

Chief Executive Officer's Statement



The past year has seen unprecedented levels of activity and growth in Hong Kong's securities and futures markets. We have seen the world's largest ever IPO take place in Hong Kong and we have been ranked ahead of New York in terms of capital raised. It has been a busy year for everybody in the market including us as its regulator.

Market overview

In 2006-07, we saw a rise both in the number of new listing applications submitted for our review under the Dual Filing arrangements and also the size and complexity of the proposed offers. Out of the 95 new listing applications submitted in 2006-07, 62% planned to raise more than \$500 million, compared to 42% out of the 86 applications in 2005-06, with the vast majority of applications relating to Mainland based businesses.

The average daily turnover of shares over the past 12 months has increased substantially to \$39 billion per day, 83% higher than the previous 12-month period. Trading in futures and options contracts was also active increasing 71% over the same period. This increase in activity has been accompanied by changes in the mix of trading in particular towards listed warrants and Mainland related stocks. This has required us to consider carefully the focus of our market monitoring activities both from a compliance perspective as well as for matters that might have implications for market stability.

The strong performance of the local market together with the resurgence in interest in Mainland issues was reflected in activity in the retail investment funds industry. 314 products were authorised during the year to 31 March 2007, bringing the total number of SFC-authorized investment products to 2,686. We also authorised 8,235 marketing documents for fund products, 24% more than the previous year.

We also saw a significant rise in the number of structured products and authorised 106 prospectuses of retail structured note issues, with an aggregate issue size of \$10,691 million. The number of offer documents/marketing materials applications for retail equity linked investments also increased significantly - 64% up over the previous year - with an aggregate issue size of \$142,736 million.

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The favourable market conditions attracted many newcomers to our market and we have had a steady flow of individuals and corporations seeking licences over the past 12 months. The number of licensees as at 31 March 2007 stood at 28,940, a rise of 13% over the previous year.

The high levels of market activity have been reflected in the financial results of market intermediaries who recorded strong growth in the year to 31 December 2006. Operating income of securities dealers and securities margin financiers increased 69%, as compared to 2005, while profitability jumped 124%. The number of active clients of securities firms also increased, by 12%, with more investors being attracted by favourable market conditions.

Some further details on retail investment funds, SFC licensees and the stockbroking industry are provided for the interest of the reader in the chapter on Activity and Market Data starting on page 104.

What we have done

Our work each year is influenced by developments in the market and also our view of the future changes that may occur and how we, as a regulator, need to respond. This year the big issues which we feel will influence our future remain the same; namely the development of the Mainland's economy, in particular its financial markets, and increasing global competition.

Listings by Mainland enterprises have continued to play a vital and increasingly significant role in the development of the Hong Kong capital market and they presently account for about half of both the market capitalisation and turnover of the Hong Kong stock market. China's continuing financial

market reform poses further opportunities but also significant challenges for Hong Kong. The SFC has therefore been working increasingly closely with the Mainland authorities with a view to facilitating Hong Kong's participation in the overall growth opportunities that the development of Mainland financial markets presents. This will continue to be an area of emphasis for us going forward.

Leading markets such as New York and London have recognised the need to improve their competitive position in order to attract new business, and Hong Kong must recognise and face the challenges that this will present. We need to constantly improve the efficiency of the market, maintain and improve its integrity and above all take measures to ensure that we promote and maintain investors' confidence. We have made progress in a number of these areas and for the coming year will be focusing our attention on increasing the efficiency of our processes and in particular how we interface with market participants. While we will still consider investors' interest first we will also re-examine how we can balance this responsibility with our role in facilitating market development.

Hong Kong's development and growth has not gone unnoticed and there have been a number of articles in the international press ranking Hong Kong as the leading Asian financial market. A recent survey of competitiveness of the major financial markets by the City of London Corporation ranked Hong Kong third in world financial centres behind London and New York. The report on the Global Financial Centres Index concluded that Hong Kong “performs well in all of the key competitiveness areas, especially in regulation” and “is a real contender to become a genuinely global financial centre”. Whilst everybody in the industry will have been delighted by these comments, for us it is tempered by the report's observation that it is most likely to be a change in the regulatory environment that could alter the competitiveness of a financial centre most quickly. We are aware of our responsibility in this area and we are not complacent about the need to continually reappraise what we have done and what we still need to do. We have a number of initiatives in place which are looking at regulatory reform most notably the work which has been ongoing for some years to establish statutory backing for certain parts of the listing rules and we have been considering this change very carefully. However, if we are to maintain our new position in the world order we will need to be prepared to make further changes in order to keep our market attractive to both issuers and investors.

The SFC has made progress over the past year in the three principal areas of our work - Regulate, Facilitate, and Educate.

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Regulate

With effect from 1 January 2007 we introduced a new sponsor regime, to ensure that only firms and individuals with suitable qualifications can act as sponsors to listing candidates.

We believe that raising the standards of sponsors is key to promoting high standards of corporate governance and behaviour in the Hong Kong market, which in turn is crucial to Hong Kong maintaining its status as a fund raising centre.

Major progress has been made in the exercise to give statutory backing to certain important listing requirements. Together with the Government, we have developed proposals that address concerns previously expressed by market participants that the statutory rules would be too onerous. We will work closely with the Government to introduce a bill to the Legislative Council to give legal effect to these proposals.

During the year we announced the conclusions of a major consultation regarding modernisation of the prospectus regime set out in the Companies Ordinance. This is a part of the ordinance, governing the public offering of securities, that the SFC administers. The proposed reforms include measures which will enhance investor protection and harmonise regulations and we are now moving forward with drafting the necessary legislation to give effect to these proposals.

