

2008 FINANCIAL MARKET INTEGRITY INDEX

HONG KONG

CFA Charterholders and Professional Integrity

With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is the not-for-profit, professional association of 98,000 financial analysts, portfolio managers, and other investment professionals in 128 countries, of whom 84,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute Centre for Financial Market Integrity is the research, policy, and advocacy arm of CFA Institute.

The CFA designation is widely recognized as the designation of professional excellence within the global investment community. CFA charterholders must pass three rigorous examinations that test their understanding of a number of financial disciplines, including ethics and professional standards, and must complete several years of qualifying financial work experience to earn the charter. To retain the designation, CFA charterholders also must annually renew their pledge to adhere to the CFA Institute Code of Ethics and Standards of Professional Conduct.

In 2002, when CFA Institute and the United Kingdom Society of Investment Professionals partnered, UKSIP members were adopted into CFA Institute and holders of the corresponding FSIP and ASIP designations were accepted into CFA Institute membership based on the comparable level of rigor needed to obtain these designations. Although all CFA Institute members adhere to an ethical standard, only CFA, FSIP, and ASIP designees also have displayed a level of mastery in investment principles. Therefore, this research does not include responses from all CFA Institute members but, rather, only from those who are active members with CFA, FSIP, or ASIP designations; all will be referred to collectively as “CFA charterholders” throughout this report.

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Introduction

Value of the FMI Index

The Financial Market Integrity Index (the FMI Index) was developed by the CFA Institute Centre for Financial Market Integrity (the CFA Institute Centre) to gauge the perceptions investment professionals have about the state of ethics and integrity in six major financial services markets. Specifically, the index measures the level of integrity that investment practitioners experience in their respective markets—Canada, Hong

The FMI Index is distinguished from other market surveys and is proprietary in that it capitalizes on our exclusive access to seek the opinion and perspective of the CFA Institute membership (see inside cover for details). CFA charterholders are investment professionals who have earned the CFA designation and are required to adhere to a stringent code of ethics. The informed opinion of this particular respondent group offers valuable

The Financial Market Integrity Index was developed to gauge the perceptions investment professionals have about the state of ethics and integrity in financial services markets.

Kong, Japan, Switzerland, the United Kingdom, or the United States—and the practitioners' beliefs in the effectiveness of regulation and investor protections to promote such integrity. This pragmatic input from working investment professionals will help raise awareness of leading issues in the capital markets and will inform the work of the Centre in conducting regulatory outreach and developing enhanced professional standards.

insight into the current state of ethical practices and standards in select global markets and will help to inform regulators and other financial industry thought leaders concerning potential areas for improving the investment profession.

The CFA Institute Centre provides this report on the findings of the survey (the Report) to advance the cause of ethics and integrity in financial markets

*The CFA Institute Centre
provides this report to advance
the cause of ethics and integrity
in financial markets.*

through the views and opinions of trained investment professionals so as to:

- Inform investors and regulators of the perceived ethics and integrity of practitioners and the effectiveness of regulatory systems in the market;
- Encourage investors to consider whether they are likely to be treated fairly and ethically if they invest in the market;
- Help assess whether a particular country or market has specific integrity issues that need to be addressed by regulators; and
- Inform practitioners in the market about how others perceive their actions and honesty, in general, and to stimulate remedial actions on their part where appropriate.

Each FMI Index Report measures the sentiments expressed by a cross section of survey respondents concerning ethical standards and investor protections of a particular market. The ratings discussed in this Report represent the opinions of a distinct group of professionals, CFA charterholders, responding to a series of questions about their experiences with practitioners, regulations, and investor protections in Hong Kong. This survey was specifically designed to gather the perceptions of only the Hong Kong market. Because respondent populations differ significantly between markets, we believe it will be more valid and informative to assess each country's report independently of the others, rather than trying to make cross-country comparisons.

About the FMI Index Methodology

The FMI Index is constructed to give equal weight to two dimensions of evaluation: (1) the ethics of market participants and (2) the effectiveness of market systems in ensuring market integrity.

