



SECURITIES AND  
FUTURES COMMISSION  
證券及期貨事務監察委員會

## Regulatory Challenges and Responses

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# SECURITIES AND FUTURES COMMISSION

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This document sets out the key regulatory challenges and issues the SFC faces over the next three years (2006/07-2008/09). It also identifies the key strategic initiatives we will implement to respond to these challenges.

# **INVESTORS FIRST**

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## INTRODUCTION

1. Our purpose is set out in the Securities and Futures Ordinance.
2. We are responsible for administering the laws governing the securities and futures markets in Hong Kong and facilitating and encouraging the development of these markets.
3. Our statutory regulatory objectives as set out in the SFO are:
  - to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - to promote understanding by the public of the operation and functioning of the securities and futures industry;
  - to provide protection for members of the public investing in or holding financial products;
  - to minimise crime and misconduct in the securities and futures industry;
  - to reduce systemic risks in the securities and futures industry; and
  - to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.
4. The strategic initiatives in this document address at a strategic level, risks to our regulatory objectives.
5. This document looks at the overall environment in which we sit, identifies regulatory risks and challenges we face and presents the key strategies we will implement over the period to address them. In many cases, strategies to address these issues are already in place.

## OVERVIEW

### We Regulate

6. Hong Kong is a strong and vibrant market place. It has a reputation for open markets and innovation. Investors need to be able to rely on markets having strong integrity, on financial products that are sound and clearly explained, and on advisors and intermediaries that are accessible and have high standards of conduct. Many of the strategic responses in this document reinforce our commitment to strong but well-balanced regulation. In the three-year period we will focus on tightening standards of corporate governance and behaviour, on improving the regulation of investment products and on enhancing the standard of intermediaries' conduct through vigorous gatekeeping and supervision.

### We Enforce

7. Effective regulation needs to be backed by credible enforcement. In our strategy we continue to build our enforcement capability, recognise the challenges presented by possible increases in our responsibilities and we seek to address the difficulties posed by cross-border activity.

### We Educate

8. The laws of Hong Kong, the statutory objectives of the SFC and our codes and guidelines set the overall regulatory framework. However, investors have their own part to play. The SFC has long believed that well-informed, financially literate investors are the first line of defence against fraud and bad practice. For this reason, we will continue our strong efforts in investor education and communication.
9. Taken together, these objectives will provide better safeguards for investors – consistent with our overall objective of putting “Investors First”.

### We Facilitate

10. While our primary role is to regulate the securities industry, we recognise that we have a role to play in allowing a healthy industry to develop. We also have a role to play in supporting Hong Kong's continued development as an international financial centre.
11. Our strategy acknowledges our role in facilitating the introduction of new financial products and the start-up of new financial intermediaries in the market-place. It also addresses the part we play in keeping Hong Kong at the forefront of international regulatory thinking and practice. As markets become more global, as financial intermediaries operate across borders, the SFC needs to play its part in shaping, and keeping up with, international regulatory practice.

### **How we go about our task**

12. We have a responsibility to regulate fairly and be as transparent as possible, given our role as a regulatory and enforcement agency. We will always seek to find the right balance in our regulatory approach so as to not inhibit market development.
13. We will also continue to move down the path of risk-based regulation: picking the important problems and addressing them.
14. Regulators have finite resources and it is important we use those resources to serve the investing public in the best possible way. This means we often have to prioritise between competing matters and sometimes make a decision to not resource a matter or initiative.

### **Achieving our objectives – Our people**

15. We can only achieve our objectives through the efforts of the people who work at the SFC. We are committed to attracting the best possible talent and providing interesting and rewarding careers for them. We will continue to improve the working conditions for our staff and provide training and development opportunities.

## THE ENVIRONMENT

16. The Hong Kong economy recovered from the set-backs of a few years ago and appears to be on an upward track. In 2004-2005, growth rates rose, unemployment fell and property prices showed a marked increase.
17. The stock market has also had solid momentum over the past year – both in terms of turnover and market capitalisation.
18. New equity raisings are high, with at least one third of these over the past year being for Mainland enterprises. The proportion of Mainland fund raising continues to increase.
19. Looking more widely, interest rate increases in the US, exchange rate volatilities, oil price movements and volatilities in major stock markets pose some threats to the Hong Kong economy. Most economists and analysts believe that Hong Kong should be able to maintain good, but slower economic growth in the years ahead.
20. At the same time, flows into Hong Kong based managed funds remain healthy. The funds management industry continues to grow both in size and in the variety of products available to the market. Most inflow is from outside Hong Kong, as the market here continues to develop. Continued emphasis on the need for people to build their own retirement income should see retirement based products continue to grow and the need for advice become more apparent.

