**International Regulators Seminar 2007**
**Financial Services Authority**
**London**

**3 December 2007**

*"Developments in the Capital Markets of China and Hong Kong"*

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Good morning.

1. I am both honoured and delighted to be here this morning. This seminar is a flagship of the FSA for regulators of financial systems and markets around the world, and I welcome this opportunity to speak before such a distinguished gathering. We are all part of the community that has the responsibility to ensure the maintenance of sound and well-functioning financial markets, the cornerstone for the conduct of finance and commerce that promote economic prosperity. Personally, it is always a pleasure to be in London.

2. I have been asked to talk about the day-to-day challenges that we at the SFC face. I shall focus my remarks on the challenges and opportunities for Hong Kong as China develops its capital markets and its importance in global markets grows.

3. China's economic progress has been remarkable. A country of 1.3 billion people, China's GDP has grown at an average annual rate of 9 per cent over the past 30 years. According to the World Bank, of the 3.9 per cent of global economic growth, China contributed 0.5 percentage points. It overtook Japan as the third largest exporter after the US and Germany in 2004, and has created 120 million new jobs and pulled 400 million people out of poverty over the past 20 years. The foreign reserves of China amount to US$1.43 trillion.

4. Mainland companies have raised large amounts of capital from global capital markets. In November, PetroChina which is listed in Hong Kong, made its debut trading in Shanghai, while Hong Kong saw the listing of another Mainland company, Alibaba.Com. PetroChina surged 163% on its debut, pushing up its market capitalisation to become the first US$1 trillion company in the world. Alibaba was 257 times over-subscribed in Hong Kong, receiving orders of US$57 billion.

5. The world has witnessed the rapid emergence of the Chinese economy and growth of Mainland enterprises. Its growth remains strong, registering a third quarter year-on-year growth of 11.5 per cent. It is therefore not surprising that China's capital market is attracting the interest of global investors wishing to participate in its growth story. The rapid growth of China's capital market has created huge opportunities for Hong Kong and also poses some challenges.

6. In the next few minutes, I shall talk about the development of China's stock market that has evolved through various reforms, how it has shaped Hong Kong's capital markets and the regulatory challenges that have arisen.

**Development of China's Capital Market**

7. The Mainland stock market began in late 1980s. The existing two stock exchanges in the Mainland, namely the Shanghai Stock Exchange and the Shenzhen Stock Exchange were established in 1990. There are "A-shares" and "B-shares" listed and traded in these two exchanges. "A-shares" are issued by companies incorporated in China, but they are reserved exclusively for trading by Mainland residents and, since December 2002, a small number of approved Qualified Foreign Institutional Investors (QFII). Otherwise, since 1992, foreigners are only allowed to trade "B-shares" issued by these companies. Currently, the size of the B-shares market is insignificant as compared to that of the A-shares market.

8. The Mainland investors welcomed the opportunity to invest in stocks in late 1990s and 2000 with great enthusiasm, as its economic success had built up a huge pool of savings that found limited avenues for investment and there are restrictions on investments abroad. Moreover, the free float of shares available to the public was quite small, and these factors resulted in the P/E ratio of the Mainland stock market reaching 60 times during that period.

9. In mid-2001, the Central Government decided to implement a number of measures to improve market structure. One of the foremost measures was to sell state-owned shares to the market. Until then, most of the large listed companies in the Mainland were owned by the State which held on average about two-thirds of the entire shareholding of a listed company. The stock market reacted with a sharp fall in the index, as the reform measure would substantially increase the supply of tradable shares. The Central Government decided to step back and suspend the plan. Nevertheless, market sentiment was weighed down by the expectation that sooner or later the Central Government would proceed with its plan to reduce the shareholding of the state. From mid-2001 to early 2005, the A-shares market in the Mainland consolidated by more than 50% even though the real GDP of China increased from 6.6% in 2001 to 9.9% in 2005.

10. At the end of April 2005, the China Securities Regulatory Commission (CSRC) announced a plan to convert the state-owned shares into tradable shares in phases, and to stop any new IPO activity immediately to support this share reform programme. The state-owned shares are known as legal person shares and they are not tradable. Currently, over 90% of the state-owned companies have already completed their share reform. However, while the shares are now tradable, the amount of free floating shares remains relatively small. In June 2006 the IPO suspension was lifted and Mainland companies were once again allowed to raise capital through new IPOs.

