hong Kong in an optimal position to tap the enormous opportunities arising from the recovery of global equities markets and the continued strong growth of the Mainland economy. Its close relationship with the Mainland and its advantages as an international financial centre complement the Mainland's market reform. This enables Hong Kong to serve as a platform bridging the international marketplace and the Mainland, resulting in win-win results for both markets.

At the start of this period, Hong Kong was hit by the SARS epidemic, which caused tragic loss of lives and serious damages to economic and financial activities. But the stock market rode through the storm without any systemic problems. Such resilience was attributable to the continuous system enhancements and our improved abilities to handle emergencies following the Asian Financial Crisis.

The Hong Kong market has grown from strength to strength in recent years (please see the attached table that shows the major market statistics of 2007 as compared with those of 1997). This is reflected in the elevation of Hong Kong in the world ranking as an international financial centre, a broader and deeper market, and its emergence as an important facilitator complementing the Mainland capital market reforms. In various authoritative global studies, Hong Kong has been accorded with high regard. In 2007, the Global Financial Centre Index ranked Hong Kong third as an international financial centre and considered it a real contender to become a genuine global financial centre like London and New York. Hong Kong leads the Capital Access Index in terms of accessibility to capital.

The SFC has continuously worked on facilitating market and product development. The derivative warrants market, re-launched in 2002, is currently the most active market in the world. Investment products such as REITs and callable bull/bear contracts (CBBCs) were introduced during this period. The types of ETF have now diversified to include bonds, commodities and Mainland's A-shares.

Our modernised market also meets the need of the Mainland's capital market reforms. The Central Government announced in 2004 that the Mainland would utilise overseas capital markets and strengthen financial co-operation between Hong Kong and the Mainland. The Mainland share reform and the suspension of domestic fund raising activities beginning in mid-2005 reinforced Hong Kong's role as the **premier listing centre** for Mainland enterprises. In 2006, Hong Kong became the second largest IPO fund raising centre, surpassing the New York Stock Exchange, and handled the listing of mega-sized IPOs such as Bank Of China and Industrial and Commercial Bank of China, the latter being the world's largest ever IPO.

Hong Kong is also a premier trading centre for the shares of Mainland enterprises. Over 70% of the trading in shares of Mainland enterprises which are also listed in the US and UK is conducted in the Hong Kong market.

Financial integration between the Mainland and Hong Kong is not limited to the stock market only. Earlier this year, the HKSAR Government published an Action Agenda in relation to the financial services sector in its **Report on the Economic Summit**. The Action Agenda echoed the Mainland's 11th 5-year Plan and proposed wide ranging recommendations for the development of the Hong Kong financial services market, which aim to position Hong Kong to play a strategic role in the Mainland's financial reform and development. The SFC is working closely with market participants on the initiatives, and will encourage financial innovation. It is foreseeable that the two financial markets will become increasingly integrated.

The asset management experience and international visibility of Hong Kong enable Hong Kong to serve as a conduit for funds investing both in and out of China. Earlier this year, the China Banking Regulatory Commission widened the scope of investments allowed under the **QDII** (Qualified Domestic Institutional Investors) business of Mainland commercial banks. Recently, the China Securities Regulatory Commission also allowed brokerage houses and fund managers to invest clients' monies in overseas equity markets. The Hong Kong equity market and fund management industry will benefit directly from these new policies. At the same time, the relationship between Hong Kong and the Mainland, the common culture and Hong

Kong's familiarity with the practices and systems in the Mainland are our unique advantages in tapping international funds for investments in the Mainland. Such a two-way flow of capital will generate demand for a wider variety of investment products, risk management and other professional advisory services. These will in turn provide additional momentum for the development of the market and will further strengthen Hong Kong's position as an international financial centre.

As the financial market becomes increasingly sophisticated, it is vital that investors also have a good understanding of the benefits and risks involved so that they can play their part in the market properly. SFC's **investor education** work will be focused on the more complex and diversified products. This year, the SFC has announced a plan to form a new body providing investor education across various financial sectors.

Conclusion

Our efforts in regulation, market facilitation and investor education have yielded significant achievements over the past decade. Issuers, intermediaries and investors from around the world have shown their confidence in our regulatory regime and our decision to facilitate sustainable development of the market. Nevertheless, there is no room for complacency. The SFC will continue to work to maintain a favourable environment for market development and a high quality regulatory regime of international standards.

Our close connection with the Mainland offers opportunities for the future. Capitalising on a critical mass of professionals, a favourable business environment, facilitative regulatory framework, sound market infrastructure and strong international ties, Hong Kong will continue to play its unique role as a "platform" bridging the Mainland and the international marketplace. The SFC will continue to play its part in this continuing success story by providing the high quality regulatory environment which is so necessary for an international financial centre to flourish.

28 June 2007

Major Market Statistics Comparisons between 2007 and 1997			
		May 2007	**End 1997**
1.	**Market Capitalisation (HK$ bn)**	**14,982 (+368%)**	**3,203**
	Worldwide Ranking	8th	12th
	As % of GDP	1,016%	235%
2.	**Total Funds Raised (HK$ bn)**	**525 (+112%) (2006)**	**248**
	Worldwide Ranking	4th	4th
3.	**IPO Funds Raised (HK$ bn)**	**334 (+307%) (2006)**	**82**
	Worldwide Ranking	2nd	5th
4.	**Asset Under Management (HK$ bn)**	**4,526 (+205%) (end 05)**	**1,485 (end 2000)**
5.	**No. of SFC Licensed Individuals**	**28,426 (+90%)**	**14,967**
6.	**Hang Seng Index (HSI)**	**20,634 (+92%)**	**10,723**
7.	**Hang Seng H-shares Index (HSCEI)**	**10,035 (+240%)**	**3,139**

Remarks: Figures in parentheses are percentage growth over 1997 except for those figures that have the year of comparison specifically indicated.

Sources: SFC, HKEx, World Federation of Exchanges, Census & Statistics