“Raising the Bar on Regulating Hong Kong’s Financial Markets”

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Good afternoon.

Distinguished guests, ladies and gentlemen,

Thank you for inviting me to speak in this gathering of the World Pension Forum. I would like to share with you a little bit of the SFC’s experience in regulating financial markets. I will give an overview of the regulatory philosophy – I know you have had a pretty heavy weight agenda so far, so a dose of regulatory philosophy will help your digestion. I’ll also talk a little on some of the developments for the fund industry in Hong Kong that we are actively involved in.

Hong Kong as a Global Financial Centre

As Mr. Stephen Ip, our Acting Financial Secretary, mentioned this morning, Hong Kong is widely recognized as an international financial centre and the asset management hub and platform for international market players to manage assets. We see more international financial groups from places such as UK, France, Australia and Switzerland, who have shown interest in setting up business and bringing their products to Hong Kong. Its not just that the Hong Kong market itself is the attraction – it is not the dominant market in its time zone in the way that say London or New York are – rather that HK is an excellent place from which to cover the Asian time zone. This is due to a number of factors – language, convenience, availability of skilled resources, legal framework – and not least its proximity to the world’s most exciting market, which provides market players with a level playing field and investors with a transparent market.

The City of London published a report on leading financial centres earlier this year. The report was an attempt to rank the leading International Finance Centres – but also to establish some criteria – how do you judge them? This put London and New York as the leading IFC’s – by some margin. The report also concluded that Hong Kong is a real contender to become a genuinely global financial centre and currently third on this league table. Just ahead of Singapore but well ahead of markets such as Shanghai or even Tokyo. These markets are important markets – Tokyo today, and Shanghai undoubtedly in the future – but they are essentially domestic markets, albeit very large domestic markets. The report highlights the usual reasons for dominance of financial centre – critical mass, communication links, costs – but in every survey the issue which is in the top 2 criteria – and as a regulator you have to expect me to say this … is the regulatory environment.

According to the Commission’s Stakeholder Survey 2006 conducted by an Australian market research firm, the SFC was seen as a better and tighter regulator than other regulators in Asia and it was considered to be more approachable and easier to deal with than other Asian regulators. We recognize the importance of effective regulation to the success of the financial markets and our role in supporting Hong Kong's continued development as an international financial centre. Our view is further supported by a recent study commissioned by Mayor Michael Bloomberg in the City of New York, which highlighted the existence of an appropriate regulatory regime as being a key factor in competitiveness.

Now of course this begs the question "What is a good regulatory regime?" You may have noticed, that even in the genteel world of regulation, that there is some controversy between the different approaches to regulation. This is reported with glee by such august organs of truth as the Financial Times and the Wall Street Journal. One week you will see the FSA exposing the virtues of "principles" based regulation as against the "rules" based approach which prevails on the other side of the Atlantic. Next week you will see the massed forces of Paulson, Bloomberg and SEC commissioners take aim at AIM – please pardon the pun – and accuse other markets, notably but not exclusively the UK, as being soft on enforcement. When Commissioner Cox was in Beijing in 2005, he delivered a speech which essentially said – "Chinese banks list in HK because they cannot meet the standards of New York". As you can imagine, this did not go down too well in this part of the world.

SFC's regulatory philosophy

As a securities regulator, the role of the SFC is to maintain a regulatory framework with international standards and market integrity. This, we hope, will attract investors and quality market players, and preserve an environment that is conducive to product development, which in turn, will facilitate the growth of the market. In this regard, the Commission has to uphold a fine balance between market facilitation on the one hand, and investor protection and reputation of HK as an international financial centre on the other.

To elaborate our thinking further - we have a core mission to protect the interest of investors. As a corollary to this, we work towards: (i) maintaining market confidence and promoting high standards; and (ii) facilitating market and product development. We must therefore set high regulatory standards for market participants and encourage the use of best practices. We must continue to enforce against misconduct and illegal practices in the market firmly and fairly. This cannot be compromised. But our rules and regulations must be effective without creating unnecessary or undue compliance burdens, and our processes must be efficient and user friendly.

The regulated environment – and by this I mean the operators in markets – represent what I would call the regulatory 'ice-berg' – 90% is invisible. These are the compliant operators who want to know what the parameters are, and stick to them. For this group – the role of the regulator is largely to provide information – the rules of engagement of course but also codes, guidelines – in fact any information to help the silent majority remain compliant. The visible part however is what attracts most attention. And this visible part I would split into two – one part wants to operate at the edge – and occasionally beyond it – if what is legal. Our strategy for this group is detection and deterrent. We want them to know that we have the tools to detect market malpractice and abuse – and we will use the penalties at our disposal – whether that be civil or criminal proceedings to send a strong message to the market. The final group – and fortunately for us just the tip of the iceberg – are those who consistently and deliberately breach the rules. And our strategy here is very simple – we want them out of the industry.