## REGULATORY CHALLENGES AND RESPONSES

*In this section we set out the key regulatory issues and challenges in the markets that we regulate and how we respond to those challenges over the next three years.*

### **Challenge One: Improving standards of corporate governance and behaviour**

21. In any fast-growing market it is important that appropriate standards of corporate governance are achieved. Companies and their directors must make decisions that are in the interests of shareholders and they need to have practices and processes in place to ensure those decisions are properly taken. Companies also need to make sure they properly disclose relevant matters to the market-place and be properly accountable to shareholders.
22. Over the coming period we are likely to see a significant number of listings on the stock exchange. We anticipate a significant number of Initial Public Offerings by companies from the Mainland. This provides considerable growth and development for the Hong Kong market. While initial offerings by companies need to meet the listing criteria of Hong Kong Exchanges and Clearing, there are risks that governance standards in newly listed companies are not as well developed as more established companies. Our Dual Filing team continues to work closely with HKEx in monitoring these issues.
23. The role of sponsors in bringing new ventures to market is an important one. We are concerned that not all sponsors are meeting the required standards or being as diligent as they should be. We have underway a number of enforcement actions against sponsors and we will continue to supervise their conduct.
24. We also expect continued merger and acquisition activity and we continue to efficiently administer the Codes on Takeovers and Mergers and Share Repurchases to ensure affected shareholders are fairly treated.
25. The Government has proposed giving statutory backing to certain of the HKEx Listing Rules. This will mean that some of the tasks now performed by the Stock Exchange will transfer to the SFC and that a breach of the Rules will become a breach of the law. We believe this initiative will further improve the governance of companies and promote investor confidence. While the final form of the legislation and its commencement is not yet certain, it will involve a changed and increased role for the SFC both for regulating and enforcing. We are assessing what resources we will need to devote to this role, what training we will need to provide to our staff and what our processes and work practices will be.
26. We recognise that the profile of our regulatory staff, work practices and enforcement capability will depend on the final form of the legislation which will enact statutory backing of the Listing Rules.
27. We also recognise the challenge posed by cross-border regulation. For example, our



ability to gain access to and take action against directors of Mainland companies listed in Hong Kong and the companies themselves is to some extent limited. Inability to take action against such Directors can damage the reputation of Hong Kong markets.

**What we'll do -**

**To promote consistently high standards of corporate governance and behaviour across the Hong Kong market we will -**

- 1.1 enforce relevant laws and regulations**
- 1.2 pay particular attention to IPOs and M&A activity**
- 1.3 work with Government and other agencies to improve cross-border enforcement**
- 1.4 supervise and enhance the sponsor regime**
- 1.5 effectively implement statutory backing of the Listing Rules (when approved)**
- 1.6 communicate to all relevant stakeholders, our regulatory stance and our approach to enforcing the statutorily backed Listing Rules**

**Challenge Two: The increased exposure of retail clients to complex and structured products, and differences in how financial products are regulated**

28. Complex or structured products have found their way to the retail market at an unprecedented speed. These products are reaching retail investors through various channels, for example by brokers, banks or insurance intermediaries. There is a risk to investors if they do not properly understand these products or if they are not being properly advised.
29. Risks also exist where products have very similar economic characteristics but may be regulated differently because of their different legal forms. For example, sales of insurance products are regulated differently from sales of funds, even though they can have similar characteristics and investment objectives. Each of these issues provides fertile ground for mis-selling.
30. As product and market convergence increases, the importance of a consistent approach to regulation across the financial sector becomes more acute.

31. Further, as the population ages and as the personal responsibility to fund retirement incomes increases, the impact of mis-selling rises.