The CFA Institute Centre, in consultation with Harris Interactive, developed the FMI Index to specifically reflect the perspectives and opinions of investment professionals identified as being committed to the highest level of professional ethics. CFA charterholders and holders of the ASIP and FSIP designations were asked to evaluate and rate a number of financial “market participants,” including sell-side analysts, hedge fund managers, board

members, and others, and “market systems,” such as market regulation and investor protections, including corporate governance, shareowner rights, and transparency. The questions relate to how market participants and market systems contribute to financial market integrity. Respondents were asked to answer a number of questions that rate on a five-point scale the ethical behavior of these market participants and systems.¹

FMI Index Questions and Rating Scales

Please rate the overall ethical behavior exhibited by the following groups in Hong Kong.



For each of the following, please rate the overall effectiveness of market systems for ensuring market integrity in Hong Kong.



Figure 1

The ethical behavior of market participants and the effectiveness of market systems were the two dimensions of evaluation that produced the final FMI rating.

More than 2,000 professionals in six countries who hold the CFA, FSIP, or ASIP designations participated in the research by taking the survey either online or by scripted telephone interview between 2 April and 8 May 2008.

To provide the most statistically reliable opinions, this Report will use in-market ratings when referring to an index rating or score, unless otherwise noted.² Out-of-market ratings will be used for discussion and comparisons only where noted because these results are statistically less significant as a result of smaller sample sizes.

The FMI Index is constructed to give equal weight to the two dimensions of evaluation: (1) the ethics of market

participants, or investment professionals, and (2) the effectiveness of market systems in ensuring market integrity. Data gathered during phone interviews were transformed so that they could be integrated with online responses. This is an opinion-based survey, and CFA Institute makes no representations concerning accuracy or otherwise warrants use of the FMI Index for any purposes by readers.

For more comprehensive information regarding the overall FMI Index methodology, please refer to the separate appendix available on the Centre's website at www.cfainstitute.org/centre.

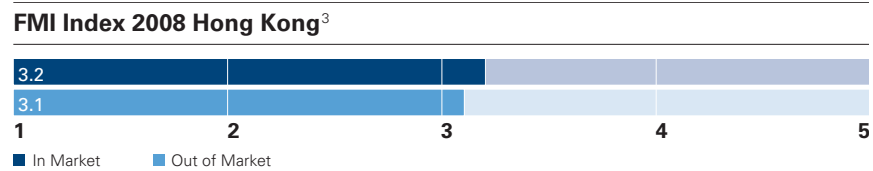
¹ One question dealing with severity of unethical behavior or ethical lapses was an exception and listed a score of 1 as not severe at all and 5 as extremely severe. This question did not figure in the final calculations of the FMI rating.

² In this Report, in-market ratings are those from respondents inside the Hong Kong market and out-of-market ratings are those given by respondents outside Hong Kong.

Executive Summary

Figure 2

Respondents inside Hong Kong gave the Hong Kong market a higher overall FMI rating (3.2) than did those outside Hong Kong (3.1).



The overall FMI Index rating for the Hong Kong market came in at 3.2, just above a mid-range score of 3.0 on a five-point scale.⁴ This rating suggests that respondents see some room for improvement in the state of ethics and integrity in the Hong Kong market.

Based on respondent comments collected in the survey, conflicts of interest and transparency appear to be primary areas of concern. Respondents also expressed concern with ethical issues surrounding financial products sold to investors.

Conflicts of interest, maintaining the client's interests first, and properly educating investors concerning risk top the list of CFA charterholders' concerns.

Comments highlighted such challenges as financial advisers' lack of knowledge of complex structured products, investors' understanding of the risks involved, and the suitability of some financial products sold to investors.

The current regulatory regime in Hong Kong and the issue of shareowner rights (particularly minority shareowner rights) are also topics that elicited a number of comments.

For the most part, respondent rankings by those outside Hong Kong agree with in-market rankings on matters concerning the ethical behavior of financial professionals in Hong Kong and the effectiveness of market regulation and investor protections.

Conclusions

- Hong Kong's overall rating reflects the perception that ethical behavior and market systems are better than "good" but that there is still room for improvement in certain areas.
- Based on ethical behavior and capital market protections, in-market respondents are still likely to invest in Hong Kong.
- Conflicts of interest, maintaining the client's interests first, and properly educating investors concerning risk top the list of CFA charterholders' concerns about the behavior of individual market participants.
- Transparency, regulation (with a focus on enforcement), and shareholder rights (particularly minority rights) elicited the most comments about market systems concerns.

