

Regulatory Challenges and Opportunities Speech at Association of International Accountants Annual Dinner

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Thank you for inviting me your Association's annual dinner celebration.

My remarks will highlight some of the major regulatory challenges and opportunities confronting financial regulators globally, domestically in Hong Kong, and the opportunities for Hong Kong's securities market.

Global financial reforms

Post-Lehman, the world is a changed place. Financial reforms are on an unprecedented scale and are being spearheaded and closely watched by the G20 Leaders. The reforms aim to:

- strengthen the resilience of the global financial system, and
- prevent the recurrence of a global financial and economic crisis as what we saw in 2008.

Regulation is also extending beyond the traditional boundaries of regulation to include unregulated financial markets and products, such as over-the-counter (OTC) derivatives, and unregulated entities, such as hedge funds and credit rating agencies (CRA).

Financial regulation is also moving beyond national borders and beyond the soundness of individual institutions. In this regard, there will be:

- closer cross-border cooperation and exchange of information among regulators for more effective supervision of global financial institutions that are systemically important;
- new focus on the monitoring, mitigation and management of systemic risk; and
- national committees for the oversight of overall financial stability.

Regulation is also becoming more intrusive. You would have heard about measures to regulate bank remuneration and bonuses. At the national level, the UK is consulting on banning the sale of certain retail financial products. The US "Volcker Rule" seeks to ban proprietary trading.



The Dodd-Frank Act will overhaul US financial regulation, although full implementation will take quite a number of years. The EU proposals have also attracted much debate, both inside and outside the EU, on reforms such as the regulation of hedge funds and short selling.

Naturally, there are concerns whether the global reform agenda:

- would be able to maintain momentum or would national priorities and industry lobbying slow down the process;
- would have unintended consequences, causing more harm than good;
- would be implemented evenly; if not regulatory arbitrage would undermine the effectiveness of the reforms; or
- would stand the test of successful implementation given the massive resource implications.

Domestic regulatory reforms

Hong Kong is an international financial centre, consistently ranked among the top 3 of the world, and global players are active participants in our market. It is therefore important that regulators remain vigilant to international market and regulatory developments that have an impact on the orderly functioning of financial markets or that would change the financial landscape.

Hong Kong's financial system remained stable and continued to function without disruption during the global financial crisis. However, the Lehman episode in Hong Kong put a spotlight on the selling practices of financial intermediaries as a result of allegations by investors of mis-selling by intermediaries.

The Securities and Futures Commission (SFC) took the opportunity to conduct an extensive public consultation on measures to strengthen investor protection in 2009. The measures were aimed at addressing the issues identified from the complaints of investors.

On the product side, we introduced a new requirement for a summary document setting out key features and risks of products for investors. The document, known as the Key Facts Statement (KFS), aims to make it easier for investors to understand and compare different products.

Investors have given us positive feedback on the KFS.

- We encourage the use of diagrams, charts, graphs or other illustrations in KFS where they may be helpful to investors.
- On the risk side, we require a narrative approach rather than a risk-rating system.
- The KFS complements but does not supplant the offering document for a product.



The KFS came into force in June last year, and Hong Kong is one of the first major international financial centres to require product summary statements. The EU introduced the Key Investor Information Document last July, and regulators in major markets are also considering introducing summary documents.

We also introduced ongoing disclosure obligations throughout the life of certain products, so that investors are updated on material information on an ongoing basis.

In addition, issuers and intermediaries would be required to provide investors with a cooling-off period. This is to allow investors the opportunity to cancel or unwind the transaction within the first few days after investing in the product.

We also emphasised that a product must be “fair” to investors. In designing products, the needs of the investor must be considered, and the payout and design cannot be skewed one way.

On the conduct side, the SFC proposed enhancement to the “know-your-client” process for intermediaries. For example, an investor’s net worth is not necessarily an indication of his or her experience or sophistication in financial matters. So, where derivatives are embedded in a product:

- We require intermediaries to assess the experience of their clients in investing in those types of products, and
- When a client without knowledge of derivatives wishes to purchase a derivative product, the intermediary should warn the client about the transaction and advise on the suitability of the derivative product.

Intermediaries are required to disclose monetary and non-monetary benefits they receive from product issuers for distributing investment products.

Moreover, intermediaries are restricted from offering gifts in selling products so that investors would not be distracted from the features and risks of the product being promoted.

On the side of investors, the challenge is investor education and investor responsibility. Investor education is one of the pillars of our regulatory approach; the other two are to regulate and to enforce. Informed investors, who are financially literate and understand their rights and obligations, are able to look after their own interests.