So to come back to philosophy – we don't particularly want to step into the debate of rules vs. principles – both are necessary and we use both – or the debate of whether we are enforcement lead or not – again enforcement is a tool to be used appropriately.

We are mindful that the key roles of the SFC include not only regulation and enforcement, but also market facilitation and investor education. We see each of these roles as equally important. SFC is not just here to regulate and police the financial market, but also to actively help enhance its quality and status. We aim to enhance the breadth and depth of our market such that investors can have access to a wide range of quality products and services. This would be essential to support the continuous development of Hong Kong as a leading international financial centre.

<u>SFC's initiatives in developing Hong Kong's fund management business</u>

Perhaps let me illustrate how the SFC achieves its goal and regulatory objectives by reviewing some of our efforts in shaping our regulatory framework to facilitate development in the fund management industry.

With the introduction of the Mandatory Provident Fund Scheme in 2000, retail investors' interests and understanding in fund investments have been growing significantly. Investment funds are now one of the most popular investment vehicles for Hong Kong retail investors. According to the data released by the HKIFA (Hong Kong Investment Funds Association), as at end 2006, 20% of Hong Kong's adult population invested in investment funds. Such participation rate is getting closer to the 28% participation rate of equity investment. The SFC has authorized nearly 2,000 unit trusts and mutual funds for offering to the public. In addition to the rapidly increasing number of funds, there has been a corresponding increase in the types and complexity of investment products available to the retail public in the past few years, as retail investors seek to invest in a diversity of products including alternative investment tools to achieve diversification and absolute returns. Unlike institutional and professional investors, retail investors may not have the relevant knowledge and expertise in investing in sophisticated products, thus products that are allowed to be offered to retail investors must meet certain structural and operational safeguards and adequate risk management and internal controls commensurate with the complexity and investment strategy. The acceptability of the fund managers and trustees/custodians will also be reviewed and transparency is essential.

We believe it is also essential for investors to have a wide range of investment choices which suit the different investment needs. To facilitate product innovation, we adopt a disclosure-based approach in respect of a fund's investment strategy and fee structure as these features should be subject to commercial decisions. Fund managers are provided with the flexibility in the design of their products as long as they meet our basic structural and operational requirements as mentioned above.

You know very well that investment involves risks and the SFC authorization does not imply official approval or recommendation. There are a lot of factors which may affect the performance of an investment product, e.g. market risks and the performance of the manager. It is therefore important to promote investors' understanding of any new or specialized products. The SFC is committed to educating the public about the nature, special characteristics and related risk factors of new products. We must ensure that our investor education efforts meet the varying needs of our growing and more diverse investor base.

Retail Hedge Funds

Given hedge funds may provide absolute returns or returns with very low correlation to the stock market and there are in fact mutual funds adopting hedge funds like strategies, we believe that retail investors should not be excluded from such investment tools if they are well aware of the nature and related risks of hedge funds.

Our regulatory framework for retail hedge funds provides a good example of how we seek to strike the right balance between giving investors sufficient access to appropriate investment choices while ensuring a proper level of investor protection. Hong Kong is one of the very first jurisdictions in the world to allow the sale of hedge funds to the retail public. This also marked our effort to deregulate rules that inhibit competition and innovation in the fund management industry. We have adopted a multi-pronged approach in discharging our role as a gatekeeper:

(i) First, we assess the acceptability of the hedge fund manager.
(ii) Secondly, we ensure adequate structural safeguards and proper disclosure in the fund set-up. We adopt a market segmentation approach via minimum subscription thresholds for different types of hedge funds.
(iii) Thirdly, we encourage the industry to offer more investor education.

There are now 14 retail hedge funds authorised by the SFC with a total net asset value of about USD1.7 billion as at March 2007. Although the size of authorised hedge funds is relatively small in the context of the whole retail funds universe, the introduction of retail hedge funds does provide investors with an access to a wider range of investment choices.

Exchange traded funds ("ETF")

To enable investors to have access to investment products that can be traded on the Hong Kong Stock Exchange like a listed stock, we authorized the Tracker Fund, being the first ETF, in Hong Kong in 1999. This opened a new panorama of investment opportunities to retail investors. In view of the special features of ETFs and growing market interests, we published specific guidelines for regulating index tracking ETFs in 2003. In June 2005, the SFC authorised the first bond index-tracking ETFs in Asia under the Asian Bond Fund (ABF) 2 project. We have also authorised the first ETF in the world to offer non-Mainland investors access to China A-shares market.