³ A market's overall rating is composed of the 10 factors that make up the financial professionals rating and the 7 factors that make up the market systems rating. The final, overall rating for this market was created by taking the average rating or score from two sets of questions. The first question set contained 10 equally weighted components from a set of questions pertaining to investment professionals (i.e., market participants). The second question set contained 7 equally weighted components of questions pertaining to the effectiveness of capital market systems in ensuring market integrity. These two sets of questions were averaged as a set, and then each set carried equal weighting in the final determination of the FMI Index rating for this market.

⁴ Final rating is based on in-market ratings.

Key Findings

Ethical Behavior of Individuals

The first group of FMI Index questions asked respondents their opinions concerning the ethical behavior exhibited by various financial professionals—also referred to as “market participants”—in the market over the past year. The “all financial professionals” category received an above-average rating of 3.4. This rating is not simply an average of the nine ratings linked to the

ethical behavior of specific professions but was asked separately as a control question. (The *average* rating of the nine professions is 3.2.)

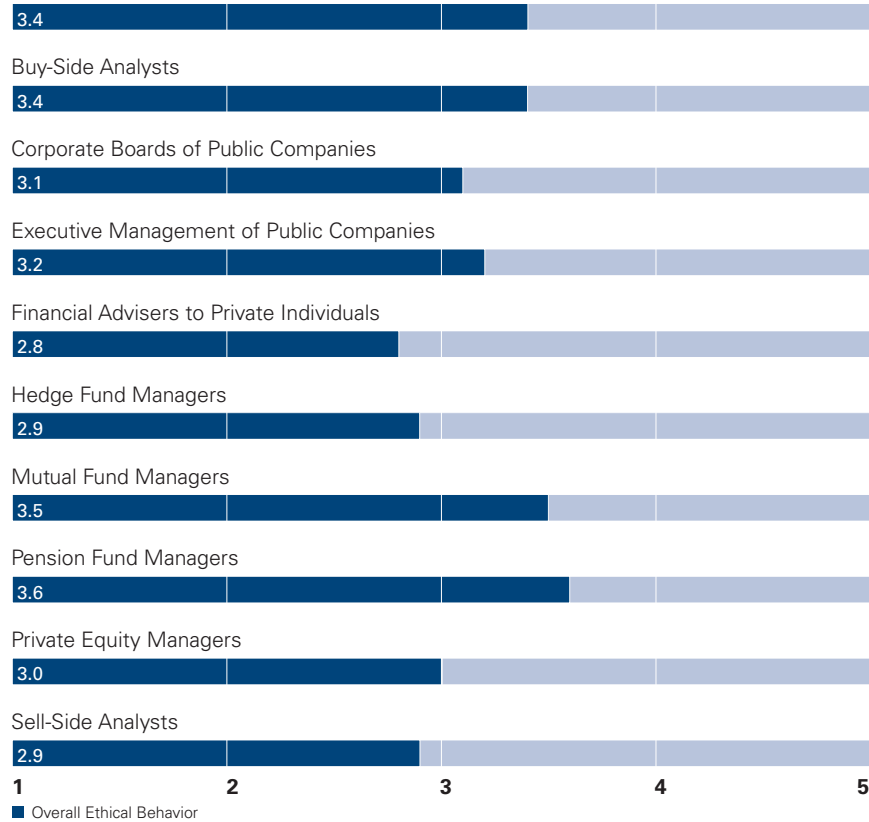
Respondents rated pension fund managers, mutual fund managers, and buy-side analysts at or above the “all financial professionals” control question rating. Hedge fund manag-

Figure 3

Respondents were asked to rate the ethical behavior of financial professionals as a whole, as well as the ethical behavior of specific financial professionals.

Ethical Behavior of Individual Market Participants

All Financial Professionals



ers, sell-side analysts, and financial advisers to private individuals all rated below a 3.0, or “somewhat ethical.”

Of the nine professions listed in **Figure 3**, the ethical behavior of financial advisers to private individuals rated lowest at 2.8 and pension fund managers received the highest marks at 3.6.

When respondents in Hong Kong were given the opportunity to comment, the profession they wrote about the most was financial advisers. Those who addressed financial advisers in their comments were particularly focused on conflicts of interest, client interests, and the risks in investment products financial advisers recommend.

“
Financial advisers should objectively explain all investment information. This allows the customer to fully understand the products, fees, and risk.