Our inspection teams identified several cases of misappropriation of client assets at brokerage firms during 2006-07. We took swift action to safeguard clients' interests and to ensure that those responsible faced disciplinary or legal consequences. Several persons have since been jailed following Police prosecution or banned by us from the industry for life. In one case, we were pleased to be able to assist in the negotiation of a white knight deal that restructured a failed brokerage so that clients would have their assets returned in full.

Facilitate

During late 2006 the SFC was a member of the Financial Services Focus Group of the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong". The group submitted a report to the Government outlining 80 action items aimed at addressing the challenges and opportunities arising from this Five-Year Plan. Some of these initiatives have already been implemented, including the adjustment of position limits on futures and options on the H-share index, the launch of Callable Bull/Bear Contracts and the Hang Seng China H-Financials Index futures on the exchange. Others are still being worked on with the SFC leading a number of important initiatives.

Together with Hong Kong Exchanges and Clearing Ltd, we have recently published a policy statement to clarify the listing requirements for overseas companies, and have issued guidance on compliance. This helps broaden the sources of companies able to list in Hong Kong and is part of the Action Agenda of the Economic Summit Report.

We continue to look at ways to facilitate the growth of the market and improve its efficiency. Going forward we propose to devote considerable resources to developing the other initiatives in the Economic Summit Report, in consultation with industry as appropriate. We are currently making good progress in a review of the position limits for Hang Seng Index futures and options contracts, as well as the regulations on short selling.

A landmark event last year, which raised Hong Kong's international status, was the SFC's hosting of the Annual Conference of IOSCO, the International Organization of Securities Commissions. This was the first time that Hong Kong had hosted the event. It attracted over 650 delegates and market practitioners from 135 jurisdictions, making it one of the most well attended IOSCO annual conferences.

Educate

In 2006 we introduced "Before you invest, ask the right questions" as our investor education (IE) theme, and various activities were conducted throughout the year around this. We produced a TV drama series with the Radio Television Hong Kong to explain the features and risks of complex or structured investment products. We also used the radio to advise investors to ask the right questions in different investment activities.

Continuing the success of the 2006 IE theme, we introduced "Know your risk" as the IE theme for 2007. For the first time we have used real life examples we have seen as regulators to create investor education material. In particular a short drama series advising investors on several risk related topics, has been broadcast on Cable TV.

Following the introduction of a new personal finance course at the Chinese University of Hong Kong, the SFC has now collaborated with all the eight local universities to promote the right investment attitude among undergraduates.

At the request of the Financial Secretary we have recently put forward a proposal to form an Investor Education Council. This will be funded from reserves that have accumulated from levy income as a result of the present high levels of stock market turnover. This proposal has received the support of other

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financial sector regulators and will commit significant resources to providing investor education across the whole of the financial sector. A cross-regulatory working group has now been formed to discuss how to take this initiative forward.

Corporate matters

Corporate Social Responsibility

As a statutory market regulator, the SFC's regulatory objectives are determined by the SFO. As a corporate citizen of Hong Kong we aim to pursue these objectives by following responsible policies and practices that allow us to make a positive impact on society.

To the SFC, corporate social responsibility (CSR) is considered in three main areas: (a) corporate governance; (b) care for employees; and (c) care for society, including our concern for the environment and the people around us. We have long been an advocate of good governance practices and believe that we set a good example in this area. However, in this Annual Report we have for the first time included a dedicated discussion on CSR issues as they relate to us and we are committed to moving forward in all three key areas during the coming year.

As an organisation we are particularly pleased that this year the Hong Kong Council of Social Service has named the SFC a Caring Organisation. The award is in recognition of our work in encouraging and supporting employee volunteering, providing family-friendly work arrangements and staff activities, and assisting social service organisations. However, I would also like to take this opportunity to commend those individuals on our staff who devote their personal time to activities in support of the community.

Finances

The SFC's revenue for 2006-07 has grown 54% from a year ago to \$1,307 million as a result of increased levy income derived from robust market activities. Despite this increase in revenue, we continue to exercise tight budgetary controls. The total expenditure for the year of \$542 million was within budget and we recorded a surplus of \$765 million.

Our budget for 2007-08 does not assume the same level of market activity as 2006-07, and this is reflected in lower budgeted revenue, of \$1,077.8 million, for 2007-08. Total operating expenses are budgeted at \$599.3 million for 2007-08 which includes only a modest increase of six posts in our headcount. While we have experienced significant increases in our workload in recent years we plan to continue to focus

on achieving operational efficiency. However, further increases in our workload are expected as we assume new regulatory functions and other additional responsibilities in the future and this may require headcount increases in future years.

The team

The past year saw changes in our Executive Director management team. Mr Alan Linning, head of Enforcement, and Mr Peter Au-Yang, Chief Operating Officer (COO) and head of Corporate Finance, returned to the private sector in mid-2006. I would like to thank them for their valuable contributions. The Government subsequently appointed Mr Mark Steward as head of Enforcement and Mr Paul Kennedy as COO. They bring to the SFC rich experience in public sector enforcement in Australia and private sector management in Hong Kong and Mainland China. I was also delighted when Mr Brian Ho and Mr Keith Lui, both having many years of SFC service, were appointed Executive Directors to lead the Corporate Finance and Supervision of Markets divisions respectively. We now have a full complement of Executive Directors and I look forward to working with them on the challenges we face.

Much of the work done by our staff may not be immediately apparent to the public. Typically in an active market, like last year, we have to watch trading activities very closely, we have to review more listing and investment product applications as well as licence applications, and we have to ensure the market infrastructure can cope with high volumes and volatility. Meanwhile, we have to constantly remind investors to assess the risks of investments and communicate to the public and the market any regulatory developments. To all my colleagues I offer my sincere thanks for their commitment and hard work during this very busy year.



Martin Wheatley
Chief Executive Officer