

**CEPA Forum, Beijing 2006
New Opportunities and Challenges Ahead
for Mainland and Hong Kong Financial Practitioners**

Progress under CEPA – A Regulator’s View

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The Hon Frederick Ma,
Mr Huang,
Mr Kwan,
Ladies and Gentlemen,

I am grateful to the Hong Kong Securities Institute for the opportunity today to share with you from a regulator’s view the progress under CEPA in the securities and futures industry. The implementation of CEPA has indeed created new investment opportunities for both Mainland and Hong Kong brokerages.

I would like to discuss the following four aspects today:

- Current status of the Hong Kong securities and futures markets
- Regulatory philosophy of the SFC
- CEPA – Current status and development
- Way forward for CEPA

Hong Kong as the largest stock market in Asia (ex-Japan)

The growth of the Hong Kong stock market has been encouraging since the recovery of the local economy in 2004. Hong Kong has maintained its position as the largest stock market in Asia excluding Japan. As of the end of 2005, the total market capitalisation of the Hong Kong stock market reached US\$1,055 billion, an increase of 23% over 2004. As at the end of March 2006, the total capitalisation of the stock market exceeded US\$1,200 billion, rising nearly 15% in the first quarter of 2006.

Continued growth in the Hong Kong derivatives market

Hong Kong’s derivatives market has also performed very well and has recorded sustained growth for many years. In 2005, a total of 25.52 million futures and options contracts were traded in Hong Kong, one of the most active derivatives markets in the world. All this points to Hong Kong’s vital role and position in the international financial arena.

Continued growth in the total NAV of Hong Kong's combined fund management business

Findings of the SFC Fund Management Activities Survey revealed that Hong Kong's fund market continued to maintain healthy growth.

As at the end of 2004, the total NAV of the combined fund management business in Hong Kong was over HK\$3,600 billion, up 23% from 2003. This was equivalent to 54% of its total stock market capitalisation, and reflects Hong Kong's ability to maintain its pre-eminence as an international financial centre in the region and attract funds to Hong Kong for management.

Latest developments in the Hong Kong investment product market

Compared to the USA, Australia and other Asian regions, the market of real estate investment trusts (REITs) in Hong Kong is still at its infancy, with the first REIT launched only in November 2005. However, our REITs market has been growing rapidly. As at the end of 2005, a total of three REITs had been authorised by the SFC and listed on HKEx with a market capitalisation of US\$5 billion in aggregate.

Trading in REITs has been active, with an average daily turnover of US\$121 million, representing approximately 4% of the average daily turnover of the Hong Kong market as a whole. This ratio is higher than those in more mature REITs markets in USA and Australia etc, and the turnover is 6.5 times higher than that in Singapore.

The rapid growth of hedge funds has posed huge challenges for regulators all over the world. Hong Kong is an important base for hedge funds in Asia. As at January 2006, 133 hedge funds were based in Hong Kong with assets under management of US\$14.8 billion in aggregate. Most of them, being non SFC-authorized hedge funds, cannot be offered to the public. Currently, there are 13 SFC authorised hedge funds with an asset value of US\$1.2 billion in aggregate. The market expects to see more hedge fund activities involving Asian equities.

We believe that there are pros and cons for hedge funds. As a regulator, we have allocated additional resources and stepped up our efforts to understand the industry, identify the risks and study how to make use of hedge funds to facilitate economic development, while formulating regulatory measures to protect investors.

Profile of Hong Kong intermediaries

The growth of the securities and futures intermediary market in Hong Kong is encouraging. As at the end of March 2006, there were 1,290 SFC-licensed corporations, with SEHK participants and HKFE participants accounting for one-third and close to 10% respectively. The non-exchange participants shown in the chart mainly include fund managers, sponsors and investment advisers, etc.

Hong Kong as an international financial centre – internationalised intermediaries

As an international financial centre, Hong Kong attracts overseas financial institutions to set up operations here by virtue of its prudent regulatory framework, free economic

system, advanced financial infrastructures and a wide range of financial products and instruments.

The securities and futures intermediaries in Hong Kong are highly internationalised. As at the end of March 2006, the controlling shareholders of nearly 40% of our licensed corporations were from overseas: mostly from Europe, which accounted for 14%, the United Kingdom alone accounted for 7%; and United States, 9%. The percentage (6%) of companies based in the Mainland ranked top in Asia. This means Mainland financial market opens up, a large number of Mainland financial institutions will use Hong Kong an important base for overseas expansion.

The business activities of Mainland companies in Hong Kong are significant to the development of the Hong Kong market. In 2005, the turnover of Mainland-backed securities firms amounted to HK\$760 billion, or around 4% of the total turnover of the Hong Kong market. As at the end of 2005, their clientele numbered approximately 95,000, or 14% of the total number of active clients in Hong Kong. These Mainland-backed securities firms engage in not only securities brokerage business but also fund management, corporate finance, dealing in futures contracts and investment advisory services, etc. With the financial and economic reforms in the Mainland and the continued enhancement of CEPA, we expect more and more Mainland companies to embark on new business activities here.