— Survey Respondent

”

Ethical Behavior of Individuals

(continued)

We received more than 45 comments concerning conflicts of interest in Hong Kong, many of which specifically address the compensation and incentive structure of financial advisers and employees at financial institutions who sell a variety of financial products.

that, too often, client interests are not taken into consideration—not just by financial advisers but by a number of financial professionals. Some respondents suggested that a better-educated base of financial professionals may be part of the

“
When the front-line employees at banks sell products, they don't understand the products and they aren't clear about how much risk the product carries.

— Survey Respondent

A number of respondents noted that customers are not always provided with sufficient information about the fee structure, investment risks, and other important information on investment products.

Changes in ethical practices cannot be regulated into the fabric of a financial community but must begin at the firm level. There was at least one respondent whose comments reinforced that ideal.

We also received another 20 comments from respondents who suggest

”
answer. For the six markets surveyed, the education of financial professionals was a topic (we received 22 comments on this topic) unique to Hong Kong. A number of those who commented voiced concern about the level of understanding among financial professionals, especially those in a sales role, of both the products they were selling and the risk profile of their clients.

More than 30 survey respondents noted that risk and suitability is an issue in need of more attention in this market. Most comments in this

area focused on the need for a better understanding of the investment risk of financial products. Respondents particularly raised concerns about structured products and their suitability for investors according to the investors' risk profile.

A few respondents mentioned accumulator products as an example of advisers neglecting clients' interests

and of a situation where financial professionals provide inadequate explanation of risk to their clients. Comments about accumulator products—structured financial contracts issued by banks to individual investors to accumulate stock positions over time—reflected a concern that investors do not always receive proper advice on the inherent risk of these derivative products.

“
The level of risk for investment ideas is not clearly discussed.

— Survey Respondent

”

Effectiveness of Regulatory and Investor Protections

The second group of FMI Index questions asked respondents their opinion concerning the effectiveness of regulatory and investor protections in the market (referred to as “market systems”) over the past year.

In the control question seeking ratings of “all capital market systems,” this group of investor protections received a rating of 3.3. This control question rating of 3.3 differed little from the *average* rating of 3.2 earned by the group of six capital market systems. Of the six individual systems listed

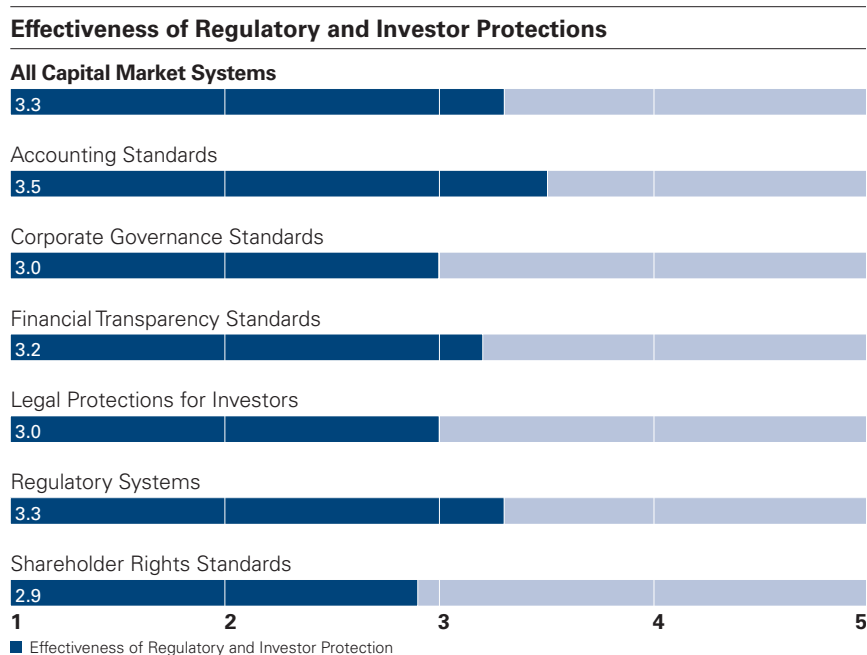
in **Figure 4**, only shareholder rights received a below-adequate rating, less than 3.0.

Shareholder rights was an issue of predominant concern among respondents, eliciting more than 25 comments. Most of the comments concerning shareholder rights noted the need for stronger minority shareholder protection (16 out of 26 comments) in the Hong Kong market.

