

Chief Executive Officer's Statement

Crises often give rise to thoughts of regulatory reform. They require that we check how efficient and effective our regulatory system is in responding to problems and where necessary, seek ways to enhance it.

The past 12 months was undoubtedly an eventful period for the Securities and Futures Commission (SFC) and for regulators around the world. In addition to the collapse of Lehman Brothers (LB), which is still an issue for many, we also had to deal with a number of other concerns. Losses arising from investing in "accumulator" products, investigation into share trading and privatisation of major listed companies, and debates on short selling and the black-out period were some of the major issues. To this list, we must add the review of the existing regulatory regime of Hong Kong.

The SFC is 20 years old. Whilst the popular image of a securities regulator is that it is all about enforcement, the discharge of our responsibilities rests on three important pillars – regulation, education and market development.

Whatever else happens in the market, we will continue to maintain the necessary balance between regulating and promoting market development. We make full use of the powers available to us to deter misconduct through enforcement actions.



We will also look for ways to reduce regulatory burden and to support market and product development, ensuring in the process that investor interests and market integrity are not compromised.

There can never be too much investor education. The first line of defence against mis-selling is an informed investor. In 2008, we significantly increased resources for investor education. That was a good decision then and it remains so today – investor education is a key priority.

Managing crises

As an open market, Hong Kong has been through numerous domestic and global crises in the last 20 years. Past experience has taught us to stay vigilant at all times, to monitor the market for orderliness and to help investors better understand risks.

Throughout the reporting year, we kept up our surveillance of licensed corporations and reminded them of their obligations, including making adequate disclosure of material information to investors, ensuring client suitability and adopting prudent risk management policies and procedures. In terms of risk management, we reviewed the share margin financing policies and practices of brokerages and held seminars to share our findings with the industry. And recognising the increasing complexity of investment products on offer to retail investors, we increased our education efforts to explain product features and associated risks, especially risks associated with structured products and derivatives.

Since 2007 when the subprime crisis began to surface in the United States, we have witnessed a series of failures of financial institutions across the world. These include: the credit crisis of the British banks Northern Rock, Royal Bank of Scotland and Barclays, the failure of Icelandic banks, the insolvency of Landesbanks in Germany, government-backed rescues of Bear Stearns, Fannie Mae, AIG, Wachovia and Merrill Lynch in the United States (US), and last but not least, LB's closure. The direct and indirect effect of these failures has been felt by investors all around the world.

Immediately after LB filed for bankruptcy in September 2008 in the US, we issued restriction notices on its four companies in Hong Kong to preserve their assets and those of their clients. As in other major markets, retail investors complained of the domino effect of holding complex products linked to the collapsed US investment bank. Recognising their worries, we posted prominently on our homepage as well as InvestEd site, structural details about such products, including the ultimate counterparties, while urging intermediaries to take a more proactive role to explain to their clients the impact of LB's collapse. Meanwhile, we also issued circulars to intermediaries, reminding them to maintain good practices in risk disclosure, selling process, trading control and red-flag transactions reporting.

The investigation into the alleged mis-selling of Minibonds has been the SFC's highest priority since last September. We concluded the first two investigations and negotiated the full return of the principal invested to relevant investors. More details of our investigations are discussed in another chapter of this report.

Reviewing to improve

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The root cause of the present financial crisis stems primarily from the US and was a mixture of macro-economic imbalances, increasing complexity of the securitised credit model, easy credit, as well as weak market discipline. However, this does not free us from questions about the effectiveness of Hong Kong's regulatory regime.

No regulatory model around the world has protected investors completely from this financial crisis. Although we are better off than some other markets that have had major institutional failures, I still believe that now is the right time to review the different regulatory models being adopted by jurisdictions around the world and to reconsider the different benefits and drawbacks that each brings.

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Like other major markets, our disclosure-based approach requires the regulator to make sure that all product features and risks are fully disclosed when the products are brought to us for document approval. The system further requires due diligence on the part of the selling intermediaries to ensure suitability of a product for an investor. The big question we face today is whether our current regulatory structure is ideal. This same question is being contemplated by all leading economies in the world.

The regulatory philosophy of some major jurisdictions has been that product regulation would stifle innovation and that the regulator is a less appropriate agent than the market to judge whether products deliver customer value. However, the case of Northern Rock and the other recent failures of financial institutions have prompted regulators to reconsider whether market discipline was enough in controlling excessive risk taking. At the same time, the US is also discussing a new risk-based regulatory structure that reallocates responsibilities by the three functions of financial regulation – financial systemic risk, conduct, and prudential oversight.