The SFC has launched a bimonthly e-newsletter, InvestEd Intelligence, which features articles on current market issues, popular investment products and recent regulatory developments, to provide investors with more comprehensive information about investing. This is on top of our regular mass media, outreach and online programmes for investors.

The Government has endorsed a proposal for the establishment of an Investor Education Council to take up the role of investor education across different sectors of the financial industry and markets. This is an important initiative to ensure a holistic approach in educating investors in a market where the intermediaries selling them the products are regulated by different regulators.



As mentioned in the beginning of my remarks, the global financial reforms have extended the scope of regulation to include CRAs and the OTC derivatives market.

The SFC consulted the market on the creation of a new regulatory regime for CRAs (Type 10 regulated activity), which received overall support from respondents. The regime is expected to be implemented in mid 2011, upon completion of the relevant code and legislative amendments.

The SFC will work with the Government, the Hong Kong Monetary Authority, the Hong Kong Exchange and Clearing Limited (HKEx) and relevant stakeholders to build a regulatory regime for OTC derivatives markets. The SFC plans to consult the market on the regulatory regime by the third quarter of 2011. The regulatory regime would cover:

- the reporting of OTC derivatives transactions (interest rate swaps and non-deliverable forwards at the initial stage) to a trade repository and
- the clearing of standardised OTC derivatives transactions through an authorized central clearing party.

Opportunities for Hong Kong

Hong Kong has a robust and efficient institutional structure, regulatory framework and market infrastructure benchmarked to international standards. Together with its simple tax structure, the rule of law and its openness, these are the hallmarks of brand Hong Kong that have made Hong Kong a successful international financial centre that has drawn the top financial and professional firms of the world to set up shop here and attracted investors from around the world.

Our success also lies in Hong Kong's unique advantage. Hong Kong is part of China – the economic powerhouse of this century – but it operates under its own systems. This combination has made Hong Kong highly attractive to international investors who like the quality of Hong Kong's institutions and are excited by the "China story".

Hong Kong has therefore been ideally placed to play a pivotal role in the Mainland's gradual and pragmatic opening up of its capital market from the early stage of fund raising, to investing its surplus savings abroad and participation of Mainland firms in Hong Kong before venturing abroad.

Our cooperation with the Mainland on its market opening has successfully won the trust of international and institutional investors on one hand, and the confidence of Mainland authorities, on the other hand, to allow a fast growing number of Mainland enterprises (first the state-owned enterprises, then the private enterprises) to list in Hong Kong.

- As at the end of February, 42% of the total number of listed companies is Mainland companies and they accounted for 56% and 48% respectively of total market capitalisation and turnover.
- For the period of 12 months ending September 2010, overseas investors accounted for 47% of trading in the cash market and institutional investors made up 65% of the cash market.



The latest phase of the Mainland's "going out" strategy is now on the internationalisation of the renminbi (RMB), and Hong Kong has been chosen as the offshore centre for RMB. This brings exciting new opportunities and challenges for Hong Kong.

The rapid growth in RMB deposits has expanded the opportunities RMB investment products. In August last year, the SFC authorized the first RMB-denominated fund for retail investors in Hong Kong, followed by a second similar fund in October. The fund assets are primarily to be invested in RMB-denominated debt instruments issued outside the Mainland.

The SFC will continue with efforts to raise investor awareness so that they better understand the features and risks inherent in RMB investment products.

To ensure industry's readiness for dealing in and clearing of listed RMB-denominated products, the SFC has taken a series of actions to assist brokers, including testing their systems with HKEx, opening RMB accounts, setting up RMB credit lines and industry briefings.

RMB products are potentially the key to Hong Kong's future development. Hong Kong is the offshore RMB centre and the 12th Five-year Plan supports Hong Kong's development as an international asset management hub.

Concluding remarks

To sum up, I would say that the international response to the global financial crisis has been quite robust, and the ongoing global financial reforms would have implications for the operations of intermediaries as well as the approach to financial regulation and supervision.

On the domestic front, the SFC has introduced regulations to enhance investor protection. The code of conduct has been revised to require intermediaries to minimise conflicts of interest, properly assess the risk profile of clients and ensure that derivative products are suitable for their clients. We have also expanded our investor education programme to provide investors more comprehensive information about investing.

Last but not least, the prospects for Hong Kong's further development as an international financial centre look very promising as the Mainland seeks to internationalise the RMB. The SFC will work with the Mainland authorities and other regulators in Hong Kong to make the RMB internationalisation a success.

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