ASIC Summer School 2008
Plenary on China and World Capital Markets
Regulatory Perspective from Hong Kong

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Distinguished guests, ladies and gentlemen.

Introduction

I thank ASIC for inviting me to participate in the 2008 Summer School. I understand that the Summer School has been such a success that it has become a hallmark programme that is attended by regulators from around the world.

I am honoured to speak before such a distinguished gathering of regulators and market participants. I shall present the view from Hong Kong, from the perspective of the SFC, as Mainland China integrates with global capital markets.

The China story is a remarkable one. Its rapid rise in a short space of time to become a leading economic power with a thriving capital market and the largest pool of foreign reserves is unprecedented in history.

It was the bold vision of the late Leader Deng Xiaoping, architect of China's modernisation and reform programme that launched China on this path and pragmatism that paved the transformation of the Chinese economy, as policy makers "crossed the river by feeling the stones". One can fully appreciate the formidable challenges that China had to face if one looks at the sheer magnitude of its transformation. First, China is huge in terms of population and geography. Second, the extent of "hardware" infrastructure development is massive. Third, the "software" development which is the most challenging – developing the professional talent pool and the institutions of a market-oriented economy, of which the capital market is but one.

Hong Kong has been fortunate as it was able to play a supporting and facilitating role as China experimented with capital market reform. To understand the role of the SFC in the success story of Mainland China, we need first to understand the background and developments of China's capital market.

The development of China's capital market

Let me begin by explaining the structure of the stock market in Mainland China. There are two stock exchanges, namely the Shanghai Stock Exchange and the Shenzhen Stock Exchange, which were established in 1990. The shares listed and traded in these two exchanges are predominantly "A shares" ("B shares" constitute only a small part of the traded shares). "A shares" are issued by companies incorporated in China, but they are reserved

exclusively for trading by Mainland residents and, since December 2002, a small number of approved Qualified Foreign Institutional Investors (QFII).

Initially, most of the large listed companies in the Mainland were owned by the State which held on average about two-thirds of the entire shareholding of a listed company. The consequence was a small free float of shares that saw the P/E ratio reaching 60 times in the late 1990s to 2000. In 2001, the Central Government announced plans to improve market structure by selling state-owned shares to the market to increase the pool of tradable shares. The market reaction was swift and negative, and the Government suspended the reform measure. Nevertheless, the stock market consolidated by more than 50% from 2001 to 2005 even though the real GDP of China increased from 6.6% to 9.9%, as the market expectation was that the reform would resume some time in the future.

And indeed, in April 2005, the China Securities Regulatory Commission (CSRC) announced a plan to convert the state-owned shares into tradable shares in phases, and to stop any new IPO activity immediately to support this share reform programme. It took about a year for the share reform to be largely completed. In June 2006 the IPO suspension was lifted and Mainland companies were once again allowed to raise capital through new IPOs. By now, over 90% of the state-owned companies have already completed their share reform.

Today, the Mainland stock market is the second largest in the world after the US, with a market capitalisation of US$4.3 trillion as at the end of 2007. There are 139 million investor accounts, of which 60 million were opened in 2007 alone. Mainland companies have raised large amounts of capital from global capital markets. In November 2007, PetroChina which is listed in Hong Kong made its debut trading in Shanghai. PetroChina surged 163% on its debut, pushing up its market capitalisation to become the first US$1 trillion company in the world.

As at the end of December 2007, Mainland companies accounted for 51% of total market capitalisation in Hong Kong and 48% of its market turnover. The implication is that the stock market in Hong Kong is very much affected by developments on the Mainland. This is in addition to developments in other financial markets, given the global nature of Hong Kong's market.

The SFC, as regulator of the securities and futures markets in Hong Kong, executes its responsibilities through three inter-related activities namely: facilitation, regulation and education. Let me now explain how the SFC in Hong Kong while discharging the abovementioned responsibilities, positions itself to interface with and meet the challenges arising from the rapid development of the Mainland market.