Hong Kong as a financial market with sustained growth – the proliferation of securities intermediaries

Apart from being internationalised, I would say that the securities and futures intermediary business in Hong Kong has experienced “sustained growth”. For example, the number of securities intermediaries (including firms and individuals) in Hong Kong has increased by nearly 15% over the past three years.

The securities intermediaries in Hong Kong continue to strengthen

In addition, securities firms have been increasing their financial strength, as indicated in the following:

(1) Strong capital base

As at the end of 2005, shareholders’ funds of Hong Kong securities firms reached HK\$80 billion in total, up nearly 30% from that in 2003.

(2) Sustained growth in turnover

As at the end of 2005, securities trading generated by securities firms in Hong Kong reached HK\$20 trillion in aggregate, which almost doubled that in 2003.

The above data show that Hong Kong is a vibrant international financial centre with sustained growth.

Regulatory philosophy of the SFC

The SFC’s core regulatory philosophy is to maintain market integrity and fairness. This is mainly implemented in the following areas:

(1) Clear regulatory policies

We make rules, regulations and codes as clear and detailed as possible so that the industry understands clearly the financial and conduct requirements that are expected of it. As part of our daily regulatory duties, we supervise our intermediaries to ensure their full compliance of the various regulations both in letter and spirit. We believe that as a regulator, we encourage intermediaries to comply with laws and regulations, while intermediaries should exercise their frontline role in risk management. Hence, one of our regulatory approaches is to promote self-discipline among intermediaries.

(2) Fair enforcement

In implementing specific regulatory tasks, we adopt a risk-based regulatory approach. When we conduct prudential supervision, we focus our resources on intermediaries with high risks.

The SFC has been adopting a prudent approach in formulating and amending rules and legislation. We will first study the various aspects of an issue and conduct full and comprehensive consultation before formulating/amending the relevant rules and legislation. For instance, in formulating the regulatory requirements to address the conflict of interests of analysts in 2004-2005, we first examined the relevant regulatory developments in overseas major financial centres. We then studied the various issues concerning analyst conflicts in Hong Kong. It was not until we had consulted the industry that we drew up specific guidelines to address potential and actual conflicts of interests involving analysts in the Hong Kong market.

As the regulator of securities and futures intermediaries, we believe that establishing a healthy, robust and prosperous market is the common objective of the regulator and industry practitioners. Hence, we seek to build partnership with the industry by extensive consultation when formulating any new rules and legislation and prior to the implementation. In on-going supervision, we work with intermediaries to reduce their potential risks.

Of course, should we discover any breach of rules and regulations by intermediaries, we would exercise the enforcement powers conferred to us under the laws proportionately without fear or favour to prevent any systemic risks.

(3) Regulate with the same standards

All SFC licensees, irrespective of their size of operations and background, are subject to the same regulatory standards. They are required to comply with the codes, rules and regulations issued by the SFC and subject to the SFC's extensive ongoing supervision of their financial position and conduct etc.

CEPA – Current Status and Development

Implications of CEPA for the securities and futures industry in Hong Kong and the Mainland

Since the implementation of its details in 2004, CEPA has fostered the exchange of qualified personnel and expertise between the Mainland and Hong Kong. It has also considerably enhanced the development of the financial industry of both markets and strengthened the economic ties.

Meanwhile, the implementation of CEPA has also created more opportunities for Hong Kong to participate in the Mainland markets. In the long run, this is conducive to expanding the overall size of the securities and futures markets of the two places and increasing employment for financial professionals. This in turn will contribute to the healthier development of the investment markets and attract more Mainland and overseas investors.

Development of CEPA

Now, let us look at some progress under CEPA. As an agreement executed by the Mainland/Hong Kong SAR governments in 2003, CEPA is aimed at creating better business environments for the Mainland and SAR and bringing more employment opportunities. Amendments were made in 2004 and 2005 as a result of mutual consultation, which further broadened the scope and contents of the co-operation, whilst streamlining the procedures for the integration of the Mainland/Hong Kong intermediaries into each other's markets.

CEPA I has brought about the mutual recognition of the professional qualifications of the Mainland/Hong Kong market practitioners, thereby greatly increasing the flexibility of the securities brokers in integrating into each other's markets. Market practitioners are only required to pass the examinations on rules and legislation across the border in order to apply for the relevant licences in the Mainland/Hong Kong. Besides, HKEx is also permitted to establish a representative office in Beijing, which serves as a contact point for Mainland enterprises seeking to list in Hong Kong.