11. As at the end of October 2007, the aggregate market capitalisation of the two Mainland stock exchanges in Shanghai and Shenzhen was about US$3,755 billion. In terms of market capitalisation, the Mainland stock market is the 2$^{nd}$ largest in the region after Japan.

12. As you can see, China's stock market has undoubtedly made significant progress. Also, Mainland Chinese companies have gained prominence in global capital markets. In this regard Hong Kong has played an important role in the integration of Mainland and global capital. There are two aspects to this unique and important bridging role that Hong Kong plays:

- First of all, Hong Kong acting as a premier fund raising centre for Mainland enterprises – that is basically, our role in bringing international capital into the Mainland.
- And secondly, our role as a platform for Mainland investors looking to invest overseas – or in other words, our role in channelling the Mainland's huge savings to the world.

**Hong Kong as a Premier Fund Raising Centre**

13. On Hong Kong's role as the platform for Mainland companies to raise capital, this started in the 1980s with the listing of "red chips". This was followed by the listing of "H-shares" in 1993. The first H-share company listed on the Stock Exchange of Hong Kong was Tsingtao Brewery Company Limited – maker of the famous Tsing Tao beer. For those of you who may not be familiar with Mainland stocks, "H-shares" (e.g.PetroChina) are foreign shares issued by enterprises incorporated in China that are primarily listed in Hong Kong and traded in Hong Kong dollars. "Red-chips" are shares issued by companies with business, assets, markets and ownership that have a strong Mainland orientation, but the companies are incorporated outside China. China Mobile, the largest market cap mobile phone company in the world, is an example of a red chip. During 2005-2006, as a result of the suspension of IPO activity in the Mainland, the listing of H-shares companies on the Hong Kong stock market accelerated.

14. Now, some numbers to illustrate the importance of these Mainland companies in Hong Kong. At the end of October 2007, there were 144 H-shares listed in Hong Kong accounting for US$816 billion or 28 per cent of market capitalisation and 36 per cent of market turnover for the 12 months ending October. The corresponding numbers for the red chips are 91 companies, US$798 billion or 27 per cent of market capitalisation and 13 per cent of turnover.

15. Hong Kong's stock market is now among the top in the world mainly because we have successfully captured the opportunities from the Mainland.

- In terms of market capitalization, Hong Kong's stock market is the 3rd largest in Asia after Japan and the Mainland. As at the end of October 2007, our total market capitalization was about US$2,958 billion. Mainland enterprises (that is H-shares and red chips) accounted for 55 per cent of our total market capitalization.
- In 2006, Hong Kong's stock market has recorded a strong growth in terms of market turnover. Total market turnover increased by 85 per cent to US$1,074 billion, as compared with the previous record in 2005. The sharp increase in market turnover was due in a large part to the strong trading interest in Mainland-related stocks. During 2006, Mainland-related stocks including both H-shares and red chips accounted for 43% of our total market turnover.

So far this year, i.e. up to the end of October, the average daily market turnover was US$10.5 billion, compared to US$4.3 billion in 2006.

- Hong Kong also ranked 1st in Asia and 2nd in the world (after London) in terms of total funds raised through IPOs in 2006. A total of US$43 billion was raised here in 2006, 88 per cent of which was accounted for by Mainland enterprises. For the first ten months of this year, total IPO funds raised amounted to US$26.1 billion.

16. Moreover, some of the world's largest IPOs have taken place in Hong Kong. For example, last year we saw the listing of the Industrial and Commercial Bank of China, which is one of the four large state-owned banks on the Mainland. It raised about US$16 billion in Hong Kong. We also saw the listing of another state-owned bank, the Bank of China last year which raised about US$11 billion. In April this year, we saw the listing of another large Mainland commercial bank, China CITIC Bank, which raised over US$4.2 billion in the market. As mentioned earlier, Alibaba was the most spectacular issue this year, receiving total subscriptions of US$57 billion.

17. Hong Kong enjoys a unique advantage that make it an ideal fund raising centre for Mainland enterprises:

- First, one country two systems. The Mainland market is at a development stage with institutional constraints (such as capital controls), and Hong Kong is an established international financial centre ready to provide an invaluable service to Mainland companies seeking global capital.
- Our second advantage is that we are ideally positioned to act as a bridge between the Mainland and the rest of the world. We enjoy close relations and proximity to the Mainland, and are also familiar with the languages, culture, practices and systems on the Mainland.

