

Speech at the Estate Agents Authority

“The Role of the SFC as a Market Regulator”

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Vice-chairman Mrs Liu, Chief Executive Officer Ms Sandy Chan and fellow members, good morning,

1. I would like to start by thanking the EAA for inviting me to speak today. Soon after I had been appointed as Chairman of the SFC, your CEO, Ms Sandy Chan, invited me to lunch. Sandy and I have known each other since the 90s when we were both involved in the work of the Housing Authority. I was a member of the HA and its Finance Committee, and Sandy was a representative of the former Housing Bureau. During our lunch, Sandy invited me to be a guest speaker of the EAA’s Continuing Professional Development Scheme, which I readily accepted. But this has again proved that there is no free lunch in this world.
2. My topic today is “The Role of the SFC as a Market Regulator”. The SFC and the EAA regulate different sectors. The EAA is responsible for regulating real estate agents while the SFC is the regulator of the securities and futures markets. However, the regulatory objectives of

both agencies have a lot in common, such as to maintain market integrity and to safeguard the interests of investors or consumers, as the case may be. Besides, both the property and financial sectors are important economic activities in Hong Kong. Hence, today I would like to compare the similarities between the two regulators.

(I) Importance of the property sector

3. (Slide 1) As at the end of March, property counters and financial counters accounted for 11% and 36% of the total market capitalisation of the Hong Kong stock market respectively. If companies with major operations in the Mainland were excluded, the weightings would have become 19% and 34% respectively, which when combined would exceed half of the market capitalisation. From this, we can see the importance of the property and financial sectors.
4. First, let's take a look at the role of the property industry in Hong Kong's economy. As you know, it played a very important part in the early 80s when the Hong Kong economy was booming.
5. It is interesting to note that most of the Hongkongers who are on Forbes' annual list of World's Richest People are property tycoons. The property market was at its peak before the 1997 handover when Hong Kong people had made their fortune through the purchase of properties. The continuous appreciation in the value of their properties made the accumulation of wealth and preservation of asset value possible.
6. In those days when the property market was in a bull run, many potential buyers queued up for days for first hand residential properties even though there was little promotion. At the same time, estate agencies were busy handling transactions in the secondary market which was also extremely prosperous.
7. As the property market became steadier following the Asian financial crisis, developers put more efforts on promotion. Apart from

advertisements and publicity campaigns, developers offered lucrative commissions to encourage estate agents to promote the sale of new flats.

8. The role of agents therefore became more important. Buyers and sellers in the primary or secondary market, or those who want to let or lease a flat, all need an agent to match them with the right property. Agency services are required in transactions of all kinds of properties.
9. Owning a property is the dream of many Hong Kong people who would work hard to save up for a property, which for many is the most important investment in their lifetime. Figures from the Census and Statistics Department as at the middle of last year showed that the median mortgage payment was \$9,500, or 30% of the average monthly household income in Hong Kong. Elsewhere, nearly 80% of respondents in Hong Kong to a survey on high-income groups in Asia said that property investments had made them rich. It can clearly be seen that you are very important to the families and indeed investors in Hong Kong!
10. Hence, the standard of agents is particularly important. The EAA is charged with the key responsibility of regulating individuals and firms engaging in the business of estate agency, ensuring their standard and safeguarding the interest of the public.

Increasing importance of the financial services industry

11. Now we would take a look at the role of the financial industry in Hong Kong's economy. In 2005, the financial services industry (including securities, futures and forex brokers, fund management and investment and holding companies etc.) accounted for 3.4% of the GDP, compared with the 1.4% in 1996. The financial services industry is becoming increasingly vital to the Hong Kong economy.
12. The financial services market in Hong Kong is made up of a number of

different sectors including banking, insurance, and securities and futures industries, together with those providing services to these principal sectors. The regulation of the financial services sector is shared by several regulators: the SFC regulates the securities and futures markets; the Hong Kong Monetary Authority regulates the banking industry; and the Office of the Commission of Insurance regulates the insurance sector.

