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Session V – Policy Makers’ Dialogue

Key Note address

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Ladies & Gentlemen,

1. It is a pleasure to speak on investor confidence at a conference organised by two such august accounting bodies. In the previous session, Accountants’ Dialogue, the issue of confidence in the audit process was discussed. Confidence in the auditing process and thereby confidence in financial disclosures is pretty fundamental to successful financial markets. The prime responsibility for that confidence rests with your members and the two professional bodies.
2. I am here to talk about what the regulators can do to enhance investor confidence. Today, I will share with you my views on 3 areas, namely :-
 - overall relationship of Hong Kong and Mainland markets and China / HK regulatory co-existence;
 - policy issues and regulatory challenges of Mainland companies listing in HK; and
 - regulatory response to the challenge of ensuring investors’ confidence.

Let me start by briefly explaining why confidence in Mainland companies is such a key issue for a Hong Kong regulator.

Anomalies and challenges of the China/Hong Kong regulatory co-existence

3. One of the statistics used by economists to look at the maturity of stock markets is the relationship between stock market capitalisation and GDP. A general rule of thumb is that a market was fairly robust and developed in a capitalist economy when the market cap is about equal with GDP. It is interesting to note that Japan's stock market has just moved back above 100% of GDP having lagged behind for a few years. The level for the US and the UK is that market cap is about 140% of GDP. If you look at China and Hong Kong separately you get some pretty startling figures. Hong Kong market cap is 650% of Hong Kong's GDP whilst China's market (Shanghai + Shenzhen) is 24% of GDP. If you combine Hong Kong's market with China however the figure is 80% - the same figure as for India.
4. The largest 10 IPOs in Hong Kong were all Mainland enterprises. Last year H-share IPOs accounted for 80% of equity funds raised through IPOs in 2005 and included the world's largest IPO, China Construction Bank.
5. From all these statistics you might conclude that the Mainland was short of capital and looked to Hong Kong to fill a need. In fact the Mainland, with one of the highest saving rates in the world has an abundance of capital. There is no shortage of capital. There is a shortage of good assets to invest in. The reason for listings in Hong Kong is a conscious and deliberate policy to import Hong Kong standards to Mainland companies and transform their governance and performance in the process. Hong Kong's standards are internationally recognised and respected – and Mainland companies – some entering the world stage for

the first time – need to be able to demonstrate their adherence to high standards of corporate governance and transparency. I am pleased to say that the vast majority of companies coming to the market understand the requirements and are keen to comply.

6. Not all do meet the requirements. Some of those get stopped at the gate and I will talk in a moment about some of the issues we face. Some fail after listing which brings us to issues of enforcement and jurisdiction.
7. The Mainland economy continues to provide GDP growth of above 9%. Investors want to find a way to access that growth. This is a market that has a natural attraction for global investors but those investors want confidence as to the standards that apply; that is the role for Hong Kong and the challenge for Hong Kong’s regulators – which brings me to the second area that I want to cover.

Policy issues and regulatory challenges of Mainland companies listing in Hong Kong

8. Mr Deng Xiaoping coined the phrase “one country, two systems” to describe the new regime for Hong Kong’s return to the Mainland – and that is exactly what we’ve got – two legal systems.
9. The domicile and main operations of the majority of new listing applicants in Hong Kong are located outside Hong Kong - this poses a challenge to our regulatory framework on how to effectively regulate these issuers – which are not quite overseas but not domestic either. The Mainland issuers, established under the laws of the PRC, are required to comply with the PRC Company Law and other domestic regulations.
10. In Hong Kong, the primary statutory corporate regulation, the Companies Ordinance, does not apply to issuers incorporated outside of Hong Kong.

The main regulatory requirements rest on the Listing Rules administered and enforced under contract by the Hong Kong Stock Exchange – but these rules are contractual rather than statutory.

11. Since April 2003, all listing applications have to pass by both the Exchange and the SFC – under what is known as Dual Filing. The SFC has the power to object to a listing if it considers that the application is false or misleading as to a material fact or omission.
12. Let me share with you some of the issues common to many listings identified in our review of listing prospectuses.
13. It is quite common for a Mainland listing to involve the restructuring of a large State-owned enterprise. The restructuring will separate the assets and operations - usually the better bits will form the listed group whilst the remaining assets are retained by the parent group. Given that the listed group often retains close business ties with other parts of the group, this begs the questions as to whether:
 - the listed entity is able to operate independently of the parent ;
 - whether there is potential competition with the other businesses within the parent group; and
 - whether there are plans for reintegration, in particular the possibility of the parent group injecting its other assets into the listed group in the future.
14. In most cases, where the parent group retains businesses which compete, it would provide a non-competition undertaking. However the effective compliance with such a non-competition undertaking is an internal matter and very much relies on the corporate governance of the group – hence again why corporate governance standards are so important.