Facilitation – Providing the platform for China's changing capital needs

Bringing international capital to the Mainland

When Mainland China first embarked on its economic transformation, it required a lot of funds. Hong Kong was the window to China for the rest of the world, and played the role of a fund-raising centre for Mainland companies, providing the platform for State-owned enterprises (SOEs) that sought to raise capital to finance expansion.

There are two types of Mainland shares that are listed on the Stock Exchange of Hong

Kong – "H shares" and "red chips". For those of you who may not be familiar with Mainland stocks –

- "H shares" are foreign shares issued by enterprises incorporated in China that are primarily listed in Hong Kong and traded in Hong Kong dollars. PetroChina is an "H share".
- "Red chips" are shares issued by companies with business, assets, markets and ownership that have a strong Mainland orientation, but the companies are incorporated outside China. China Mobile, the largest market cap mobile phone company in the world, is an example of a "red chip".

Following the suspension of the IPO activity on the Mainland in the period 2005-2006 mentioned earlier, Mainland enterprises seeking capital came to Hong Kong and the listing of "H share" companies on Hong Kong's stock market accelerated.

As I mentioned earlier, by the end of December 2007, Mainland companies accounted for about half of Hong Kong's stock market in terms of its market capitalisation and turnover.

Hong Kong has been uniquely placed to facilitate and support the Mainland enterprises in raising capital:

- First, one country two systems. The Mainland market is at a development stage with institutional constraints (such as capital controls), and Hong Kong is an established international financial centre ready to provide an invaluable service to Mainland companies seeking global capital.
- Second, we have the advantage of close relations and proximity to the Mainland, and are also familiar with the language, culture, practices and systems on the Mainland.

I have to point out that apart from a need to raise capital in the early days of China's emergence, the reason for listing Mainland companies in Hong Kong was motivated by a conscious and deliberate policy to expose and subject Mainland enterprises to Hong Kong standards and fast track their transformation to world class companies that meet international norms on governance and performance.

Hong Kong's regulatory and corporate governance standards and our Listing Rules are on a par with international standards. International investors looking to tap into the fast growing China market can invest in "H shares" and "red chips" in Hong Kong. They can take comfort in knowing that Mainland companies listed here meet international standards and practices, and be assured of the institutional and legal infrastructure of a thriving international capital market.

Channelling Mainland savings to the world

The situation in the Mainland today is that of having excess capital seeking investment opportunities. The Mainland authorities continue to be pragmatic and are prepared to experiment with limited capital account opening to export some capital. At the same time, there is also recognition of the need to be cautious and to ensure an orderly and stable transition.

This experiment has presented Hong Kong with another unique opportunity to play a role in bridging the capital from the Mainland with investment opportunities outside the Mainland. The experiment is evolving, and as in the case of the tradable shares reform, this is

approached by "crossing the river by feeling the stones".

Many of you would have heard of the Qualified Domestic Investor Scheme, or the QDII scheme, which started in 2006 with the following objectives:

- widen investment opportunities for the enormous amount of savings and minimize risks through portfolio diversification;
- create a more balanced two-way flow of capital;
- provide a training ground for Mainland investors; and
- converge with international practices and raise the regulatory framework in the Mainland.

Initially, the QDII scheme allowed 19 Mainland banks and one fund management company to invest about US$15 billion in certain instruments in Hong Kong. Since then the scheme has expanded to include securities companies and insurance companies, and a wider range of financial products in Hong Kong, and in some cases outside Hong Kong, too. In addition to the QDII scheme, the Mainland authorities are also looking into different schemes that would allow individuals in the Mainland to invest in products listed on the Hong Kong Stock Exchange.

Another channel to invest China's savings is the China Investment Corporation (CIC), which was established in September last year to begin managing part of China's official foreign exchange reserves. Starting with an asset size of US$200 billion, this initiative presents huge opportunities for international financial markets and their participants.

Regulation - Meeting the challenges of China's reforms

As you know, the practical challenge for regulators is that national regulation stops at the border. To conduct an investigation on any of the Mainland enterprises listed on the Stock Exchange of Hong Kong, the SFC would need the regulatory assistance from Mainland regulators such as the CSRC.