The implementation of CEPA II directly enables Hong Kong futures intermediaries to enter the Mainland futures markets in the form of joint ventures.

Under CEPA III, we agree to allow qualified Mainland securities and futures companies to establish subsidiaries in Hong Kong to carry out regulated activities.

CEPA – Current Status

To ensure the smooth implementation of CEPA, the CSRC and SFC have been in close contact and liaison with a view to carrying out well-planned policies to facilitate the process.

CEPA I

In the implementation of CEPA I, the Hong Kong Securities Institute and The Securities Association of China have made the necessary examination arrangements for market practitioners in the Mainland and SAR respectively. As such, practitioners

who wish to sit for the Mainland or Hong Kong regulatory examinations may do so in their respective jurisdictions.

Ever since the implementation of CEPA I,

- Around 200 Hong Kong securities/futures practitioners have already passed the relevant Mainland regulatory examinations, enabling them to apply for industry qualifications in the Mainland;
- Through our efforts, the Hong Kong Securities and Futures Licensing Examinations can now be held in Shenzhen; close to 200 Mainland securities/futures practitioners have already passed the examinations;
- HKEx has set up a representative office in Beijing.

The implementation of CEPA I enables intermediaries benefiting from CEPA II and III to make more flexible arrangements in the deployment of professionals, so they may dispatch appropriate professionals to joint venture companies or subsidiaries across the border to perform their duties.

CEPA II

CEPA II permits Hong Kong futures intermediaries to establish futures joint-venture companies in the Mainland, thereby opening the door for them to enter the Mainland futures market. In August 2005, the CSRC announced specific requirements under the Regulations for Administrative Licenses in regard to the vetting of shareholders' qualifications. Since the official implementation of CEPA II, we know that some Hong Kong futures intermediaries have already started talks with Mainland futures brokerage companies on joint venture co-operation. Some of them have expressed interest in filing or have already filed their applications with the CSRC. Hong Kong futures companies approved under CEPA II will be the first batch of futures intermediaries outside the Mainland who are allowed to enter the Mainland futures market. They are expected to give an impetus to the future development of the Mainland futures market.

We believe that the exchange and co-operation of the Mainland/Hong Kong firms have positive implications for enhancing product awareness, risk management skills and standards for internal controls in both markets. Meanwhile, industry practitioners in the Mainland may also take advantage of the co-operation under CEPA to prepare themselves for the entry of futures companies outside China into the Mainland market.

CEPA III

Under CEPA III, qualified Mainland securities and futures companies are permitted to establish subsidiaries in Hong Kong. This heralds the entry of Mainland securities and futures companies into the global financial market. The market experience and operating skills acquired by Mainland securities and futures companies in Hong Kong will lay solid foundations for their future expansion into the international market. Meanwhile, CEPA III also introduces intermediaries of various backgrounds into the Hong Kong markets, turning it into a more diversified investment market.

The market's response to CEPA has been very positive. According to Mainland newspapers, three Mainland futures companies have already obtained approval for setting up subsidiaries in Hong Kong. Some other Mainland intermediaries have also taken the initiative to approach us and expressed interest in developing their securities or futures business in Hong Kong. We have thoroughly explained to them the regulatory regimes and licence application and operating requirements in Hong Kong. Some of them have started their preparation work for establishing subsidiaries in Hong Kong. We believe they will soon begin the formal licence applications in Hong Kong.

The SFC encourages qualified Mainland securities and futures companies to set up subsidiaries (instead of branches) in Hong Kong. We will maintain close co-operation with the CSRC in the implementation of CEPA III.

CEPA – Current Status (cont'd)

In implementing the commitments under CEPA, the SFC adopts its core regulatory philosophy of maintaining market integrity and fairness and promoting the same standards. While CEPA has opened the door for both Mainland and Hong Kong intermediaries to enter new markets, in processing licence applications, the SFC and the CSRC will continue to adopt strict vetting procedures without compromises. To obtain a licence, intermediaries are expected to meet strict operating standards of the relevant jurisdictions.

After granting the licences, we will apply the same regulatory criteria to all licencees under CEPA, requiring them to maintain financial soundness and comply with all the rules and legislation. They will also be subject to our on-going prudential supervision.

Way Forward for CEPA

The SFC, in close co-operation with the CSRC, will provide assistance in policy and operational matters for the implementation of CEPA.

CEPA is significant for the financial market development in Hong Kong and the Mainland. By bringing the securities and futures markets of both jurisdictions closer together, CEPA brings about a win-win situation. Through the close economic ties, Mainland intermediaries in Hong Kong may prepare themselves for the further development of the Mainland financial market. On the other hand, the securities and futures industries in Hong Kong may likewise benefit from a host of new business opportunities in the massive Mainland market.

Let us join hands to continue the further enhancement of CEPA.

Thank you!