



# development

A female gymnast will have to be helped onto the asymmetrical bars either by someone or by stepping onto a springboard to begin her routine.



• providing the right support

• understanding market dynamics

• enhancing viability

• preparing for growth



In addition to maintaining market order, we are aware of the importance of helping the securities and futures markets develop. We believe that to maintain and enhance Hong Kong's position as an international financial centre, we need to provide an effective regulatory framework with appropriate rules and guidelines that accommodate changing conditions and that help keep the city competitive internationally.

Last year, we continued to work with our Mainland counterparts and other regulatory and government bodies to strengthen the framework for complementary expansion of the securities and futures markets in Hong Kong and on the Mainland, took steps to streamline regulatory requirements and reduce certain compliance costs, sought opportunities to broaden and deepen our markets and continued our work in the international arena to contribute to policy initiatives and stay abreast of developments in other markets.

## Strengthening ties with the Mainland

During the year, we maintained our close dialogue with Mainland authorities and financial institutions.

In May 2009, we provided support to the Government in concluding Supplementary Agreement VI to the Closer Economic Partnership Agreement (CEPA VI) and worked jointly with Mainland authorities to facilitate the implementation of the CEPA VI measures. CEPA VI focused on liberalisation of economic ties between Hong Kong and the Mainland. Both parties agreed to explore introducing to Mainland markets exchange-traded funds (ETFs) linked to Hong Kong-listed stocks. The terms of the supplementary agreement also laid the groundwork for eligible securities companies from Hong Kong and the Mainland to set up joint venture securities investment advisory companies in Guangdong. Subsequently, in January 2010, the China Securities Regulatory Commission (CSRC) released a set of guidelines for parties seeking to enter into these types of joint ventures under CEPA VI.

In early 2010, under the auspices of the Government, a new round of discussions commenced with Mainland authorities on Supplementary Agreement VII to CEPA.

We attended the 40<sup>th</sup> meeting of the Memorandum of Regulatory Co-operation (MORC meeting), hosted by the Shanghai Stock Exchange in Xinjiang in June 2009 and then hosted the 41<sup>st</sup> MORC meeting ourselves in Hong Kong in March 2010. At these meetings, we exchanged views with representatives from the CSRC and the stock exchanges of Shanghai, Shenzhen and Hong Kong on the latest initiatives in Mainland and Hong Kong financial markets, and discussed cross-border regulatory co-operation.

We attended regular meetings with senior representatives of Mainland government agencies and regulatory authorities, including the Ministry of Commerce, the People's Bank of China, the Hong Kong and Macao Affairs Office of the State Council, the CSRC, the China Banking Regulatory Commission, the China Insurance Regulatory Commission and the State Administration of Foreign Exchange. Our staff attended training sessions provided by the China National School of Administration in July 2009 and by Tsinghua University in October 2009 to enhance our understanding of Mainland political and economic issues.

We paid visits to Mainland authorities to share our experience in various areas, such as overseeing listings, regulation of retail funds and supervision of securities intermediaries.

We also provided support to the Government in expanding cross-border financial co-operation with Mainland cities through agreements, forums and other measures including:

- the Co-operation Agreement of the Expert Group on Hong Kong/Guangdong Financial Co-operation signed in August 2009;
- the Letter of Intent in Taking Forward Co-operation on Modern Service Industries, concluded between Hong Kong and Shenzhen in August 2009;



- the Memorandum of Understanding Concerning Advancing Hong Kong-Shanghai Financial Co-operation, concluded in January 2010;
- attending the first Hong Kong/Guangdong Financial Expert Group meeting in November 2009 after the group was formed in August 2009, during which we provided our input to the Government with respect to the Framework Agreement on Hong Kong-Guangdong Cooperation and financial policies in Qianhai; and
- joining a financial services delegation led by the Government in August 2009 to meet the Shanghai Municipal Government and regulatory authorities to explore co-operation opportunities. In this regard, we also met with the vice mayor of Shanghai and with Shanghai regulatory authorities in March 2010 to exchange market updates and discuss avenues for collaboration and mutual assistance in the development of the securities and futures markets.

## Enhancing process efficiency

We continued to devote considerable efforts to streamlining regulatory requirements and removing dispensable constraints or obligations.

