

HKIFA Luncheon Keynote Speech

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China's Capital Market Development – Positioning Hong Kong at the Dawn of a New Era

Opening

Good afternoon to you all. First, let me thank Gerry, Chairman of IFA, for this valuable opportunity to join you in this luncheon. This marks my first public speaking engagement since my recent appointment on 1 March 2008 as the Executive Director of Policy, China and Investment Products and the Deputy CEO of the SFC.

I am hoping to use this opportunity to share with you my recent experience and some of my views on the latest development of the Mainland Chinese financial market. It is my belief that the Mainland market is poised to enter a new era and the imperative for us now is to find our role in this new era.

As you might have read in the newspapers last week, the China Insurance Regulatory Commission signed, for the first time, a regulatory co-operation agreement with the SFC to enable the use of Mainland Insurance Funds outside the Mainland. We are honoured that they chose us as their first partner. As a result, Hong Kong is the first destination for Mainland insurance funds wishing to invest overseas. You will recall that a year ago, the China Banking Regulatory Commission also chose us as their first partner when they moved to open up the space for Mainland banks to manage their clients' wealth overseas. To date, the SFC has signed regulatory co-operation agreements with 3 key financial regulators of the Mainland namely, CSRC, CBRC and CIRC.

Through these agreements, we have laid the groundwork for Mainland funds and their investment managers, advisers and financial intermediaries to take full advantage of what the Hong Kong market has to offer. And as you know, many of them have started doing so. Many more will be starting soon.

I am sure the veteran fund managers among the audience here could not have imagined such milestone developments to have taken place so quickly. I still recall how many of you here clamoured for a fund passport into the Mainland as recently as the first few years into the Millennium. Today, you have the passport. The Mainland market has seen swift and fundamental changes in the last 10 years, moving from a fledging size of 1.75 trillion yuan in 1997 to 32.71 trillion yuan in 2007, just as Mainland GDP tripled (from 7.48 trillion yuan in 1997 to 24.67 trillion yuan in 2007) during the same period. We are privileged that the Mainland Government has picked us as their financial market partner in this momentous journey of growth.

There lies ahead much bigger growth opportunities in the Mainland financial market. The Chinese economy is poised to overtake Germany's to become the No 3 economy in the world. To fund their growth, Mainland companies will increasingly turn to the capital markets. In parallel, the Mainland is fast growing from a net importer to a net exporter of liquidity. But dark clouds are gathering. The global environment is no longer as benign as in previous years. Equally, within the Mainland itself, the market faces colossal challenges today – explosive growth of liquidity as against a scarcity of investment choices and products thus pushing asset bubbles, financial intermediaries having to quickly learn the skills of risk and financial management in the global markets, and the daunting task of educating the Mainland's tens of millions of retail investors whose financial market literacy is a necessary ingredient for stable growth and maturity of the Mainland's market.

In Hong Kong, we are used to asking questions like “What can the Mainland do for me?” At this time as the Mainland looks for quick yet longer term solutions to their issues, the question we need to ask today should be “What solutions can I offer the Mainland?” That should be our ultimate end game, as the one who provides the solutions is the one who will be invited to stay for the party.

I would like to offer three key terms to explain my vision for the solutions that we can offer:

- Integration
- Engagement
- Education

Integration

Integration between Hong Kong and Mainland markets

Over the past 15 years, we have seen a gradual integration between the Hong Kong and Mainland markets. Since the listing of the first Mainland company in the Hong Kong stock market in 1993, Hong Kong has become the capital raising centre for Mainland companies.

As at the end of February 2008, 439 Mainland companies (including H shares, red chips and other non-H share Mainland private enterprises) were listed on the Hong Kong Stock Exchange. The market capitalisation of these Mainland companies equals 58% of the total market capitalisation of the Hong Kong Stock Exchange, and their turnover accounts for 69.8% of the total turnover of the Hong Kong Stock Exchange¹.

In recent years, this integration has been gaining enormous momentum. We have seen Mainland companies list A and H shares simultaneously. For all practical purposes disclosure requirements in the two markets for companies that issue both A and H shares have been aligned. We have built very effective cooperation platforms between us and the CSRC with respect to the regulation of these companies.

