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Good afternoon, Chairman Shelby and distinguished members of the Senate Committee.

Thank you for inviting me to testify about the international impact of the Sarbanes-Oxley Act and developments concerning convergence of international securities laws.

A brief background about the Hong Kong securities market

First, I must give the disclaimer that the views I express here are my personal views and do not reflect the views of the Hong Kong Securities and Futures Commission, the individual members of the Commission nor its staff, nor of the International Organization of Securities Commissions

("IOSCO"), where I currently serve as Chairman of its Technical Committee, nor any of its member jurisdictions.

Hong Kong is the largest stock market in Asia outside Japan and is the eighth largest market in the world in terms of market capitalization. There are a total of 1,074 companies listed on the Hong Kong Stock Exchange with a total capitalization of US$713.9 billion as at the end of July 2004 and market turnover of US$486 billion for the 12 months ending July 2004.

Hong Kong is the leading international financial centre in its time zone, with 80 of the top 100 global banks having offices in Hong Kong, as well as most of the major U.S. investment banks and securities houses. Hong Kong has the largest concentration of international accountants and legal offices in Asia outside Japan. As at the end of 2003, the equity securities of 21 companies were traded concurrently on the Hong Kong Stock Exchange and New York stock exchanges (19 companies on the New York Stock Exchange and 2 on NASDAQ). A major feature of the Hong Kong market is that roughly 80% of Hong Kong listed companies are incorporated outside Hong Kong, primarily in Bermuda, the Cayman Islands and the mainland of the People's Republic of China.

Another feature of the Hong Kong market is that unlike many other Asian markets which are retail dominated, local and overseas institutional investors account for 28% and 39% respectively, of the total market turnover during the period 2002-2003.[i] Overseas investors, principally institutional investors, have increasingly become dominant players in the Hong Kong stock market. U.S. investors are active in the Hong Kong market and, likewise, Hong Kong investors are familiar with U.S. and other international markets.

Hong Kong regulation of issuers

All issuers whose securities are listed for trading on the Hong Kong Stock Exchange must comply with the Securities and Futures Ordinance and other Hong Kong securities regulations, such as the non-statutory Listing Rules[ii] and the Takeovers Code,[iii] irrespective of their place of incorporation.

For historical reasons, our Listing Rules are based on the Listing Rules of the United Kingdom. The Hong Kong Stock Exchange is currently finalising a new corporate governance code for listed issuers called the Code on Corporate Governance Practices, which is benchmarked against the U.K. corporate governance code, known as the "Combined Code". The Hong Kong Code operates on a comply-or-explain principle.

Since the Securities and Futures Ordinance came into operation in April 2003, all initial public offerings of securities in Hong Kong are filed with both the Hong Kong Stock Exchange and the Securities and Futures Commission (the "HKSFC"), thus strengthening the enforcement of disclosure requirements by issuers. The Hong Kong Stock Exchange is responsible for enforcing its Listing Rules, and the HKSFC is responsible for enforcing corporate disclosure requirements pursuant to the Securities and Futures Ordinance. It is a criminal offence under the Securities and Futures Ordinance to provide the HKSFC with false or misleading statements in a corporate disclosure filing.

The Hong Kong government has also agreed to amend the law to give statutory effect to the more important listing requirements in the Listing Rules. Once these statutory listing rules come into force, listed issuers, their directors and corporate officers will each be criminally and civilly liable for compliance with the specific disclosure obligations set out in the rules. These rules, too, will not distinguish between domestic and foreign issuers.

The Hong Kong accounting and auditing standards essentially follow the International Financial Reporting Standards and the International

Standards on Auditing. The Hong Kong accounting standards reflect 95% of the current International Financial Reporting Standards and are on course to be fully compliant with International Financial Reporting Standards.

Similarly, the Hong Kong auditing standards-setting body is in the final stages of completing an exercise to make some minor amendments to current Hong Kong auditing standards to bring them into full compliance with International Standards on Auditing by January 2005.

The Hong Kong and U.S. market

There are considerable U.S. and Hong Kong cross-border securities and capital transactions. The HKSFC has always valued its long and productive relationship with the U.S. Securities and Exchange Commission (the "U.S. SEC") and the Commodity Futures Trading Commission ("CFTC"). In October 1995, the HKSFC entered into Memoranda of Understanding with the U.S. SEC and the CFTC, respectively, to enhance our mutual cooperation in the administration and enforcement of securities laws in our respective jurisdictions.