18. I have to point out that apart from a need to raise capital in the early days of China's emergence, the reason for listing Mainland companies in Hong Kong was motivated by a conscious and deliberate policy to expose and subject Mainland enterprises to Hong Kong standards and fast track their transformation to world class companies that meet international norms on governance and performance.

19. Hong Kong's regulatory and corporate governance standards and our Listing Rules are on a par with international standards, and as a TC member of IOSCO our securities regulations are benchmarked to IOSCO's principles. Mainland enterprises must comply with Hong Kong's requirements before they can be listed here. Moreover, professionals in Hong Kong who work on the listing of a Mainland enterprise can help companies raise their corporate governance standards and gain credibility and recognition among international investors. As these enterprises become accustomed to international standards and practices, their conduct and governance would help to enhance the quality of the Mainland markets. Today, many Mainland enterprises are also listed in New York and London and their appeal to investors and markets is growing.

20. International investors looking to tap into the fast growing China market can invest in H-shares and red chips in Hong Kong. They can take comfort in knowing that

Mainland companies listed here meet international standards and practices, and be assured of the institutional and legal infrastructure of a thriving international capital market.

21. So, that is Hong Kong's role as a prime fund raising centre. I turn now to our role as a platform for Mainland investors looking to invest outside of China.

**Hong Kong as a Platform to Channel Capital**

22. Currently, there are still restrictions on overseas investments and cross-border capital flows on the Mainland, but these barriers to capital flow are gradually being relaxed. The Mainland's QDII scheme – Qualified Domestic Institutional Investor scheme – is a good example. The scheme was launched in 2006 and the objectives of the QDII scheme are:

(1) widen investment opportunities for the enormous amount of savings and minimize risks through portfolio diversification;
(2) create a more balanced two-way flow of capital;
(3) provide a training ground for Mainland investors; and
(4) converge with international practices and raise the regulatory framework in the Mainland.

23. Under the scheme, banks, fund management companies, brokers and insurance companies approved by the Mainland authorities are allowed to invest their own funds or those of their clients in certain types of financial products offered in overseas markets including Hong Kong. The largest allocation is US$19.5 billion granted to five fund managers for them to offer offshore wealth management services, followed by US$16.6 billion granted to 21 banks.

24. The scope of the QDII scheme for banks was widened from investment in fixed income securities to include equity investments. There are conditions attached to such equity investments:

- Individuals have to invest a minimum of RMB 300,000 (or US$40,540).
- Stocks can account for up to 50% of the net value of a QDII product, with the net value of a single stock capped at 5%.
- QDIIs are only allowed to invest in equities and equity funds authorized by a supervisory authority with whom CBRC has a MOU.

25. The SFC signed an MOU with CBRC in April which would allow for co-operation and information sharing with respect to Hong Kong licensed intermediaries who provide services to Mainland commercial banks conducting QDII business. This MOU has established a solid foundation for effective regulatory co-operation between the Mainland and Hong Kong and will enable Hong Kong to play a more active role in Mainland's development of the overseas wealth management business.

26. On 20 August 2007, SAFE (the State Foreign Exchange Administration) announced a trial program to allow retail investors to invest directly in Hong Kong's stock market, namely, the "Through Train" Scheme. The operational

details are being studied by the Mainland authorities, which have to take into consideration four elements as stated by Premier Wen Jiabao:

- Beijing must promulgate a law to regulate outward Mainland funds to minimise the shock to the Mainland capital market;
- Make "scientific judgment and analysis" on the possible negative impact on the Hong Kong market;
- Raise the awareness of risk of Mainland investors and their understanding of the HK market; and
- Seek the opinions of related financial regulators, including those in Hong Kong.

27. When the "through train" was first announced, market sentiment in Hong Kong was boosted amid the turmoil of the sub-prime crisis. The index rebounded strongly as investors picked up more stocks in anticipation of a huge inflow of capital from the Mainland. As it will take some time for the operational arrangements to be completed, the exuberance has moderated somewhat recently.

28. The QDII and "through train" schemes open up opportunities for both the Mainland and Hong Kong, and in both cases, these include opportunities for immediate and longer-term benefits.

