

**The Hong Kong Institute of Directors
Directors' Conference 2008
“Directorship in the 21st Century”**

Regulation and Global Competition

**Eddy Fong
Chairman
Securities and Futures Commission**

9 April 2008

Dr. Moses Cheng, Conference Chairman,
Mr. Peter Wong, Chairman of the HKIoD,
Distinguished guests
Ladies and gentlemen

Introduction

1. I wish to thank Peter Wong for inviting me to this Conference. I am both honoured and delighted to be here this afternoon to speak before, essentially, the leaders of corporate Hong Kong and, I understand, from around the region.
2. I am particularly honoured to be invited because organisers of events such as today's often have a choice between inviting the Chairman of the Stock Exchange or the Chairman of a regulatory body such as the SFC, they normally prefer the former over the latter. The Exchange is viewed as market friendly, optimistic and upbeat, while the Regulator is considered to be dull, cautious and risk averse. Maybe, in the present market turmoil and volatility, Moses and Peter feel that this is the time for the regulator to speak.
3. Today I have chosen to speak on the topic of “Regulation and Global Competition”. But first, I would like to say a few words on regulation to give the bigger picture and to put the issues in perspective.
4. The market situation often has a great impact on the viewpoint of stakeholders and policymakers on what kind of role regulation should play. In good times, the cry from

the marketplace is for less interference. Any regulation that restricts the freedom of the market to conduct its business is viewed as anti-competitive.

5. When a crisis erupts, such as what is happening in the US and Europe at the moment, the mood changes dramatically. There are normally two reactions. First, who is to blame? Why was the regulator asleep at the wheel? Why was a particular type of activity or intermediary or segment of the financial market not regulated? You know, it is always easy to give an opinion after the fact. And, suddenly there are a lot of expert opinions on what should have been done or should not have been done. Hindsight gives us 20/20 vision, and no doubt we can draw invaluable lessons. But it requires foresight to make the right judgment call each and every time and this is not possible in the absence of complete information in a rapidly changing market situation.
6. The market participants and politicians also tend to forget that when the party was in full swing, no one heeded calls for caution. Also, they did not want to hear talk of having more regulation. Worse still, regulators are blamed all the same when the very event they were warning the market against actually happens.
7. The second reaction after a crisis, as history shows us is that there is normally a call for more regulation, expanded powers, or sometimes even an overhaul of the regulatory structure after a crisis happens. Examples that come to mind are the introduction of Sarbanes-Oxley in the aftermath of corporate scandals like Enron. Last week's proposals by the US Treasury to improve regulatory coordination and oversight and to modernise the regulatory structure are the most sweeping overhaul since the Depression. Similarly, there were calls in the UK to review the regulatory arrangements following the failure of Northern Rock.
8. To sum up, there are two points I wish to make. First, regulation cannot guarantee zero failures or against crises happening. For financial markets to remain robust and well-functioning, it calls for self-discipline, market discipline and regulatory discipline to be exercised by the different stakeholders in the marketplace. In this respect, corporate directors have a major role to play.

9. Secondly, regulators have to ensure that there is not too much regulation or too little regulation. Regulators have to decide on a regulatory framework that protect public interest and maintain market confidence, while not hindering the ability of a financial market to provide competitive financial products and services. In other words, achieving regulatory balance.
10. I will now return to the topic of my talk today on *Regulation and Global Competition*.
11. In preparing my remarks, I asked myself four questions.
 - First, why is the regulator often accused of being anti-competitive? In this regard, I will examine why there had been calls for less regulation.
 - Second, how do regulators achieve regulatory balance? I will touch on the international experience.
 - Third, what is the approach of the SFC in achieving regulatory balance in Hong Kong?
 - Finally, how does Hong Kong as a whole measure up?

The call for less regulation

12. Now, on my first question: is regulation anti-competitive? I agree that regulation can be stifling, anti-competitive and costly. This can happen where financial innovation is not encouraged or is only allowed with such restrictions that reduce its attraction, or where new market entrants are restricted, or where there are unnecessary or obsolete regulations.
13. What is important to the business community is that regulation does not impede competition and create unnecessary administrative procedures that is both time consuming and costly. For example, New York's regulatory regime is often cited as one of the reasons for its loss of competitiveness as market participants move their business to jurisdictions such as London where regulation is considered to be more efficient. The US Treasury report I mentioned earlier had identified the need to reduce redundancies and gaps in regulation.

14. As I see it, there are four developments in capital markets that had led to calls for less regulation. One was the listing of demutualised stock exchanges that transformed exchanges into for-profit organisations. In pursuit of revenue sources and profit for shareholders, exchanges had asked for a relaxation of trading rules in order to facilitate more transactions, and a shorter time to market to launch new products.
15. To retain star performers, intermediaries had attractive compensation packages that rewarded generously those that brought in the most business. Industry wanted minimal interference in this area, but as we have seen sometimes the incentive structures encouraged excessive risk taking by staff in order to earn huge bonuses.
16. Another area where there was a call for less or no regulation was in respect of hedge funds, as they brought in huge business to prime brokers and helped to create deeper and more liquid markets.
17. Finally, as the number of high net worth clients grew, coupled with a search for higher yield in a low interest rate environment, there were calls for a lighter regulatory regime for this category of investors compared to the regime that was in place for retail investors.