To make our licensing procedures more user-friendly and to enhance our communication with intermediaries, we are going on line. We successfully launched the first phase of the SFC Online Portal in September 2009 to enable intermediaries to submit their annual returns and notifications electronically. Using the portal, intermediaries may also view their profile information and receive messages from the SFC on line.

To encourage licensees and registrants to use the system, we conducted introduction and demonstration sessions for potential users and will do so on an ongoing basis to promote portal usage.

The system has been well-received by intermediaries. As at 31 March 2010, over 90% of licensed corporations and registered institutions, and over 70% of licensed individuals, have activated their portal accounts. In addition, around 10,000 annual returns and 6,000 licensing-related notifications previously filed in paper form were received online in the first six months after the portal's launch. The launch of the second phase in April 2010 enabled licensees to generate invoices electronically and make annual fee payments online in addition to the conventional means.

We approved amendments to the Listing Rules proposed by The Stock Exchange of Hong Kong Ltd (SEHK) to improve efficiency. The measures aimed to:

- Shorten the minimum notice period and the minimum subscription period for book closure for a rights issue to give listed companies quicker access to the funds raised and to lower market risks;
- Streamline the listing process by simplifying the filing procedures and checklist requirements for the listing of equity securities and waiving the requirement for listing applicants to file certain documents, such as, an expert's certification to issue a prospectus; and
- Amend the notifiable transaction rules to remove the requirement for listed companies to obtain prior shareholder approval in order to build fixed assets, such as plant or machinery, in the usual course of business.

In May 2009, we also approved rule amendments proposed by Hong Kong Exchanges and Clearing Ltd (HKEx) that streamlined the process for Exchange Participants to notify the exchanges of changes to company names, changes in directors and/or responsible officers and changes of principal and branch addresses, etc.



41st Memorandum of Regulatory Co-operation meeting



China Financial Markets Conference



FIX Conference

## Promoting development of markets and products

We continued to pursue opportunities for our markets and wider choices for investors.

### Exchange-traded funds

We authorised 37 ETFs during the year, raising the total number of SFC-authorized ETFs to 61 as at 31 March 2010. The market capitalisation of these ETFs (excluding the gold ETF) totalled US\$23.5 billion as at 31 March 2010, up 69% from the year-ago level of US\$13.9 billion. The average daily turnover for Hong Kong-listed ETFs in the year ended 31 March 2010 amounted to US\$264 million, reaffirming Hong Kong's position as the second largest ETF market in Asia in terms of both market capitalisation and turnover.

We authorised the first series of China A-share sector ETFs, the first ETF managed by a Hong Kong subsidiary of a Mainland financial institution and the first Hong Kong equity value-based ETF managed by a Hong Kong-based fund manager. China A-shares remained the most popular investments among Hong Kong ETF investors. As at 31 March 2010, 20 ETFs in Hong Kong tracked the performance of A-share indices and their average daily turnover amounted to about 70% of the local ETF turnover.

During the year, we worked towards developing Hong Kong's ETF market on several fronts:

- In May 2009, we signed a side letter to our bilateral memorandum of understanding (MOU) with the Taiwan Financial Supervisory Commission (FSC) to facilitate the cross-listing of ETFs in the two markets. Thereafter, three Hong Kong ETFs were listed on the Taiwan Stock Exchange and one Taiwan ETF was listed on SEHK in August 2009. One of the Hong Kong ETFs listed on the Taiwan Stock Exchange raised more than \$1.64 billion in its public offering. It was ranked the third largest ETF in Taiwan by market capitalisation and had the second highest turnover as of the end of March 2010.
- We reviewed and approved trading arrangements for 37 new ETFs and provided comments to the Stamp Office for stamp duty relief applications made by several ETFs.
- To reduce trading costs for regional ETFs, we worked closely with the Government and HKEx on extending a stamp duty concession to ETFs that track indices in which Hong Kong stocks comprise 40% or less of the constituent securities. This new stamp duty concession, effective since February 2010, may help attract the listing of regional ETFs in Hong Kong.