To facilitate product innovation, we have recently authorised an ETF which tracks a commodities futures index. The new commodities futures ETF provides retail investors access to the commodities markets which have previously been difficult for retail investors to gain access to. By listing on the stock exchange, the commodity futures ETF can easily be traded by retail investors like a listed stock.

To date, there are 15 SFC-authorized ETFs. Our ETF market is the largest in Asia ex Japan in terms of market value and turnover and has recorded a significant growth. According to a recent report by Morgan Stanley, the total market value of authorized ETFs in Hong Kong amounted to approximately US$9.55 billion as at 31 December 2006, an increase of 42%

from 2005. This has not taken into account the six ETFs newly listed in April this year which have bought the total market value to US$10.13 billion as at April-end. In terms of turnover, the average daily turnover increased substantially by 180% from 2005 to 2006.

Real Estate Investment Trust ("REIT") market

To further reinforce Hong Kong's leading position as an international financial hub, we introduced a regime for the authorisation of REITs. This was a significant milestone in the development of a new type of investment expertise and a new asset class in the continuing diversification of our financial markets.

REITs widen the product range for retail investors and transform what is otherwise an extremely capital intensive investment into a scalable investment that allows investors to participate in a share of a diversified portfolio of professionally managed properties and enjoy a recurrent source of income, yet without committing substantial amounts of capital. It would be a good long term investment tool.

We are mindful of the development of REITs in the international arena and to apply our rules in a pragmatic manner to deal with issues as they arise, while bearing in mind protection of investors' interest. For instance, in June 2005, the SFC revised the REIT Code to allow investments in overseas properties. Given the limited size of Hong Kong and the fact that most of the properties that are of investment grade are already listed on the Hong Kong Stock Exchange, the opening up of overseas investments significantly enhances the development prospects of the Hong Kong REIT market. Hong Kong can, as a result, provide a platform for the listing of REITs that invest in properties in Mainland China and the rest of the region, thus broadening the investment choices and attracting participation of international investors. In fact, the lifting of geographical restriction was crucial in enabling the listing in Hong Kong of the first REIT in the world with 100% exposure to Mainland properties at the end of 2005.

To date, the six REITs in Hong Kong offers investors a wide choice of properties, including retail properties, commercial properties in decentralised locations in Hong Kong, Grade A offices in Hong Kong, and properties in mainland China. At the end of March 2007, we also saw the listing of the first hotel REIT in Hong Kong.

China Opportunities

No talks would be complete without the mentioning of the PRC market. Hong Kong is strategically positioned to act as a bridge between the Mainland and the rest of the world. Our deeply rooted Mainland connection makes us an attractive platform for international players to invest in the Mainland. On the other hand, Hong Kong serves as an investment platform for Mainland investors looking overseas, thus acting as a conduit for channelling the Mainland's huge savings to the international market.

The QDII (Qualified Domestic Institutional Investors) presents an immense opportunity for industry participants in both the Mainland and Hong Kong to develop new business opportunities. The SFC has been actively working with the Mainland regulators to develop the QDII regime. In April 2007, the SFC signed an MOU with China Banking Regulatory Commission ("CBRC") for cooperation and information sharing with respect to Hong Kong licensed intermediaries who provide services to Mainland commercial banks conducting overseas wealth management business on behalf of their clients. On 11 May 2007, the CBRC issued a new Notice which widens the scope of investment allowed under QDII and Mainland commercial banks are now allowed to invest in a wider range of asset classes, including equities in the Hong Kong stock market and equity funds authorized by the SFC. This will no doubt result in a win-win scenario for both the Mainland and Hong Kong. Mainland investors will be able to enjoy a wider choice of investment products available in Hong Kong, and at the same time benefiting Hong Kong's intermediaries and financial markets.

Conclusion

Hong Kong already has a robust regulatory framework in place, which is bolstered by a large pool of talent, experience and world-class financial services and legal system and a deep, broad pool of well-managed investment products. We hope to continue to attract quality market participants and investors, which will in turn facilitate the growth of the overall market. As a regulator in today's world, our role is not just to regulate but to be facilitative on market developments. We need to keep reviewing our rules and regulations to remove any obsolete requirements and to enhance our regime to ensure that our regulatory standards are in line with internationally recognized standards. We will continue to work in partnership with the industry on market facilitation bearing in mind interests of investors. We will also continue to maintain close dialogue with other regulators, whether in the Mainland or overseas, to enhance co-operation in regulating and developing our markets. All these efforts are important in maintaining Hong Kong's competitive edge and its position as an IFC in the region.

Thank you.