13. (Slide 2) Unlike the EAA, the SFC regulates a wide scope of activities, which fall into three main groups: first, intermediaries such as brokers, investment advisers and investment bankers, who must conduct their business in compliance with the conduct and financial resources requirements; second, issuers of securities, including listed companies and investment funds, which are required to comply with certain disclosure and other regulations in order to be able to sell securities to the investing public; third, market operators directly overseen by the SFC, such as Hong Kong Exchanges and Clearing (HKEx).
14. The remainder of my talk is divided into two parts. In the first part, I would make some general comparisons between the regulation of intermediaries by the SFC with the regulation of estate agents by the EAA. In the second part, I would briefly introduce the three principal areas of the work of the SFC.
15. As I said before, the SFC has a wider scope of regulation. Today, I would only limit the discussion to the regulation of intermediaries.

(II) The SFC and the EAA

Background

16. Both the SFC and EAA are statutory bodies established by law.
17. (Slide 3) The EAA was set up in 1997 under the Estate Agents Ordinance. The SFC was set up in 1989 under the Securities and Futures Commission Ordinance, or the SFCO. The SFCO and nine other

securities and futures related ordinances were consolidated into the Securities and Futures Ordinance, which came into operation on 1 April 2003.

18. Both regulatory bodies were set up in response to the specific market conditions at the time. The EAA was set up amid growing concern about the practice of some estate agents. The government intended to enhance the standard of the industry and protect consumer interest by establishing the EAA.
19. The SFC was established as a result of the stock market crash in 1987, which had not only led to the closure of the exchange for four days, but also exposed the deficiencies of the then regulatory framework. After the stock market crash, a six-member Securities Review Committee, chaired by Mr Ian Hay Davison, was formed to examine Hong Kong's regulatory structure and regime and how they could be improved, in order to avoid a repeat of the disruptions and chaos of October 1987. The Committee recommended that the structure be replaced with a single statutory body outside the civil service – namely the formation of the SFC.
20. While the SFC is accountable to the Government for the performance of its functions, it is an independent securities market regulator – it operates outside of the civil service. Funding is derived directly from levies on stock market transactions or fees charged to market participants. The SFC has made no claim for government funding for over 10 years.
21. I would now display some charts to show the similarities and differences between the EAA and SFC in the regulation of intermediaries.

Regulatory functions

22. (Slide 4) The principal functions of the EAA are to regulate the practice

of estate agency, promote their competence and facilitate training for them. The primary purpose of the SFC is to maintain and promote fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry. Its statutory objectives are set out in the SFO. Its intermediaries-related functions include formulating licensing criteria; approving licence applications; monitoring the financial integrity of licensed persons and their compliance with all the relevant regulations; as well as investigation, discipline and prosecution of intermediaries for misconduct.

Fit and proper

23. One needs to be fit and proper in order to be licensed by the SFC or the EAA. What is meant by being fit and proper?

24. (Slide 5) Although the specific requirements for fitness and properness are different, both the SFC and the EAA expect licence applicants to be of good character, honest and reliable.

25. SFC licence applicants have to pass an examination before getting the licences. It is to ensure that their knowledge and skills have attained the basic level.

Categories of licences

26. (Slide 6) There are three categories of licences issued by the EAA, including salesperson's licence, estate agent's licence (individual) and estate agent's licence (company). The SFC also has a similar licensing regime, with licences for corporations and individuals. For individuals, we have separate licences for responsible officers and representatives. We also classify business activities requiring a licence into nine types of regulated activities. Relevant approval is needed for engaging in different regulated activities. For example, a company dealing in securities and futures has to be licensed for types 1 and 2 regulated activities.

Unlicensed dealing/practice

27. Like the law governing the estate agents, carrying out regulated activities without a licence is also prohibited by the SFC. Penalties under the SFO are heavier – upon summary conviction a person is liable to a maximum fine of \$500,000 and imprisonment for 2 years.