Apart from listed companies, we also see Mainland intermediaries such as banks, insurance companies and securities and futures broker dealers establish operations here, competing alongside their international and local Hong Kong peers. Very soon, Mainland asset

¹ Source: Hong Kong Stock Exchange Monthly Market Highlights – February 2008

managers will be joining this crowd. As well, they have started investing their money, and their clients', here.

Our two markets are coming together closer by the day, if not out of logical development then definitely out of necessity. To realise its full strategic potential as a developed market within China, Hong Kong must continue to build linkages and integrate further with the Mainland market.

Because we are part of China, we enjoy the trust of the country and its people. And we have demonstrated that we are worthy of this trust. Yes, we are different, and there have been times that our different discipline has made the integration challenging. But it is precisely this difference that has made us a valuable and strategic partner. We are a developed market within the Chinese developing market; in fact, we are a developed offshore market that is really onshore. No other developing market in the world has the luxury of having within its political boundaries an international market which is a strategic ally, and in which it can experiment with new initiatives and imbibe experience and opportunities that international markets and investors can offer. The H-shares, red chips, QDIIs and CEPA arrangements are precisely such experiments, designed to give the Mainland issuers, financial intermediaries, regulators and investors first hand experience operating in an open and international market.

At this time, the Mainland and the Hong Kong markets have built smooth linkages in fund raising and the flow of funds and intermediaries. What we hope to see in the near future is a further integration of systems, platforms, regulations, standards and products that would make the ultimate China market (comprising the Mainland and Hong Kong) a strong competitor on a global level.

I will now turn to examine how Hong Kong could help the Mainland market develop to the next level.

Engagement

The Mainland financial market, in particular its equity market, has come a long way. The Mainland exchanges and the financial services sector have demonstrated their ability, whether in skill, infrastructure or liquidity, to manage mega size IPOs. However, to maintain sustainable and long term growth and maturity, a raft of complementary capabilities needs to be enhanced.

These capabilities include market transparency, proper disclosure, good corporate governance and compliance, proper due diligence on investments proper checks and balances to deter misconduct and abuses, and informed investors who understand their risks and take responsibility for their decisions.

Fiduciary duty

Many of these capabilities are manifestations of the core concept that financial market players have a fiduciary duty. An intermediary has a fiduciary duty to its clients. A listed company director has a fiduciary duty to his shareholders. The duty is to put investors' interest first, and refrain from unfairly benefiting from their proximity to the market or access to price sensitive information. In other words, a fiduciary must avoid conflicts of interest. It is

these conflicts that destroy the fabric of trust in the market. Investors will shun those markets where they do not believe they will be given a fair deal.

While this may sound all too familiar, we should not overlook the fact that the concept of fiduciary duty has been developed on a set of common law principles which has throughout underpinned the structure and operations of our market. The same concept of trust and fiduciary duty is relatively new to the Mainland market, especially given its very young history. Temptations abound in all financial markets. This is why it is important to get concepts of fairness and fiduciary obligations to take root.

Investor behaviour

Another building block for a sustainable and vibrant market is the quality of its investors. Much has been said worldwide about the herd instinct among retail investors. In times of irrational exuberance, investors jump in the market with wild dreams of quick riches. The difficulty is, when these dreams are broken, investors will need to understand, painful as it is, that they made bad investment decisions, and learn from the mistake. In other words, investors must be accountable for their decisions; there is no safety net to catch them from falling down on bad investment decisions. This may be difficult in emerging markets, especially those where investors are used to expecting the authorities to take administrative actions regarding the market, for instance, to keep it from falling. The Mainland market exhibits some of these signs at the moment. It will be a hard lesson for investors. All other developed markets have gone through this phase. If investors do not accept this, it would be hard for their market to grow towards maturity.

Hong Kong as part of the solution

Having put in the building blocks in the last 20 years, the Mainland market has now reached a critical juncture. It is important that they get it right, so that they can move to the next level.

How could we help? The solution would be to offer to help to Mainland companies, intermediaries and regulators to build capabilities similar to those that have supported the Hong Kong market and made it an international success.