The SFC has long enjoyed a very warm, constructive and mutually respectful relationship with the CSRC. In 1993, the Mainland and Hong Kong entered into a Memorandum of Regulatory Cooperation – what we commonly refer to as the MORC. There are five parties to the MORC – the SFC, our counterpart the CSRC and the three stock exchanges, that is the Shanghai, Shenzhen and Hong Kong stock exchanges.

The MORC was entered into in recognition of the increasingly close relationship between the Mainland and Hong Kong markets and the corresponding need to establish and foster regulatory cooperation for the protection of investors and preservation of market integrity. A main focus was to facilitate consultation and cooperation through regular liaison and exchange of personnel. Over the years, this relationship has been strengthened through consultation, cooperation and exchange of personnel.

On 30 March 2007, the SFC and CSRC exchanged side letters to the Memorandum of Regulatory Co-operation and the Memorandum of Regulatory Co-operation Concerning Futures. The side letters will further enhance the ability of the two regulatory agencies to co-operate in the investigation of cross-border crimes and regulatory breaches.

Under the new arrangements, the SFC may request assistance from the CSRC in obtaining information in the Mainland for SFC investigations. If a person from whom the information is sought refuses to comply, the CSRC may seek court sanctions against that person. This power for the CSRC to compel the provision of this information has been made possible by amendments to Mainland securities laws in 2006. Previously, the SFC had to rely on the CSRC seeking voluntary co-operation from persons from whom information was sought.

The SFC will also be able to exercise its investigatory powers to help the CSRC in its investigations that have a Hong Kong element.

In addition to the bilateral MOU, both the SFC and CSRC are signatories to the IOSCO Multilateral MOU that facilitates the exchange of enforcement-related information.

Education - Helping China investors understand the Hong Kong market

Another characteristic of Hong Kong is the high level of participation of retail investors in the stock market – about 42% compared to 58% in respect of institutional investors. On the Mainland, the level of retail participation is even higher.

The participation of Mainland investors (e.g. through QDII) in the Hong Kong market is expected to grow and their present experience and knowledge of the Hong Kong market is limited. To have better understanding of the Hong Kong securities market, they could make use of the education information which is written in Mainland Simplified Chinese and posted under the "Overseas Investors" section on the SFC investor portal, the InvestEd website (www.InvestEd.hk). The SFC will support the Mainland authorities (e.g. CSRC, CBRC) in their areas of investor education.

Concluding remarks

Hong Kong has had the front row seat in participating in and enjoying the success of China's transformation. It is natural that as China progresses and develops its own financial markets, Hong Kong would need to continually reposition itself to stay competitive. This is evolution and competition. There is a niche and a role for different markets, as long as they are able to identify the niche and stay nimble enough to anticipate changing needs.

From history, we have seen how the financial services needs of a large economy like the US have been principally serviced over the years by two financial centres that are New York and London. I believe that the rapid rise of the Chinese economy provides ample opportunities for both Shanghai and Hong Kong to serve the needs of the country.

Indeed, Shanghai and Hong Kong can complement one another, and it is not a zero sum game. Shanghai has a huge domestic market to serve and I have no doubt that it would be highly successful. Hong Kong can continue to play its role as a bridge with the rest of the world for companies that wish to have an international profile and presence.

There are both challenges and opportunities for Hong Kong's capital markets as China integrates with the global economy and assumes an increasingly larger and more important role in global financial markets. The Mainland and Hong Kong capital markets enjoy a healthy symbiotic relationship. The pragmatic approach of the Mainland authorities augurs well for China to stay the course with its development agenda for its capital markets. And

everyone would agree that China's continued success would be good news for Asia and the world.

In concluding, I wish to say that forums such as the ASIC Summer School provide an oasis for reflection of recent events in financial markets, an opportunity to gain new insights, and also to draw lessons of what is good and bad for well-functioning markets. While uncertainty and pessimism abounds today, history shows us that markets will rebound and continue to innovate and thrive.

I note that this is the 13th Summer School. In spoken Chinese the number 13 and the year 2008 have an auspicious ring which carries the meaning of "continued success and growth" and "prosperity". On this note, I congratulate ASIC once again for organising this event and wish it continued success for years to come.

Thank you.