The HKSFC is also a signatory to the IOSCO Multilateral Memorandum of Understanding[iv] ("IOSCO MMOU"), the first global information-

sharing and enforcement cooperation arrangement among securities regulators introduced in 2002. The IOSCO MMOU sets a new international benchmark for cooperation among securities regulators in order to enhance enforcement of securities laws internationally. Through the IOSCO MMOU, the world's securities regulators have set the broad terms of cooperation and assistance a securities regulator must offer to its fellow securities regulators in order to be considered a responsible member of the international regulatory community.

The globalization of international financial markets has also precipitated an increasing convergence between the Hong Kong and U.S. models of securities regulation. In my view, the Hong Kong government's decision to give statutory effect to the more important provisions of our Listing Rules moves Hong Kong closer to the U.S. SEC regulatory model.

Impact of the Sarbanes-Oxley Act on Hong Kong

U.S. based firms, and companies whose securities are traded both in Hong Kong and the U.S., are already familiar with the Sarbanes-Oxley Act and are required to comply with its requirements. My personal view of Sarbanes-Oxley is that it was a quick and effective response to potential an erosion of confidence in U.S. capital markets resulting from high profile accounting frauds and corporate governance failures at

issuers such as Enron and WorldCom. Sarbanes-Oxley heightened awareness around the world of the scope of directors' fiduciary responsibilities. It has also raised awareness of the need for enhanced corporate governance and auditor independence, the need to improve oversight of the accounting and audit professions, as well as the need to strengthen the protection of investors' interests. Market participants tell me that preparation to comply with the certification and internal control review requirements under Sarbanes-Oxley often identified control weaknesses. These are areas clearly where Sarbanes-Oxley made a difference.

On the other hand, there is industry concern over the rising costs of compliance with Sarbanes-Oxley's increased regulatory requirements, not only in monetary terms, but also in terms of manpower and IT development. Some feel that the requirements are restrictive and excessively onerous in nature, compared to corporations that do not have to comply with Sarbanes-Oxley.

However, it must be pointed out that Hong Kong rules and regulations do not conflict with Sarbanes-Oxley requirements. Our regulatory regime covers most, but not all, of the main areas addressed in Sarbanes-Oxley, albeit in much less detail and with less prescription. For example:

- **Audit committees.** Our Listing Rules require companies whose securities are listed in Hong Kong to set up audit committees composed of a majority of independent non-executive directors, one of whom must have appropriate accounting or related financial qualifications or expertise.

  The Code on Corporate Governance Practices that will be incorporated into the Listing Rules will recommend that a listed issuer's audit committee review and monitor the independence and objectivity of their external auditors and the effectiveness of the audit process. The Code will further recommend that the audit committee's terms of reference include a responsibility to advise the board of directors on the appointment and removal of the external auditors and to approve the remuneration and terms of engagement of the external auditor.

- **Responsibility for financial statements.** Directors have a legal obligation to prepare statements of accounts that give a true and fair view of the company's financial position at the end of its financial year. Failure to do so is a criminal offence under the Companies Ordinance.[v] Although the company's statement of

accounts is signed by two of the directors, the board of directors has collective responsibility for the company's accounts as it must be approved by the board of directors.[vi] This contrasts with the Sarbanes-Oxley obligations that require the chief executive officer and the chief financial officer to certify, amongst others, that the financial statements and other financial information in the company's financial report fairly present in all material respects the financial condition and results of the company as of, and for the periods presented in the report.

Once the statutory listing rules come into force, listed issuers, their directors and corporate officers will each be criminally and civilly liable for false and misleading financial statements published by an issuer.