Code of conduct/ethics

28. (Slide 7) Like the EAA, the SFC also has its code of conduct, which intermediaries have to comply with in addition to the law. There are many similarities between the two. For example, SFC licensed intermediaries are required to act fairly and diligently and to avoid conflict of interests.
29. The SFC also assists the industry in complying with and understanding our policies and regulations by issuing guidance notes and circulars. As both the financial and property markets are constantly changing, the issuance of codes and guidelines enables us to regulate flexibly and to respond quickly to market developments. As investment products are becoming increasingly sophisticated, apart from the regulators who need to keep to date with regulatory know-how, intermediaries should also equip themselves with the latest industry knowledge. Hence, both estate agents and financial intermediaries are expected to undergo continuous training in order to enhance their professionalism.

Disciplinary sanctions

30. (Slide 8) People who breach our regulatory requirements face disciplinary actions or even prosecution. There is a wide range of sanctions that we may impose, including reprimands and fines (the SFC may fine up to \$10 million, compared with EAA's \$300,000). The SFC is also empowered to suspend or revoke the licence of a person and prohibit intermediaries who have committed breaches from re-applying for a licence.
31. By now you may agree that there are many similarities between the SFC and the EAA. Both agencies set out to maintain market order and safeguard the interests of investors or consumers. But as a regulator we have one more thing in common – we are often doing a thankless job when performing our duties. I would now explain why.

A compliant industry

32. To maintain market integrity, an appropriate level of regulation is necessary as this enhances public confidence, which will in turn benefit the industry as a whole.
33. Both the SFC and EAA play the role of a regulator. The following analysis will illustrate who among those regulated by the SFC react most strongly to our regulation?
34. (Slide 9) The layers within this triangle represent different kinds of licensed persons. Those at the bottom tier are the compliant majority. Those in the middle tier are what we call the "opportunists". Those at the top are the non-compliant market practitioners.
35. Our experience shows that most of the market practitioners are compliant with the laws and regulations. For this group, the SFC's role is to help and guide them on compliance.

36. People belonging to the middle tier are opportunists. They would take advantage of any regulatory loopholes or grey areas for their own benefit. To deal with these people, we need apply both the carrot and the stick. On the one hand, we need to provide them with incentives to comply with the laws and regulations. On the other hand, we need to ensure that the regulations have sufficient deterrence and that practitioners fully understand the serious consequences of breaching them.
37. I believe the non-compliant practitioners account for only a small minority in both the financial and property sectors. The SFC is committed to cracking down on them, and considerable resources have to be employed although they are only a minority. It should be understood that even the best regulations cannot totally prevent breaches.
38. Although the non-compliant top tier only accounts for a small part of the industry, they are often vocal in opposing regulations and might complain that they were victims who had been unfairly treated. It is therefore important that we continuously communicate with the public and the media to promote their understanding of our work, or any misunderstanding could affect SFC's credibility as a regulator and Hong Kong's reputation as an IFC. We would of course not overlook the need to communicate with the industry in order to understand their needs.

(III) The SFC's regulatory philosophy

39. I would now explain the three principal areas of the work of the SFC.
40. (Slide 10) Today's talk coincides with the publication of the SFC Annual Report 2006-07. The theme of the annual report is "Investors First" – that we would first consider the interest of investors when performing our functions. Below the heading are the three principal areas of work of the SFC: Regulate, Facilitate & Educate. I would now explain these three areas and give you a brief account of our achievements over the

past year.

Regulation

41. (Slide 11) In carrying out our regulatory responsibilities, we adopt a philosophy of considering the interest of investors first. In establishing and maintaining the regulatory environment we aim to achieve an appropriate balance between facilitating the efficient functioning and continuing development of the securities and futures markets and at the same time providing adequate, but not absolute, protection to investors. In considering what regulations to put in place we also pay close attention to the rules and regulations in other international financial centres to ensure that our regulatory environment is of a similar standard.
42. In enforcing regulations it is not our aim to identify and prosecute all minor breaches but rather to encourage compliance and good business ethics through the selective sanctioning of malpractices and enforcement action. However, in the most serious cases of abuse or fraud we seek to remove participants from the industry in order to maintain overall market standards and to protect investors.
43. While we rigorously pursue those who defraud investors we have no legal powers to order an intermediary to pay compensation. However, a separate investor compensation fund exists to compensate investors in cases of broker default and we work closely with this fund to facilitate the processing of relevant claims.
44. We continue to adopt a risk-based approach to the supervision of intermediaries and to encourage licensed corporations to maintain and raise their own standards. One of our key supervisory tools is on-site inspections: routine inspections are conducted to assess the general compliance of a firm; theme inspections are held on selected samples of firms with similar activities (e.g. investment advisers); and special inspections are targeted at specific firms considered to pose serious or immediate risks to their clients or the market. These inspections also

help us identify trends of market development and gaps for policy consideration.