A number of issues may influence this focus on minority rights, although one

Figure 4

Respondents were asked to rate the overall effectiveness of capital market systems as a whole, as well as the effectiveness of specific systems and standards.



of the most prominent is the structure of companies. Many Hong Kong companies are conglomerates that resemble the structure of a pyramid, with ownership and power flowing from a controlling ownership position at the top. A dominant shareholder often controls the most shares in a holding company, which, in turn, holds controlling share ownership in a handful of key subsidiaries. This structure means that one shareholder or shareholder group at the top of such

weakens the capacity of minority shareholders to exercise their rights. As a result of this concentration of ownership, the appointment of independent, nonexecutive directors is often controlled by a major shareholder, which limits directors' effectiveness in acting as a guardian of the rights of minority shareholders.

A further impediment to the exercise of these rights is the practice at Hong Kong general meetings to use a

“
Shareholder responsibility and supervising shareholder rights are the main ethical issues to which a board needs to pay attention.

— Survey Respondent

a conglomerate pyramid often holds voting power over shareholders in each company contained at each lower level of the pyramid. Shareholders at lower levels of this pyramid structure often cannot vote down a resolution or proposal that may prove harmful to their own investment but may aid another part of the conglomerate or the controlling shareholder at the top.

This large number of controlling shareholders in Hong Kong generally

“show-of-hands” voting style. By conducting voting at an annual meeting in this way, a vote may be determined by how many people are in the room rather than by the true wishes of all a company's shareowners. In January 2008, the Hong Kong Exchange published a consultation paper seeking the market's views on (among other things) making voting by poll in shareholder meetings mandatory.

(Preliminary consultation responses are available but not yet aggregated,

Effectiveness of Regulatory and Investor Protections

(continued)

and the exchange has made no decision as this Report goes to print.)

Report about a lack of disclosure on investment risk in financial products.

Forty-seven charterholders commented on transparency, making it by far the most pressing concern raised about market systems in Hong Kong.

Financial transparency at the corporate level was also an area of concern about which we received a number of comments.

Many of those who commented on transparency in Hong Kong echoed the particular concerns cited earlier in this

Respondents also were asked two subquestions that did not figure into the final financial market integrity

“
Corporate information and transparency need to be detailed and provided in a timely manner. A lot of investors don't get information fast enough. They might make a decision to invest only to find out long after that it was a mistake.

— Survey Respondent

”

“

The government should try and bring down the compliance and regulatory related costs.

— Survey Respondent

”

rating of 3.2 for Hong Kong but that were designed to further illuminate reasons behind the overall score.

The first subquestion asked about the effectiveness of capital market policies, and the second addressed the effectiveness of enforcement of each capital market system. Respondents rated the policies themselves as “good” (an average rating of 3.2 out of 5.0) and the enforcement of these policies nearly the same (3.0 out of 5.0).

Respondent comments concerning enforcement reflected a perception that more effort needs to be devoted to enforcing the rules and regulations governing listed companies and the markets. At the same time, there were concerns about the costs of compliance associated with adhering to existing rules and regulations.

Willingness to Invest in Hong Kong

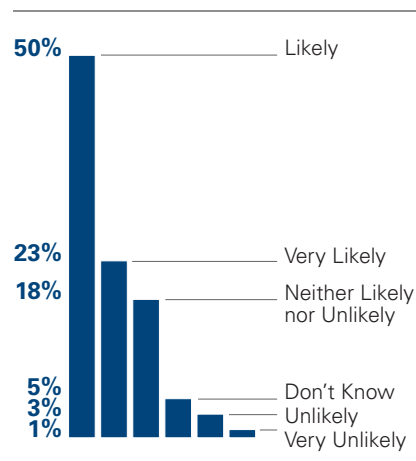
To test the connection between confidence in market participants and systems and the willingness to invest in Hong Kong, we asked respondents about their willingness to recommend investing in the Hong Kong market based *solely* on the ethical behavior of financial professionals and the effectiveness of capital market systems.

The results demonstrated in **Figure 5** allow us to compare respondents' willingness to invest against the ratings they assigned to the integrity of the market participants and systems in Hong Kong.

When asked whether they would recommend investing in the Hong Kong market, about three-quarters of Hong Kong respondents said that either they are likely or very likely to make such a recommendation. Again, those views were to be based only on the ethical behavior of individuals and the effectiveness of capital market systems in ensuring market integrity. Only about 4 percent of in-market respondents said they were unlikely or very unlikely to invest based on the same criteria.