- **Prohibition of loans to directors.** Hong Kong company law prohibits loans to directors. There are certain exceptions to the general prohibition, particularly for banks, which are allowed to lend money or provide guarantees or any security to their directors, provided the terms of the financial assistance given are no more favorable than those given to third parties.[vii]

Convergence of securities regulations

Contradictory or duplicative regulations in different jurisdictions covering similar regulated activities in various capital markets place a heavy burden on issuers, market participants, and investors active on a cross-border basis in those markets. With the advent of globalization, conflicting regulatory requirements of different jurisdictions can impede cross-border capital flows or create barriers to entry to the provision of services on a cross-border basis by a financial services firm. With respect to the regulation of cross-border transactions and services in international capital markets, each national securities regulator has had to assess its regulatory requirements, within the context of its domestic law, to try to strike an appropriate regulatory balance. On one hand, regulators do not want to impose or maintain regulations that increase costs to market participants without enhancing investor protection. On the other hand, the role of regulators is to protect investors and maintain investor confidence through the imposition of appropriate regulations, notwithstanding the resulting costs to market participants. Maintaining market confidence is paramount, and regulators internationally agree on the need to facilitate cross-border capital formation without jeopardizing investors' interests.

To achieve this, securities regulators around the world must take a global view of regulation and work together. There must be international convergence of securities regulation. In my view, such a convergence of regulations applicable to capital markets internationally would be very beneficial to all who participate in those markets. For example, it would facilitate individual jurisdictions' move towards a common goal of implementing effective securities regulations locally; thereby minimizing costs to market participants whilst maintaining uniformly high levels of investor protection and confidence in capital markets.

Please note that I use the term "convergence of securities regulation" rather than the term "harmonization of securities regulation." I do this intentionally because, as I see it, "harmonization of securities regulation" implies that each jurisdiction would have identical or nearly identical rules and regulations. This is not a realistic goal as securities regulations must fit each jurisdiction's legal and regulatory environment and reflect the realities of their different market structures. As these differ significantly internationally, a full harmonization of securities rules and regulations is not strictly feasible.

"Convergence," on the other hand, occurs when two or more sets of regulations gravitate towards one another to achieve almost identical

regulatory principles or objectives. Convergence of regulation recognizes that while there are certain international regulatory principles and objectives that each jurisdiction strives to reach, different rules and regulations can achieve the same basic regulatory goals, such as the frequency of auditor rotation, and the composition and duties of the audit committees. However, I feel strongly that international securities regulations must converge at international best practices; in "a race towards quality" rather than "a race to the lowest common denominator."

Why is convergence of regulatory standards important?

With international convergence of regulation, investors could be confident that their interaction with foreign market participants and issuers are subject to the same regulatory requirements as those in the domestic market, allowing foreign and domestic issuers and market participants to compete on a level playing field.

As an added benefit, convergence of regulation will reduce compliance burdens and encourage multiple market access. Market forces rather than regulatory costs would become the determining factor for issuers and investors alike in choosing the markets they wish to participate in and the extent of such participation. International convergence of regulation will lower transaction costs for issuers and market participants who are

currently dealing with the varying regulatory requirements of all jurisdictions in which they operate while promoting the highest standards of investor protection. As market forces would be the driver for the selection of markets, jurisdictions around the globe would strive to enhance their regulatory model and market infrastructure. At the same time, investors would enjoy greater protection of their interests.

The work by the U.S. Financial Accounting Standards Board and the International Accounting Standards Board to converge the U.S. GAAP with the International Financial Reporting Standards is probably one of the most important, if not the most ambitious, convergence exercises to date. True convergence of the U.S. GAAP and International Financial Reporting Standards would eliminate the need to reconcile statements of accounts prepared in accordance with one set of standards with results that would pertain using the other set of standards. Upward convergence would enhance investor protection in all jurisdictions that adopt International Financial Reporting Standards, as investors will be able to easily compare the financial statements in all of these markets. The progress towards market integration and the reduction in the regulatory burden of multiple market access will largely depend on the success of this effort. I personally agree with and support such convergence of

international accounting standards and commend both standard-setters on their work.

One of the much debated topics where accounting standard-setters are seeking to adopt common principles worldwide is the issue of expensing stock options. I support the proposals to expense stock options. I believe that financial statements should reflect the true position of all transactions. Granting employees stock options is a form of compensation; it gives employees a benefit and is an expense to the company. In putting the case for this treatment, I cannot improve on the sage words of Warren Buffet: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

How do regulators achieve convergence of their regulatory standards?

The international regulatory community must work together to avoid conflict in regulatory approaches and facilitate cross-border business while maintaining high regulatory standards. This can be achieved through dialogue, be it bilateral dialogue between two regulatory agencies

or multilateral dialogue through international organizations, such as IOSCO. Both SEC and CFTC are prominent members of IOSCO.