China Financial Markets Conference



Signing ceremony of MOU between the SFC and State Securities Commission of Vietnam

## Other retail investment products

Our efforts on other fronts to expand the range of investment products and increase competitiveness included the following:

- We authorised 244 collective investment schemes during the year, bringing the total number of authorised collective investment schemes to 2,596 as at 31 March 2010.
- We signed a Declaration of Mutual Cooperation on Development of Islamic Capital Market and Islamic Collective Investment Schemes with the Securities Commission Malaysia (MSC) in November 2009. The declaration provides the framework for the SFC's and the MSC's mutual recognition of Islamic collective investment schemes offered to the public.
- We authorised the issue of 24 offering documents and advertisements for unlisted structured products offered to the public during the year. Issuers have generally been co-operative in providing documents with enhanced upfront disclosure of risks in relation to structured products in light of recent market events and the proposals in our public consultation in this area.
- We authorised the first real estate investment trust (REIT) with units listed on the Singapore Exchange Securities Trading Ltd to seek a dual primary listing by way of introduction on SEHK. The market capitalisation of all SFC-authorized REITs stood at US\$9.9 billion at 31 March 2010, representing a year-on-year increase of 52%.
- We approved HKEx's proposal to introduce flexible options contracts on the Hang Seng Index and Hang Seng China Enterprises Index. Launched in February 2010, flexible options contracts allow investors to choose strike levels and expiry months that are different from the standard contracts. This

facilitates market participants moving some of their over-the-counter (OTC) trades to the exchange trading platform and thereby enhances the trading transparency.

During the year we authorised three providers of automated trading services, including some internal crossing platforms operated by brokerages, which are a type of dark pool. We studied the development of dark pools in Hong Kong and communicated with providers about operational and structural considerations for these types of services under the existing regulatory framework. In addition, we visited a number of dark pool service providers in Hong Kong to review their current operations, discuss their plans for future development and assess the potential impact on traditional forms of trading. We continue to monitor global developments in this area and will review our regulations as appropriate.

To improve market efficiency, a working group, chaired by the SFC and including representatives from HKEx and the Federation of Share Registrars Ltd, was set up to develop an operational model for implementing a scripless securities market. A three-month joint public consultation was launched last December to invite views on a proposed scripless model. The proposed model would enable investors to hold and transfer securities electronically in their own names.

We also worked with the Government on an initial set of related legislative amendments to remove existing obstacles to implementing the scripless initiative, such as the current provisions compelling the use of paper documents of title and paper instruments of transfer. The amendments were incorporated into the Companies (Amendment) Bill 2010 tabled before the Executive Council and Legislative Council in the first quarter of 2010.

## Licensing of intermediaries

To promote a healthy market, we encourage and facilitate the licensing of intermediaries from Hong Kong and overseas. For the full year, we processed 6,403 licence applications, down 17% from the previous financial year due to the decreased number of individual applications. The total number of SFC licensees decreased by 2% to 36,581.

We continued to see growth in the hedge fund industry this year. The number of licensed hedge fund managers/advisers increased by about 20% from the year before and the growth rate of licensed individuals accredited to these firms was close to 25%. We leveraged the streamlined initiatives introduced in June 2007, and the average processing time over the year was approximately eight weeks, with well-prepared applications able to be approved in principle within six to eight weeks, similar to the situation in the preceding two years.

The one-off annual licence fee waiver for some 37,000 intermediaries came into effect on 1 April 2009. This initiative helped reduce their regulatory cost burden.

## Working with overseas counterparts

We actively participated in a number of task forces and international forums of the International Organization of Securities Commissions (IOSCO), each focusing on specific topics with a particular set of objectives. These task forces included:

- the Task Force on Unregulated Financial Markets and Products, which published its recommendations directed at improving confidence and transparency in the OTC markets, with a particular focus on securitised products and credit default swaps;
- the Task Force on Commodity Futures Markets, which reconvened to address the Group of Twenty's directives on enhancing the transparency and regulation of the energy and energy derivatives markets; and

- the OTC Derivatives Regulators' Forum that provides regulators, central banks and authorities with a means to co-operate, exchange views and share information relating to OTC derivatives, central counterparties for OTC derivatives and other regulatory issues.

In February 2010, delegates from 16 jurisdictions attended a meeting of the IOSCO Standing Committee on Regulation of Secondary Markets, which we hosted in Hong Kong to exchange ideas on various regulatory issues and the development of secondary markets.