29. From the Mainland's perspective –

- The immediate effect is that the scheme provides an opportunity for some of the US$5 trillion pool of savings in the Mainland to be invested in a wider range of financial products in international financial markets, thereby giving investors the benefits of choice, better return and risk diversification.
- In the longer run, the scheme will expose Mainland financial institutions and investors to the attributes of mature markets, where competition produces both choice and quality in products and services and the protection of investor rights. Over time, Mainland financial institutions and investors that have had this experience would come to expect similar standards of conduct and service in the Mainland. This has the potential to induce financial services providers in the Mainland to invest in improving their business model towards the standard and quality abroad. In essence, the QDII scheme would help to develop a pool of professionals and informed institutional investors to take the development of China's capital market to the next level.

30. The schemes offer opportunities for Hong Kong to serve as a platform for the distribution and channelling of Mainland savings, generating business opportunities for the different sectors of our financial services industry. Hong Kong is well-positioned to play this role:

- Hong Kong offers a broad range of investment products ranging from low risk funds (such as bond or money market funds) to more sophisticated and specialised products (such as REITs, ETFs and hedge funds). We are also a leading fund management centre in Asia and our fund management industry has an international and offshore nature. Around 60% of our investment funds are sourced from outside Hong Kong and the majority of assets are invested outside Hong Kong. Hong Kong therefore has much to offer in terms of skills, experience and advisory services and can play a key role in advising Mainland institutions seeking to invest overseas.

- Other large international firms with primary focus on institutional investors already have an established network to international capital markets and sophisticated products and services. So, again, they will be able to play a key role in advising Mainland institutions seeking to invest overseas.

31. That covers our second role in channelling Mainland's investment funds to overseas markets. I will now briefly discuss the impact of the Mainland stock market on Hong Kong.

**Regulatory Challenges**

*Increasing market volatility*

32. I mentioned earlier that Mainland enterprises now account for 54 per cent of the market capitalisation of our stock market. Some of these Mainland enterprises also have A-shares listed domestically in Mainland stock exchanges. As a result of the dual listings of the Mainland enterprises, the stock market in Hong Kong is not only correlated with major international stock markets, but is also increasingly affected by the Mainland stock market.

33. With further integration and linkages between the Mainland and Hong Kong markets, we expect that our market could become more volatile. This is an area which we as a regulator are giving increasing attention to.

*Closer regulatory cooperation*

34. The dual listings of A- and H-shares also require much closer coordination between exchanges in Hong Kong and China. On 23 April 2007, trading of the A-shares of China Life was suspended before market opened at 9:30 a.m., whereas trading of the H-shares in Hong Kong was allowed during the pre-opening period. As a result, 8 million shares were matched in Hong Kong. These incidents show that we need to review the trading suspension policy and mechanism between the Mainland and Hong Kong stock markets to minimise confusion.

*Enforcement issues*

35. The listing of Mainland enterprises in Hong Kong has also increased our difficulty in taking enforcement action, because the bulk of the operation and assets of these Mainland enterprises are in China. To conduct an investigation on these Mainland enterprises, we need the regulatory assistance from Mainland regulators such as the CSRC.

36. The SFC has long enjoyed a very warm, constructive and mutually respectful relationship with the CSRC. In 1993, the Mainland and Hong Kong entered into a Memorandum of Regulatory Cooperation – what we commonly refer to as the MORC. There are five parties to the MORC – ourselves the SFC, our counterpart the CSRC and the three stock exchanges, that is the Shanghai, Shenzhen and Hong Kong stock exchanges.

37. The MORC was entered into in recognition of the increasingly close relationship between the Mainland and Hong Kong markets and the corresponding need to establish and foster regulatory cooperation for the protection of investors and preservation of market integrity. A main focus was to facilitate consultation and cooperation through regular liaison and exchange of personnel.

38. I think it is fair to say however that both sides recognize that whilst the MORC is helpful, more needs to be done particularly in terms of cooperation in enforcement. On 30 March 2007, the SFC and CSRC exchanged side letters to the Memorandum of Regulatory Co-operation and the Memorandum of Regulatory Co-operation Concerning Futures. The side letters will further enhance the ability of the two regulatory agencies to co-operate in the investigation of cross-border crimes and regulatory breaches.

39. Under the new arrangements, the SFC may request assistance from the CSRC in obtaining information in the Mainland for SFC investigations. If a person from whom the information is sought refuses to comply, the CSRC may seek court sanctions against that person. This power for the CSRC to compel the provision of this information has been made possible by amendments to Mainland securities laws last year. Previously, the SFC had to rely on the CSRC seeking voluntary co-operation from persons from whom information was sought.