IOSCO provides an effective forum where securities regulators can exchange views and explore new ideas and approaches to strengthen cross-border securities regulation and cooperation in a coherent manner that closes gaps in regulation, while avoiding duplication or conflicts in regulation. For instance, Hong Kong participates in an IOSCO Chairmen's Task Force that is developing a Code of Conduct for Credit Rating Agencies. This Code of Conduct seeks to address many of the concerns raised by the industry, and the role credit rating agencies play in modern financial markets. The proposed Code will follow the general structure of an IOSCO Statement of Principles Regarding Activities of Credit Rating Agencies adopted in October 2003 and would serve as a model code of conduct for credit rating agencies all over the world.

Since its establishment 21 years ago, IOSCO has undertaken numerous projects designed to improve the regulation of securities markets and the level of cooperation among its members, including issuing regulatory standards and principles. These standards and principles are not legally binding and do not prescribe a certain type of regulation or any particular regulatory structure; rather, they reflect a consensus among securities

regulators on regulatory objectives in each of these areas. Each IOSCO member jurisdiction may then devise the means most appropriate to its own structure and circumstances by which to implement the IOSCO principles. Through IOSCO, the member countries work together to develop the highest standards of regulation. For instance, the IOSCO principles governing oversight of auditors[viii] and auditor independence[ix] have become the international standards for the regulation of auditors. These IOSCO principles have become the principal framework for securities regulation in many countries.

Is convergence of regulatory standards enough?

However, merely converging regulation to meet international standards and principles is not sufficient; as disparities in the implementation of these regulations can nullify the benefits of convergence. It is essential that there is some degree of consistent interpretation, application and enforcement of these regulations to create a level playing field for a truly global market. IOSCO has a key role to play in this regard and increasingly it is focusing its attention on facilitating the implementation of its standards and principles among its member jurisdictions.

The HKSFC has a long history of cooperating extensively with other regulatory and law enforcement agencies, including the SEC and CFTC.

We have entered into 33 cooperation arrangements with our counterparts in other jurisdictions to exchange confidential information or to facilitate cross-border investigation and enforcement actions. The HKSFC is also one of 26 signatories so far to the IOSCO MMOU. Through IOSCO, and more particularly the IOSCO MMOU, we have sought to promote cooperation and information sharing among the international securities regulatory community, especially in the area of investigating and prosecuting violations of securities laws and regulations. The IOSCO MMOU does not create legally binding obligations on its signatories nor does it supersede domestic laws. Nonetheless, it has encouraged a number of jurisdictions to enact laws to permit their securities regulators to share information and cooperate with their foreign counterparts in accordance with the international benchmark articulated in the IOSCO MMOU.

Conclusion

Let me conclude by saying that in light of today's globalized markets, regulators face a multitude of challenges. Not only are the issues complex, with financial innovation and market developments raising new issues daily, but also investor expectations are at an all-time high. The recent high-profile global financial and securities fraud scandals have rocked the world's financial markets and underscored the need for high

standards and cross-border cooperation. Tremendous strides have been made in many areas in seeking global approaches to securities regulation. Regulators must continue to work together, through international organizations such as IOSCO, to establish the high regulatory standards that the world's investors rightly expect and to cooperate on cross-border enforcement actions. International convergence of regulation and strengthened cooperation in enforcement of these regulations together offer the best way to create a truly global regulatory framework for the global securities market.

Thank you for your attention.

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[i] Understanding Investors in the Hong Kong Listed Securities and Derivatives Markets, Essie Tsoi, Research & Planning Department, Hong Kong Exchanges and Clearing Limited (July 2004). Available on the SFC website at http://www.hksfc.org.hk/eng/statistics/html/index/index0.html

[ii] The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Ltd

[iii] Codes on Takeovers and Mergers and Share Repurchases (Takeovers Code)

[iv] IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002)

[v] Section 123 of the Companies Ordinance (Chapter 32)

[vi] Section 129B of the Companies Ordinance (Chapter 32)

[vii] Section 157B of the Companies Ordinance (Chapter 32)

[viii] Principles for Auditor Oversight (October 2002)

[ix] Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence (October 2002)