We also worked with securities regulators and central banks in major markets to strengthen standards for financial market infrastructures, such as payment systems, securities settlement systems and central counterparties, which are critical to financial stability. During the year, we participated in several discussions organised by the working group jointly established by the Committee on Payment and Settlement Systems (CPSS) and the IOSCO. The working group will continue to set the standards this year. Separately, in light of the additional risks associated with the increasing use of central clearing for OTC derivatives, we also took part in another working group jointly established by CPSS-IOSCO to review recommendations for central counterparties.

We concluded certain agreements with regulators overseas to foster co-operation. In April 2009, we signed an MOU with the State Securities Commission of Vietnam to facilitate mutual assistance and the exchange of information between us.

After signing the May 2009 side letter to our bilateral MOU with the Taiwan FSC, we held our first meeting with the FSC in November 2009 to conduct an in-depth exchange on a wide range of securities regulatory issues. This was followed, in December, by a two-week programme during which FSC representatives were seconded to the SFC to learn about Hong Kong's securities regulatory framework.



## Communicating with market participants

We maintain a constructive and effective dialogue with industry participants to understand their needs and considerations and to clearly articulate regulatory requirements.

Besides our annual and quarterly reports, we compile and issue periodical publications. The Enforcement Reporter discusses the SFC's enforcement work and highlights current enforcement issues. With articles and Practice Notes, the Takeovers Bulletin provides intermediaries with informal guidance as to how the Executive normally interprets and applies certain provisions of the Codes on Takeovers and Mergers and Share Repurchases. The Dual Filing Update regularly updates market participants on areas of concern in listing applications, including insufficient due diligence by sponsors and non-disclosure of instances of regulatory breach. We also provide weekly reports on short selling. We welcome reader feedback on all of our publications to ensure that they provide useful information.

In July 2009, we released the Fund Management Activities Survey for 2008. This annual survey covers fund management activities of licensed corporations, registered institutions and insurance companies in Hong Kong. Faced with the sharp decline in global financial markets in 2008, the asset management industry experienced one of the most difficult years in decades. The combined fund management business in Hong Kong (aggregate assets under management, excluding real estate investment trusts) dropped 39.3% year on year to \$5,850 billion at the end of 2008. However, the integrity and reliability of Hong Kong's financial system have remained intact. Hong Kong has maintained its international status as 64.2% of such combined fund management business were sourced from non-Hong Kong investors.

In September 2009, our Report on the Survey of Hedge Fund Activities of SFC-licensed Managers/Advisors gave an updated account of hedge fund activities conducted by SFC-licensed hedge fund managers. According to the survey, as of 31 March 2009, Hong Kong had 209 SFC-licensed hedge fund managers managing or advising 542 hedge funds with aggregate assets of US\$55 billion, six times the amount in 2004.

In our latest "Review of the Hong Kong Securities Industry", published in March 2010, we gave an overview of the aggregate financial position of all licensed securities dealers and securities margin financiers, including those that are not SEHK participants. We also analysed the financial performance of securities dealers in 2009 by the jurisdictions in which their controlling shareholders were based.

To better articulate our views on issues relating to licensing obligations, we clarified, by way of circulars and frequently-asked-questions, that the promotion, offering and sale of investment-linked assurance schemes and the performing of back-office functions do not give rise to a requirement to be licensed under the Securities and Futures Ordinance. We also urged inter-dealer brokers to review their business models to ensure that they comply with our licensing requirements where appropriate.

We met with senior compliance executives of various financial service groups to exchange views on a number of regulatory issues, including cross-border licensing, inter-dealer brokers or go-betweens in respect of financial products, suitability obligations and the licensing-related functions of the newly-launched SFC Online Portal. The views obtained were constructive in enhancing co-operation on regulatory matters within the financial industry.

In response to increasing interest on the part of Mainland intermediaries in setting up operations in Hong Kong, we organised a seminar for Mainland-related futures companies to help them better understand our regulatory regime and the applicable compliance obligations.

To better understand the needs of our key stakeholders and their expectations of the SFC, we commissioned a leading market research consultancy to conduct a survey during the year. A random sample of personnel in licensed corporations, industry-related professional firms and listed companies were invited to rate their satisfaction with the SFC's efficiency, staff quality and clarity of communication based on their main working relationships. We are encouraged to note that 76% of the 586 respondents expressed overall satisfaction. The valuable feedback received will enable us to review our policies and procedures and prioritise allocation of resources to fine-tune our work.