**What we'll do –**

- 2.1 monitor how investment advisors comply with requirements for competence, disclosure and quality of advice and where necessary propose changes to improve standards**
- 2.2 enforce the regulatory obligations of product providers and intermediaries**
- 2.3 work with Government and other agencies to address gaps and inconsistencies in the regulation of sales practices of functionally similar products**
- 2.4 review our practices internally to address gaps and inconsistencies in the regulation of functionally similar investment products**
- 2.5 further enhance our investor education work and promote informed investing**

**Challenge Three: That a significant market event or economic downturn may result in corporate, intermediary, fund, or broker failures. This could lead to systemic risk in the market.**

32. While current economic indicators are relatively benign, there is a risk that financial and corporate sector participants become complacent. Failure of a market intermediary can have a severe impact on its clients. It is for this reason that the SFO sets out prudential requirements for intermediaries.
33. We carry out a number of inspections on brokers and other intermediaries (licensed corporations) to monitor their compliance with their capital and other prudential obligations. However, this does not mean that no intermediary will encounter financial difficulty or even, fail. In the corporate sector generally (such as listed companies which have no statutory prudential obligations), the risk of failure by a company is one of the normal risks of free capital markets. However, listed companies and their directors are under an obligation to disclose price sensitive and other relevant information to the market.
34. Failures of market participants can affect overall market stability. Recent developments in the market (such as increased hedge fund activity and increasing use of complex financial instruments) imply that the impact of a shock or downturn may not be predictable and that such events may eventually give rise to systemic issues. International regulatory bodies are paying close attention to these factors.

35. With the risk of natural disasters, pandemics, and acts of terrorism ever present, their effect on both the local and global markets should not be underestimated. Therefore, market participants, regulators and market operators must have properly implemented and tested contingency and business continuity planning procedures in order to deal with the after-effects of such incidents and to protect investors' assets.
36. We continue to be concerned about the practice of "pooling" in securities margin financing. We have already taken steps to address this issue and intend to put in place a balanced package of measures that would offer better protection to investors, while being cognizant of the impact on the industry.

**What we'll do-**

- 3.1 encourage market operators and licensed corporations to continue assessing their ability to cope with the impact of a major market event, natural disaster/pandemic or an economic downturn, and to put in place and test appropriate contingency and business continuity plans.
- 3.2 further develop our own market risk monitoring system and indicators
- 3.3 work closely with HKEx to enhance its risk management system
- 3.4 monitor licensed corporations' compliance with their capital and other regulatory obligations
- 3.5 In the event of intermediary failure, act promptly to mitigate losses to investors
- 3.6 enhance the regulatory regime to reduce pooling risks in securities margin financing
- 3.7 enforce the regulatory obligations of licensed corporations and listed companies

**Challenge Four: Keeping Hong Kong at the forefront of international financial markets and promoting regulatory best practice**

37. One of the Regulatory Objectives of the SFC is to "*Maintain and promote the .... competitiveness.... of the securities and futures industry*". This objective is met in a number of ways – for example, considering new products (such as REITs), licensing new participants and working with HKEx on a number of listing related issues.
38. While our role is primarily to regulate the market, we work with the Government and other organisations (such as HKEx) to facilitate the further development of Hong Kong as a major financial centre.

39. In part this can be fulfilled by supporting the promotion of Hong Kong and by market facilitation, but it is also discharged by advocating a modern, consistent and appropriately rigorous regulatory architecture and apprising the Government of international developments and regulatory best practice. Capital tends to flow to markets which are open and functionally consistent, and which have strong integrity.

**What we'll do-**

- 4.1 monitor new product and market developments and respond promptly**
- 4.2 monitor the performance of HKEx and work with them to strengthen market infrastructure**
- 4.3 promote changes to the Hong Kong regulatory regime in line with international best practice**

**Achieving our objectives – Our people**

40. Our people are our most important asset. We have a commitment to attract, develop and lead a team of skilled and enthusiastic staff in a competitive employment market. Our initiatives in this regard include:
- continue to improve the work environment and conditions
  - monitor market remuneration and pay our people in line with market benchmarks
  - devote appropriate funding to training and development
  - provide opportunities for staff advancement
  - work toward a more flexible workplace
  - communicate our goals and priorities to our staff.

**Achieving our objectives – Our processes**

41. The SFC has consistently met its statutory objectives over a number of years. However, we are committed to continually reviewing and improving how we do things.
42. Like any regulator, we have finite resources. It is important that we use those resources efficiently and effectively. Our initiatives in this regard include:
- greater use of risk analysis to deal with the most important issues – and move resources to match needs
  - state our objectives clearly and explain our practices plainly wherever possible
  - develop and implement up-to-date systems which provide services to stakeholders and run our business
  - effectively manage our costs and account for the money we spend

- continue to develop practices and processes which are consistent and as transparent as possible.