Much has been said about the ingredients that make for the success of the Hong Kong market. I would like to put it in simple layman's language. Our success has to do with the values which our market players accept and practise. These values are simple: fair play, proper disclosure, free flow of accurate information, innovation which must not come at the expense of investors' basic rights, and transparent rules firmly, fairly and consistently applied throughout. This maintains investor confidence, the key to sustainable growth in the market.

Mainland companies listed here have been learning best corporate governance standards and practices. As our markets continue to integrate, the values and discipline that have served the Hong Kong market well will take root in the Mainland market. This is already happening.

As Mainland financial intermediaries continue to set up here, they will gain first-hand exposure in a global financial market setting, operate under strict market discipline, and learn international best financial skills. In fact, through their very operations here these entities are forced to compete in the global market, which demands excellent discipline, best practices in conduct and governance and fiduciary obligations. These learning opportunities cannot be

replicated in the Mainland which does not have an open market nor a critical mass of international players operating under strict free market principles.

We have a close partnership with the CSRC, our counterpart in the Mainland. They have a very important job to do. No market can rise to international acclaim without the backing of an effective regulatory framework properly enforced by a professional and committed regulator. The CSRC has done an admirable job navigating the development of the Mainland securities market. We will continue to work closely with the CSRC to share our experience and provide staff secondment and training opportunities. The SFC has a keen interest in helping the CSRC build the capabilities necessary as the Mainland experiments with new market initiatives. Through information and staff exchange, we could develop regulatory policies that would foster a synergistic relationship between Hong Kong and the Mainland.

Furthermore, with the signing of cooperation agreements with other Mainland financial regulators, we are also extending this working relationship with other key regulators in the Mainland financial industry.

Some of you would have attended the high level seminar held in Hong Kong last September for the CSRC and Mainland fund managers and brokers, on HK/Mainland fund management. The seminar was well attended by a 60 people strong delegation led by CSRC. We intend to run more seminars of this kind to foster our partnership with our Mainland regulators and intermediaries.

Our doors are always open. A good number of Mainland fund managers and brokers have come in to discuss their business plans. We will continue these efforts and seek to expand our networking to other sectors like insurance companies that wish to conduct asset management businesses here.

Given Hong Kong's experience, we are in a good position to share our knowledge and expertise with the Mainland market so that together we stand stronger and taller as we weather market uncertainties that lie ahead. In short, we should actively engage with all relevant Mainland players to help them build capabilities.

Education

The quality of a market is a function of the quality of its intermediaries, investors and regulator. Regulation alone would not deliver a quality market unless investors also play an active monitoring role. Investors with a healthy perception of what investments mean for them and the ability to take responsibility for the gains and losses as a result of their investment decisions are key to the development of a robust securities market.

Helping investors develop a sense of financial literacy and awareness is not an easy task. This is true not just of the Mainland and Hong Kong. A few years ago, I was told in a conference with other regulators that in an investor survey that was conducted in the UK, the survey shows that 50% of investors did not know what "50%" meant.

Investor education is not just the obligation of the regulator. Financial intermediaries have a share of this obligation. We are committed to give all appropriate assistance to the CSRC in this area. We recognise that their task is colossal – the sheer numbers involved, their diverse cultural, educational and social background, and the huge geographical spread. There are

restrictions on what we could do. Our law says that our statutory function of educating investors is restricted to investors of the Hong Kong market. But I believe that we could still help in different ways. We will share with the Mainland regulators our experience and knowledge. More importantly, we have started to revamp our existing investor education program and materials to make them user friendly to investors who have a Mainland background. Many of them have the right of abode here. Others are QDII investors. They would help cross fertilize the investor mass in the Mainland.

Closing

The development of the Mainland financial market has been the riveting news of this decade. Hong Kong is very fortunate to have been a primary recipient of the benefits from the opening up of the Mainland market. But we have something valuable to offer in return. As the Mainland market enters the next stage of development, Hong Kong should proactively engage with the Mainland to design and conduct further and deeper Mainland market experiments using the Hong Kong market as incubator. We are the natural partner.

Thank you.