45. During the inspections of brokers last year, we uncovered three cases of misappropriation of client assets. In all three cases, we took prompt and decisive action to prohibit those brokers from carrying on business and handling client assets and their own properties. We secured the appointment of administrators by the Court to take control of the firms and worked closely with the administrators to enable the efficient and orderly return of client assets. We also referred these cases to the Police for further investigation.
46. Mis-selling continues to be a problem in the industry. Last year, we concluded our largest case to date involving an investment adviser over allegations of mis-selling of funds and concerns about the sale of geared products. The investment adviser had decided to cease its activities in Hong Kong, limiting the regulatory options that were available to us. Nevertheless, we successfully negotiated a settlement with the firm which agreed to make record ex-gratia payments, funded by its holding company, to thousands of affected investors.

Facilitation

47. (Slide 12) While we are conscious of our primary role as a market regulator we also recognise our important role in facilitating market development. To better understand market needs, we conducted opinion surveys on our stakeholders. The 2006-07 survey found that they regarded the SFC as Asia's best securities regulator and believed that the SFC's programmes had a positive impact on the securities and futures markets in Hong Kong. They generally wanted the SFC to:
 - ensure the quality of listings, particularly those from the Mainland;
 - support Hong Kong's competitiveness in a global market;
 - to be more proactive in developing Hong Kong as a major financial

centre and be less conservative in our approach to the introduction of new products;

- exercise our powers to take on large enforcement cases ; and
- internally, address the high turnover of middle level staff, enhance the speed of response and reduce unnecessary documentation.

48. Whilst we are pleased with the results of the survey we also acknowledge the areas where more needs to be done. In particular, it seems that most of the submissions received wanted us to put more efforts on facilitation.

49. We recognise the importance of effective regulation to the success of the financial markets and our role in supporting Hong Kong's continued development as an international financial centre. In the execution of our regulatory functions and in considering market developments and regulatory changes, we therefore aim to achieve a balance between innovation and appropriate levels of investor protection.

50. In considering the authorisation of new products, and especially structured products, we consider the interest of investors first. However, we also recognise that the provision of additional products can be to the advantage of investors and that it is not our role to create a risk free market. Before innovative investment products are authorised for sale to retail investors, their managers and distributors must make proper disclosure and have in place sound management and controls.

Education

51. (Slide 13) Because well-informed and financially literate investors are the first line of defence against fraud and malpractice, we conduct a variety of activities to advise the public of both their rights and responsibilities as investors in the securities and futures markets. We

educate investors to allow them to make informed choices especially in the area of new products, structured products or areas where potential abuses may occur. We also remind investors of their own responsibility for their investment decisions. In particular they should consider carefully how much risk they can manage and to select investments, from the choices available, that are most suitable for their own risk profile.

52. Communication with investors is carried out through in a variety of channels including:

- our investor website (www.InvestEd.hk);
- television and radio docudramas;
- presentations to different sectors of the community, newspaper articles and our own Dr Wise education column; and
- collaboration with universities to educate the younger generation regarding responsible investment.

53. With support from other financial regulators, we are proposing to form a new investor education body so that more resources can be devoted to effective investor education.

54. I invite you to visit our investor website (www.InvestEd.hk). I know that the EAA also has a similar website for providing information to consumers, which I find to be very useful.

Conclusion

55. Finally, I hope that the SFC and EAA can discharge their responsibilities by maintaining the standards in their respective markets so as to enhance the reputation of Hong Kong as an IFC. Finding the right balance between investor protection and facilitation of market development is possibly the biggest challenge for the SFC over the next few years. The SFC will work closely with the Government and our

stakeholders in the financial community to ensure that we achieve this goal.

Thank you!