Hong Kong is going through much the same process as financial regulators overseas. Along with the Hong Kong Monetary Authority, we have submitted a review of those elements of our structure that may need amending following the “Minibond” incident. Our suggestions cover review of regulation for point-of-sale activities, public offering regimes and definition of the professional investors, as well as introduction of a cooling-off period for certain kinds of products. We also recommended re-visiting our proposal to establish a stand-alone Investor Education Council, which will be responsible for co-ordinating and delivering investor education programmes across the entire financial services sector.

However, introducing changes to the current structure or adopting a different model altogether is not a simple matter and must be given careful consideration. No single system can prevent things

from going wrong. Rather, we should have balanced preventative measures and also examine how quickly a system can contain problems and minimise damage to investors.

Whatever steps Hong Kong takes in the final analysis, I believe three key guiding principles should be considered:

- good disclosure: Timely and meaningful disclosure of information to the market and the public is critical for creating a transparent market;
- regulating and enforcing: We must continue to monitor financial integrity, conduct and controls of market operators and intermediaries; and
- promoting and maintaining investor confidence. This is ultimately the only way to generate and sustain market activity.

The LB crisis has highlighted a need to strengthen cross-sector regulation in the industry for better protection of small investors. We look forward to co-operating fully with any future Government initiatives in regulatory reforms.

Keeping pace with world standards

Throughout the years, we have been keen to stay at par with international regulatory developments and standards. More specifically, we apply principles that are developed and recognised by the International Organization of Securities Commissions.

Recently, leaders at the Group of Twenty (G-20) Summit have agreed to establish a Financial Stability Board to provide early warnings about macro-economic and financial risks and to take actions to address them. It proposed that all systemically important financial institutions, markets, and instruments be subject to an appropriate degree of regulation and oversight. In particular, member countries have been asked to amend their



regulatory framework to ensure that their regulators can identify and handle macro-prudential risks across the financial system.

In addition, hedge funds or their managers will be required to be registered and to report appropriate information periodically to the relevant authorities. Institutions that have hedge funds as their counterparties must also adopt effective risk management.

The G-20 also raised the need to strengthen transparency of credit derivatives markets and reduce their systemic risks and to subject credit rating agencies to regulation.

Recommendations made by G-20 will have implications for all regulators around the world. In the near future, the SFC will be closely monitoring international efforts to implement reforms for the benefit of Hong Kong, a key international market.

Corporate priorities ahead

In line with our statutory obligations of protecting the investing public and ensuring market stability, we have set our corporate priorities to address these main areas in the year ahead.

We shall continue to promote Hong Kong's development as an international financial centre and a key financial market in Mainland China. Besides maintaining dialogue with Mainland regulators for possible co-operation, we shall keep pace with international regulatory developments to ensure that changes to Hong Kong's regulatory environment are consistent with its standing as an international financial centre.

Active support and supervision of an efficient, fair and orderly securities market is necessary. It can be achieved by close supervision and firm enforcement. We will increase resources to step up monitoring and enforcement work to combat and minimise market misconduct while allowing adequate flexibility for market growth.

Educating and protecting investors continues to be a priority. The LB bankruptcy has further highlighted the importance of investors understanding the features and risks of a financial product. Well-informed and financially-literate investors are the first line of defence against fraud and malpractice. We shall continue to upgrade efforts to educate retail investors with multiple investor education initiatives.

Improving corporate effectiveness and efficiency is another focus. Apart from maintaining high professional standards, we will continue to look for more direct and meaningful ways to perform our regulatory functions. We will review the effectiveness of our gatekeeping role in licensing and product authorisation and propose enhancements where appropriate. An on-line portal is already being developed to facilitate the submission of licensing forms, along with a comprehensive revamp of our licensing functions to further enhance the overall efficiency and effectiveness of our processes.

Finally, I would like to take this opportunity to thank the staff of the SFC for their hard work and commitment over the past busy year. In the past 20 years, we have expanded our role as a regulator of the securities and futures markets but more and more challenges are ahead. I am confident that with their continued commitment and support, we can take the organisation another step forward at this juncture of regulatory reforms.

Martin Wheatley
Chief Executive Officer