

Chairman's Statement

"Our mission in 2005-2006 is to continue to implement the SFO effectively, with emphasis on raising the quality of the market. In our daily work, our staff motto is to remember: **Investors First.**"



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Investors First

This year's Annual Report delivers a concise message: the Commission puts the investors' interest first.

The Commission discharges its functions in accordance with the six statutory regulatory objectives. We aim to ensure Hong Kong's continued success and development as an international financial centre. In seeking to achieve these goals, we always remember that the investor is the reason why capital markets exist. The well-being of the investors is key to the health of the capital markets.

How do we protect investors? We do so through *Regulation, Enforcement and Education*.

We regulate through consultation and consensus with the market. Our regulations balance investor interest with market development. We balance the costs and benefits of regulation. We consider the possible impact of regulations on those whom we regulate, including the indirect costs. We focus our regulatory resources on matters that are important to the well-functioning of the market.

We enforce firmly and fairly against those who harm investors or damage market integrity. The Securities and Futures Ordinance (SFO) empowers the Commission to investigate, prosecute, and discipline using proportionate penalties. We

ensure that we are consistent in our actions while having regard to the specific circumstances of each case. Our actions are subject to checks and balances.

We educate investors to protect their own interests. Investor education provides investors with the tools and knowledge to make informed decisions. An informed investor is also the best defence against fraud. Intermediary education raises the professionalism and integrity of practitioners, which is important for building investors' confidence in the Hong Kong markets.

These are our guiding thoughts on putting investors first.

The Market in 2004-2005

In 2004-2005, the stock market advanced further, supported by improving economic fundamentals, a low interest rate environment, an inflow of funds and a continued recovery of the property market. Hong Kong's GDP growth was 8.1% in 2004. Deflation finally came to an end last July, and the unemployment rate fell to a 40-month low in March 2005.

During the year, the HSI receded to a year-low of 10,968 on 17 May 2004, but rebounded to the year-high of 14,266 on 29 December 2004. On 31 March 2005, the HSI closed at 13,517, rising 7% during the year. The average daily turnover on the Hong Kong market last year rose 13% to \$15.6 billion.

There were 61 IPOs raising \$81.7 billion (75 IPOs raising \$76.4 billion in the previous financial year). Of this, 65% was for Mainland enterprises (i.e. H-shares and red chips).

During the year, the H-share and red chip indices gained 0.3% and 7.7% respectively. The average daily turnover of H-shares and red chips was \$3.3 billion and \$2.3 billion respectively.

As at 31 March 2005, there were 1,096 companies listed on the stock exchange with a total market capitalisation of \$6,571.4 billion (US\$842.5 billion),

rising 14% from the year before. Hong Kong was the ninth largest market in the world by market capitalisation.

Hong Kong was one of the most active derivative warrants markets in the world by turnover last year. It contributed about 14% to the total market turnover. Trading of futures and options was also active, with 20.1 million contracts traded, 24% higher than the year before.

We do not make investment predictions, but we expect several concerns to linger over the markets in 2005-2006.

Between last June and March 2005, the US Federal Reserve raised its Fed Funds Target Rate (FFTR) seven times by a total of 175 basis points. Interest rate concerns, the possible return of inflation, higher oil prices and movements in major currencies all may affect investor confidence and add to market volatility.

Operational Review

Our finances improved in 2004-2005 and expenditure remained under control. The SFC achieved a surplus of \$169 million (\$125 million in the previous year). The reserves at the end of March 2005 stood at \$860 million.

Total revenue increased by 13%, or \$74 million, from the previous year to \$625 million. Levy income, our primary source of revenue, increased by 15% or \$55 million to \$435 million owing to the higher market turnover.

Total expenditure was \$456 million, \$30 million higher than 2003-2004. The increase was mainly because of variable pay awarded to staff who performed well. This is necessary in order to retain performing staff in view of an increased staff turnover rate as competitive demand for skilled staff increased with market recovery. We also spent more on areas considered necessary to improve market quality. Meanwhile, we continued to hold back on a general fixed pay increase, suspended since April 2001, so as to keep down

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our fixed cost. Variable pay in the future will be subject to budgetary consideration, staff performance and prevailing market conditions.

We made significant achievements in the four priorities set for 2004-2005: upkeeping market standards, facilitating market development, enforcing the law, and protecting and educating investors.

I would like to highlight some points, which are detailed in the divisional reports.