Only about half of the out-of-market respondents stated that they were likely or very likely to recommend investing in Hong Kong. It is unclear whether part of this relative unwilling-

Figure 5
Likelihood of in-market respondents to recommend investing in Hong Kong based solely on the ethical behavior of market participants and the effectiveness of capital market systems.



Based Solely on Ethical Behavior and Capital Market Systems, Would You Recommend Investing in Hong Kong?

ness to invest in Hong Kong by those outside the market is a symptom of a general unwillingness to invest in China. Part of this reluctance may also stem from outsiders' view of Hong Kong as a proxy for investing in China, especially through H-shares or Red Chips. Many investors outside China invest in Chinese-listed companies in Hong Kong in order to participate in the Chinese market, which is otherwise closed to them.

With the Chinese markets having struggled for many months leading up to this survey, this somewhat tepid interest in investing in Hong Kong

may actually reflect a broader lack of enthusiasm for investing in China. Out-of-market ratings of Hong Kong financial professionals and market systems may perhaps reflect a "China bias" because some respondents could be answering questions about the Hong Kong market but with China in mind. This is a question we may address more directly in future surveys; only 44 outside respondents commented on their willingness to invest in the Hong Kong market, so this result is not as materially meaningful as the one reflecting the opinions of the 300 respondents from within the Hong Kong market.

Other Key Survey Considerations

In-Market vs. Out-of-Market Perceptions

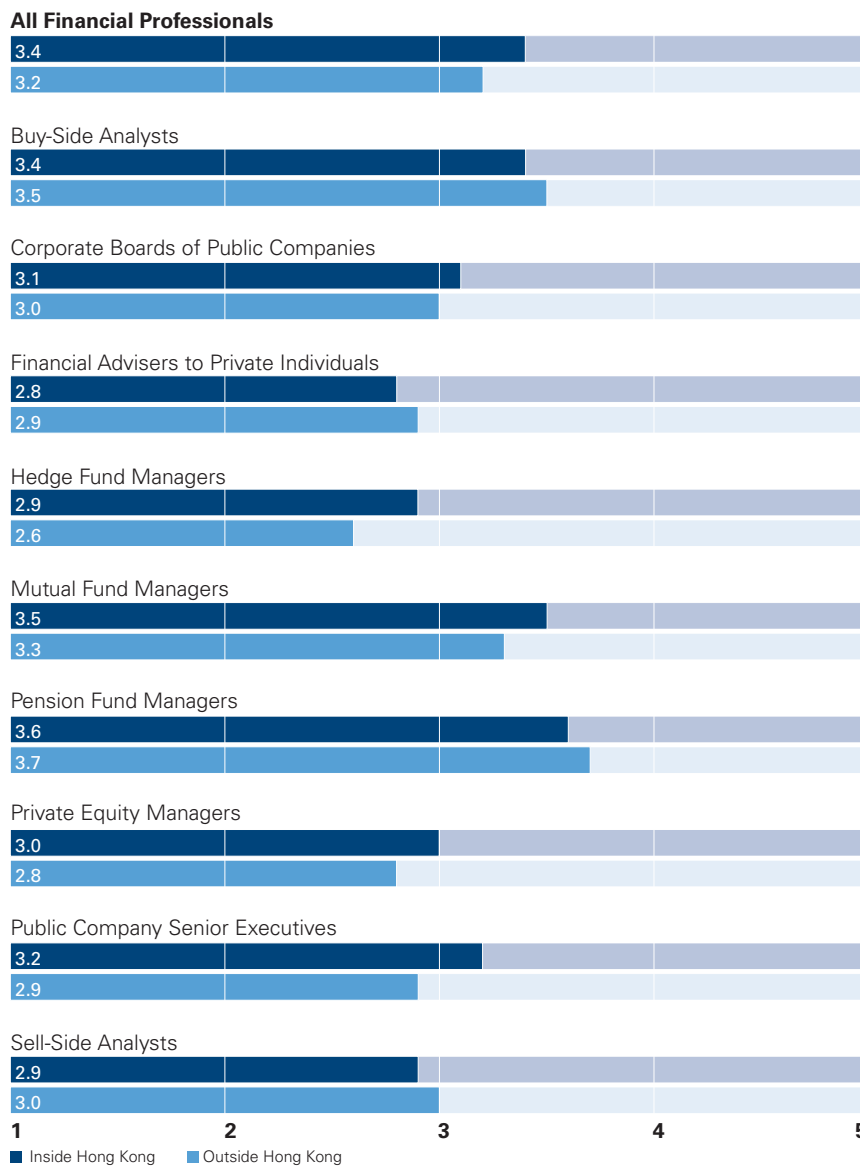
For purposes of this FMI Index, CFA charterholders from five other markets we surveyed (Canada, Japan, Switzerland, the United Kingdom, and the United States) were given the opportunity to rate and comment on both their own and the Hong Kong market. (Survey respondents were given the option to skip questions pertaining to any market about which they did not think they were knowledgeable.)