40. The SFC will also be able to exercise its investigatory powers to help the CSRC in its investigations that have a Hong Kong element.

41. It is worth noting also that the CSRC has made considerable effort to implement the IOSCO Objectives and Principles of Regulatory Cooperation, and you may be aware that at the IOSCO Annual Conference in April 2007 in Mumbai, the CSRC became a full (Annex A) signatory to the MMOU.

*Strengthening the listing regime*

42. Besides cooperation with the Mainland financial market regulator, the SFC is also adopting a number of initiatives to strengthen the quality of companies listed in Hong Kong, including Mainland enterprises. The first initiative is to enhance regulation of sponsors and compliance advisers. Sponsors and compliance advisers, who act as corporate finance advisers to listing applicants, play a pivotal role in bringing listing applicants to the Hong Kong market and providing investors with information about these companies.

43. Over the past few years, there have been increasing concerns about the standards of sponsors in view of the corporate scandals related to initial public offerings and sponsors' failure to carry out proper due diligence on listing applicants. The market and the investing public have, on various occasions, called for effective measures to raise the overall standard of professionalism in the market, and to take action against sponsors that have failed in their duties.

44. In January 2005, the SFC instituted disciplinary proceedings against ICEA Capital Limited (ICEAC). The SFC alleged that ICEAC had not exercised due skill, care

and diligence in the course of performing its duties as the sponsor of the listing of Euro Asia Agricultural (Holdings) Company Limited (Euro Asia).

45. Euro Asia was listed on the Stock Exchange of Hong Kong on 19 July 2001 with ICEAC as its sole sponsor. Trading of Euro Asia's shares was suspended on 30 September 2002 at the request of the company. At that time, the Chairman of Euro Asia, Mr. Yang Bin, was arrested by the police in Mainland on criminal charges of tax evasion, fraudulent investment schemes, offering bribes, fraudulent contracts, insider dealing and illegal occupancy of farmlands. He was later sentenced to 18 years in prison and Euro Asia was finally liquidated and delisted.

46. As the sole sponsor of Euro Asia, ICEAC, without admission of liability, agreed to pay HK$30 million (US$ 3.85 million) to settle the case.

47. To strengthen the qualification of sponsor, the SFC introduced a new sponsor regime on 1 January 2007 to impose a set of requirements on sponsors. This means that to be entitled to act as a sponsor a firm must satisfy licensing qualifications and requirements. These requirements are: (i) the initial eligibility criteria that sponsors must satisfy before they are licensed to act as sponsors, and (ii) on-going compliance obligations that sponsors, their management and staff must satisfy.

Apart from enhancing the sponsor regulation, the SFC is also working closely with the HKSAR Government, HKEx and market participants on statutory backing of the Listing Rules. The Listing Rules are rules of the stock exchange and the violation of Listing Rules is not a breach of the law. By giving statutory backing to the Listing Rules, we can strengthen our backend enforcement action against false or misleading disclosure and non-disclosure.

**Concluding Remarks**

48. Hong Kong plays a unique role in integrating China to the rest of the world. Hong Kong is China's window to the world, and the world's window to China. Hong Kong is the test bed for China's capital market reforms and the experience is both challenging and rewarding. China has made good progress as it "crosses the river by feeling the stones". Shanghai has ambitions of becoming a major financial centre. This is a natural and healthy progression.

49. Hong Kong has its strengths, and the market participants are nimble and would be able to provide value for financial services in Hong Kong where they best suit the needs of Mainland enterprises. I also believe that the demand for financial services is large enough for both Shanghai and Hong Kong to serve their niche markets. The experience of the US shows how both New York and London have been able to serve the different needs of customers for financial services over the years.

50. To conclude, I hope that I have provided you with a comprehensive picture and appreciation of the pragmatic approach that the Mainland authorities have adopted in developing their capital market, the symbiotic relationship that the Mainland and Hong Kong capital markets enjoy and the way we work together to deal with the regulatory challenges that arise.

51. As a regulator in Hong Kong, I must say that the overall experience – the scale, the dynamics, the opportunities and the challenges posed by the developments in the capital markets in Hong Kong and China – is enlightening, engaging and enriching.

52. Thank you for your attention, and I wish you all a fruitful and enjoyable seminar.