- Corporate governance standards for listed companies and regulation of listing sponsors were put in place, beginning 1 January 2005;
- We worked with the Government to give statutory backing to major listing requirements to strengthen listing regulation;
- We are tackling investment advisers' selling practices, on the back of a disciplinary settlement with a firm to pay \$255 million to investors;
- We proposed measures to address risks arising from securities margin financing;
- We issued guidelines on analyst conflicts of interest;
- We consulted on a review of the disclosure of interests regime;
- We proposed to relax the geographical restriction of investment by SFC-authorized REITs;
- We agreed with HKEx on its proposed model for a scripless securities market;
- A total of 76 entities were successfully prosecuted, including a record number of market manipulation prosecutions;
- We successfully prosecuted a company disclosure offence in the first dual filing case;
- We cleared much of the backlog of discipline cases, and used settlements where appropriate;

- Dr Wise's Column, our investor education (IE) TV dramas and radio programmes were popular; and
- Teachers' IE workshops were fully subscribed, while IE became credit courses for undergraduates.

In addition, the Commission won several awards and recognition for its corporate affairs activities. You will find these and description of our staff social services in the later chapters. You will also find a review of our investor education and communications work in the past years.

Our mission in 2005-2006 is to continue to implement the SFO effectively, with emphasis on raising the quality of the market. In our daily work, our staff motto is to remember: Investors First.

A World-Class Regulator

In the past year, we signed Letters of Intent (LOIs) with our counterparts in Indonesia, Thailand and Sri Lanka to strengthen regulatory co-operation relating to investment products. We are working on similar arrangements with several other jurisdictions. These bilateral LOIs will facilitate more Asian financial products to be traded within the region, building on the regional efforts to develop Asian Bond Fund II. We also signed a Memorandum of Understanding on regulatory co-operation with the Philippines commission.

SFC staff have made significant contributions to the committee and taskforce activities of International Organization of Securities Commissions (IOSCO), leading to some landmark initiatives such as the code of conduct fundamentals for credit rating agencies, and the blueprint on combating financial fraud.

In May 2004, during the IOSCO Annual Conference in Amman, Jordan, I was privileged to be elected Chairman of the IOSCO Technical Committee.

A Note of Thanks

I would like to put on record our deepest appreciation of the services of our Non-Executive Directors (NEDs) Ms Anna Wu, Mr Brian Stevenson and Mr Daniel Fung, who joined the Board on 1 January 1999, shortly after I joined the SFC on 1 October 1998 as its fourth Chairman. We welcome Mr Eddy Fong, Mr Kenneth Kwok and Professor Liu Pak Wai whose terms began on 1 January 2005.

1998-1999 was a most difficult time for the Hong Kong securities market, after the 1997 financial crisis, and the failure of C.A. Pacific and the Government market intervention in 1998. Turnover was low, and so was internal staff morale.

The Board and the staff banded together to rebuild confidence of the international investment community in Hong Kong. In March 1999, the Financial Secretary announced three major reforms in the securities markets, in which the Commission played a significant role.

The first reform was demutualisation and merger of the exchanges; the second, consolidation of the securities laws; and the third, enhancement of the financial infrastructure. All three objectives have been largely achieved. The scrippless market will be implemented progressively.

Emerging from the tech bubble and SARS, the stock market began a sustained recovery in the middle of 2003. In the six years until the end of 2004, the number of listed companies had grown 30% and the market capitalisation of the Main Board had more than doubled.

The Commission assumed the regulatory responsibility for brokers upon the demutualisation of the exchanges. From frontline regulator of brokers, we have also become the statutory regulator of listed company disclosure with the advent of dual filing. This latter role will be enhanced when the important listing requirements are given statutory backing, as proposed by the Government.

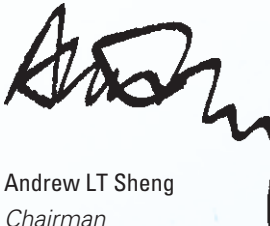
All the above could not have been possible without the experience and expertise of our NEDs in business, finance, accounting, law and public service, as well as their intellect and personal integrity. Neither could they have been achieved if not for the hard work and steadfastness of the staff.

I am pleased that the Financial Secretary has re-appointed Mrs Alexa Lam and Mr Alan Linning as Executive Directors (EDs). I thank fellow EDs Mr Mark Dickens, who left us after 14 years (serving eight years as ED), and Mr Ashley Alder, whose term ended last October. Mr Peter Au-Yang, Chief Operating Officer, has doubled up as ED of Corporate Finance since Mr Alder's departure.

By the time of the expiry of my contract in September 2005, I will have served the Commission for seven years. With the statutory backing of the listing requirements, the Commission has finally emerged as the statutory regulator of listed company disclosure, clarifying its role in the capital markets and placing the Commission on par with the roles and functions of the securities regulators in the major markets.

It has been a great honour to serve the Hong Kong market and the Commission, a great privilege to work with the NEDs, our advisers and friends in the various committees, the legislature, the Government, the market and the media, and a great pleasure to work with my fellow EDs and all my colleagues, whom I regard as friends.

It has given me great pride and satisfaction in witnessing the growth and development of the Commission over the years. I am confident that the Commission will continue to build on its strength and professionalism as the independent regulator of one of the most vibrant capital markets in Asia, if not the world.



Andrew LT Sheng
Chairman