Other Disclosure Issues

15. In our review of listing prospectuses, we also noted other disclosure deficiencies, which apply quite broadly - not only to Mainland companies. The following are some fairly typical examples:
 - Inadequate information of the industry - In one case the industry section barely covered one page and the descriptions were largely based on directors' belief;
 - Unsubstantiated claims by the applicants that they had introduced or would introduce new products to the market and that the products were expected to be successful;
 - Dependence on a single customer for most of its revenue;
 - Dependence on a single supplier for substantially all its finished goods to which it does not add much further processing; and
 - Reliance on a few distribution agents whose customers it does not know.
16. Another common feature associated with many Mainland listings relates to the significant amounts of connected transactions between the listed entity and the parent group subsequent to listing.
17. Financial assistance to controlling shareholders has been a constant feature of Mainland companies. A 2003 survey identified this as occurring in over half of the companies listed on the Mainland.
18. In light of this, one of the initiatives that the Government and the SFC are working on relates to the proposals to give statutory backing to the more important listing requirements, in particular connected transactions.
19. The Dual Filing regime emphasises the quality of disclosure. The focus is on meaningful disclosures of material information to enable investors

to make an informed decision on whether or not to invest - the listing applicant must disclose the full story. In this area our regulatory system places great reliance on the work of sponsors. Sponsors must perform sufficient due diligence to understand the context or environment in which the company operates and present a fair and accurate picture of the whole business in the prospectus.

20. As well as due diligence in respect of the disclosure, our regulatory system depends on sponsors to ensure that IPO candidates have suitable systems and controls to meet the obligation set by the Listing Rules and to ensure that the directors are aware of their responsibilities. The role played by sponsors is a key part of our system – this is why we have been gradually tightening the regulation of sponsors over the last couple of years. They are a key part of investor protection.

Enforcement Actions and Cross Border Co-operation

21. Most issuers are well managed and are well regarded by investors. They conduct their affairs with appropriate controls and practices and do not give rise to any regulatory concerns. However, there have been some well-known problem cases.
22. There were previous cases of issuers falsifying financial information in their prospectuses, channelling the funds raised from the public market to purposes other than for the benefit of the company, or providing substantial amounts of financial assistance to related parties on unfair terms. Some of these cases involve criminal elements and are still under investigation.
23. It is an inevitable fact that corporate failures or scandals happen in all markets. This is as true for London and New York as it is for Hong Kong. If it is a domestic company within the home jurisdiction, the regulator usually has a range of powers to deal with the company. Where it is

outside your own jurisdiction you have to rely on the powers of the “home” regulator.

24. There is a well developed model under the umbrella of IOSCO – the global securities regulators organisation – where signatories to a Multilateral MOU can both seek and offer assistance in investigating market misconduct and corporate failures. IOSCO’s members comprise more than 100 regulatory agencies from around the world covering 90% of the world’s capital markets. 30 of these members are full signatories allowing them to both share data in pursuing investigations – and most importantly – use their regulatory powers on behalf of each other. The CSRC, the securities regulator in Mainland China is not yet a signatory to this MOU – we have urged them to take the necessary steps to become a full signatory which would significantly enhance cross border regulation.
25. In the absence of this multilateral agreement, open to the world’s leading regulators, it is therefore crucial that the Hong Kong authorities maintain effective and close co-operation with the Mainland authorities. We have a Regulatory Co-operation agreement with the CSRC – signed in 1993. It does not cover all the areas of the IOSCO standard but is a key part of our ability to regulate Mainland companies.
26. Through this agreement, the SFC and the CSRC meet regularly to discuss regulatory issues and policies and share public and non-public information with, and render regulatory assistance to, each other. While there are differences between the legal frameworks in Hong Kong and the Mainland, both regulators have fully co-operated with each other as far as possible. The SFC has in the past received useful assistance from the CSRC which facilitated our enforcement actions.
27. Here comes my third and final area to cover today – the regulatory response to the challenge of ensuring investors’ confidence.

28. The Hong Kong authorities have put in substantial efforts to improve corporate governance of issuers, to enhance the regulatory standards of the market and to achieve effective enforcement over the last couple of years. The SFC, in conjunction with the Government and the Exchange, will continue to implement measures and pursue initiatives to enhance the quality of the listing market in Hong Kong.

- New listings – the SFC will continue to work with the Exchange to strengthen the gatekeeping for new listings. Since the implementation of the Dual Filing arrangement in April 2003, we are pleased to note that the operation has been smooth and, together with the concerted efforts of the Exchange, we believe that the quality of listings has improved.
- Regulation of sponsors – sponsors play a pivotal role in the listing process because they are the main facilitator bringing new listings to the market. They ensure sufficient due diligence and adequate disclosures are made in the prospectus. Efforts have been made to step up the regulation of sponsors. The Exchange in April 2005 issued new requirements on sponsors and a guidance note on due diligence work. Last month the SFC published details of the new regulatory regime for sponsors. The SFC has also stepped up its efforts in inspecting sponsors' work in relation to listing applications.
- Proposals to give statutory backing to more important listing requirements – the Government and the SFC issued in January last year their consultation papers on the proposed amendments to the legislation to give statutory backing to major listing rules. These include timely disclosure of price sensitive information, periodic financial reporting and disclosures, and shareholders' approval for notifiable and connected transactions. The SFC and the Government, with inputs from the Exchange and market practitioners, are in discussion to further refine the proposals.

- Co-operation with the CSRC and Mainland authorities – the SFC will continue to work with the Mainland regulators to strengthen our investigation and enforcement work relating to Mainland enterprises. As the amended PRC Securities Law has given new investigation and enforcement powers to the CSRC, we will liaise closely with them to understand how these new powers would enhance the regulatory assistance that they might offer to other fellow regulators, including the SFC.
29. So, in summary, we have seen and will continue to see Hong Kong acting as a channel for significant flows of international capital to Mainland companies. Those investors want and expect high levels of transparency and conduct in making those investments. We have created that structure in Hong Kong. It is, however, never a finished product – markets evolve and the regulatory structure must evolve with them. The regulatory changes being made both here in Hong Kong and in Mainland China are necessary to that evolution.

Thank you very much.