Regulatory balance – the international experience

18. According to various studies, the regulatory environment is one of the critical success factors of international financial centres. Other factors that have been identified for the success of London and New York are the availability of skilled people, product innovation and market liquidity.
19. In fact, an effective regulatory environment is a brand name that stands for quality market and integrity, and where markets can expect the regulators to act and enforce in a consistent, certain and predictable manner.
20. The quality of a market is judged by whether it is efficient, orderly and fair and whether investors are treated fairly. Other factors include the choice of products, the

variety of players, as well as the availability of alternative trading platforms to meet the demands of the market.

21. You would appreciate that this calls for the regulator to play a balancing act between creating an enabling environment for market innovation and development and ensuring that the interest of investors is not compromised.
22. Some commentators have expressed concern that competition would result in a race to the bottom in the regulation of financial markets. Experience shows that major financial centres have been conscientious in ensuring that their regulatory framework is benchmarked to international standards and best practices.
23. In addition, regulators are also mindful of the need to ensure that regulation does not impede the ability of the market to innovate and remain competitive. For example, the Sarbanes-Oxley Act (SOX) was introduced in response to corporate scandals like Enron and Tyco. However, over time there has been criticism that SOX and other post-Enron regulations have severely hampered the competitiveness of the U.S. capital markets. In this regard, increased compliance costs (that far exceed the benefits of the tightened regulations) have been a controversial issue since the implementation of the Act in 2002. On the other hand, we see that much commentary has held up the U.K. regulators as having model regulation, which is principles-based.
24. The balancing act is also evident in the US Treasury report I mentioned earlier. While the US is attempting to revamp the regulatory structure to plug gaps and weaknesses in regulatory oversight, it also considered the need to modernise the structure to improve efficiency and ensure the competitiveness of the US capital markets. Let me elaborate.
25. The report had called for a merger of the US Securities and Exchange Commission (SEC) with the Commodities and Futures Trading Commission (CFTC). This is because with globalisation and the convergence of products and participants, the separate regulation of capital markets by the SEC and CFTC has become “untenable, potentially harmful, and inefficient”. For example, the report recommends statutory

changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors.

26. The report also recommends that the SEC modernises its regulatory structure and adopt a more principles-based approach as is the practice of the CFTC. As I mentioned earlier, the UK's principles-based approach has been viewed by the market to be more flexible and efficient.

The SFC's approach to regulation

27. In Hong Kong, we adopt international standards of securities regulation established the International Organisation of Securities Commissions (IOSCO). In addition, the Securities and Futures Ordinance (SFO) provides for the SFC to promote a competitive securities industry and to be mindful of the need for Hong Kong to remain competitive as an IFC, over and above the normal objectives of securities regulation. To sum up, what this means is that the SFC is entrusted to –
 - Regulate and enforce to protect investors and maintain market stability;
 - Facilitate market development and innovation so as to maintain a competitive securities industry and Hong Kong's status as an IFC; and
 - Educate investors.
28. What the SFC is doing is to look closely at how we discharge our statutory role with a view to cutting back red tape and unnecessary bureaucracy. We deregulate in areas where rules, processes or regulations create structural barriers to efficiency and competition or where they are obsolete or create unintended consequences because of changes in the operating environment.
29. At the same time, we would tighten regulations, or re-regulate, where the regulations are deficient in achieving the desired regulatory outcomes, again because of changes in the operating environment, loopholes or regulatory gaps. Regulation and deregulation are not inconsistent, and in fact are complementary in achieving the regulatory objectives.

30. Investor education is an important complement to regulation, as it helps to empower the investor with basic knowledge of products and their risks, their rights, responsibilities and where to channel complaints of unfair treatment or misconduct. Enlightened investors would be equipped to ask the right questions, make informed decisions and be more alert to scams.
31. In addition to consulting the market on proposed regulatory changes, the SFC also works with the industry on enhancing efficiency. For example, the SFC announced in June last year a set of initiatives to streamline the licensing procedures for overseas fund managers wishing to operate in Hong Kong. Under the streamlined procedures, there are now cases where fund management companies can obtain their licences within four weeks.

How does Hong Kong stack up?

32. In March, the City of London published its third Global Financial Centres Index, which ranked Hong Kong third after London and New York only, but marginally above the fourth position. Hong Kong retained a strong position in the five key competitiveness areas, namely people, business environment, market access, infrastructure and general competitiveness.
33. These rankings serve a useful purpose for financial centres to benchmark their performance. Hong Kong must remain vigilant to ensure that healthy competition continues to thrive. It must identify areas where it is not competitive and close the gap. Most importantly, Hong Kong must continue to keep an open mind and adapt to changes in market trends, so that it does not get left behind.
34. Hong Kong has enjoyed a unique position in being the first stop for capital flowing to and from the Mainland. The Hong Kong platform for fund raising by Mainland enterprises has helped to boost the status of Hong Kong as an IFC. Going forward, the asset management industry in Hong Kong would enjoy a boost as more and more of Mainland asset managers come to Hong Kong. Hong Kong has and will continue to help Mainland enterprises to embrace good corporate governance and benchmark themselves to international best practices. The mutual benefits are obvious as both our

economies have enjoyed prosperity.

35. On the part of the SFC, we believe in providing an enabling environment that would help to create a critical mass and clusters in terms of players, products and alternative trading platforms. We would manage the natural tension between regulation and market development to achieve the appropriate regulatory balance so that the objectives of the SFO are achieved.
36. As directors of your own organisations, be it a listed company or a financial intermediary, you play a key role in instilling a culture of discipline and integrity in your organisations. Your exercise of self-discipline in this regard is a great complement to the SFC's regulatory discipline. Together with market discipline, our combined efforts would contribute to ensuring Hong Kong's continued success as an IFC.
37. Thank you.