Although fewer than 50 CFA charterholders from outside Hong Kong answered the survey questions for the Hong Kong market, it is interesting to note that for the most part, in-market and out-of-market ratings mirror each other.⁵

As shown in **Figure 6**, only two of the ratings of Hong Kong financial professionals by respondents outside the market deviate by more than 0.2 points from the rating of the same group by in-market respondents. Hedge fund managers drew ratings of 2.6 by out-of-market colleagues, and those in Hong Kong gave hedge fund managers a rating of 2.9. Public company executives were ranked 3.2 by Hong Kong respondents but just 2.9 by out-of-market respondents.

Ethical Behavior of Individual Market Participants

Figure 6

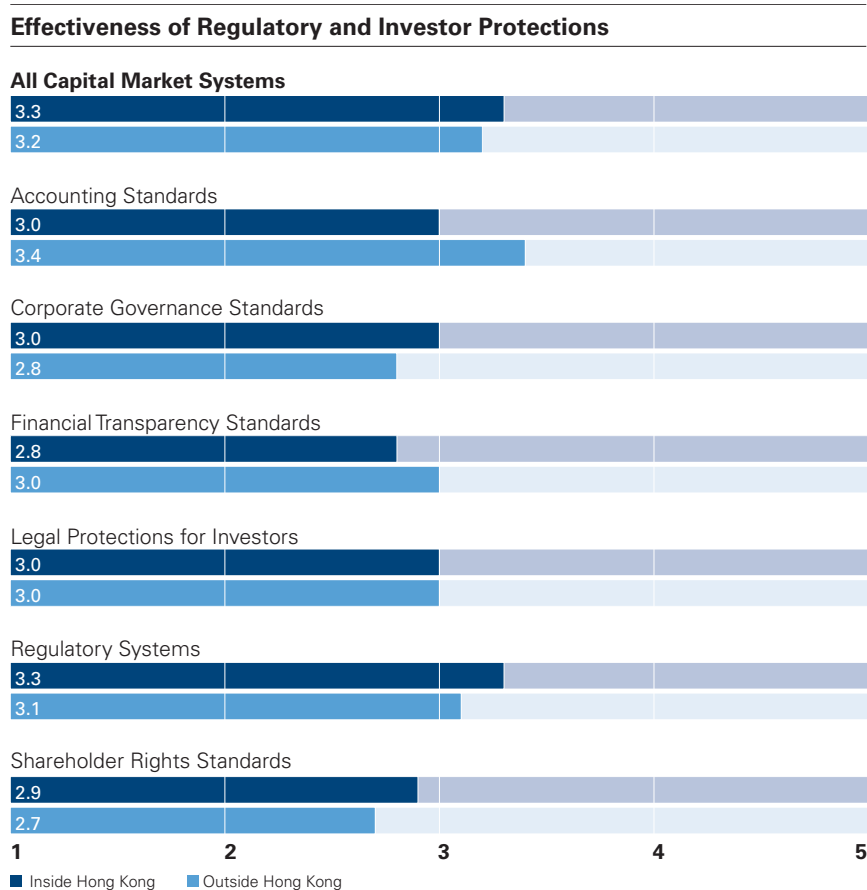


⁵Because fewer than 50 respondents from outside Hong Kong participated in this survey, their ratings may show interesting patterns but are not as statistically significant as ratings by those from inside Hong Kong.

In-Market vs. Out-of-Market Perceptions

(continued)

Figure 7



Respondents outside Hong Kong rated the overall effectiveness of capital market systems largely in line with their peers who live in Hong Kong and work in the market. Those outside Hong Kong rated its accounting systems 0.4 points higher than did their Hong Kong counterparts, showing slightly greater confidence in Hong Kong's accounting standards by those outside the market.

Comments of Survey Respondents

Respondents were given opportunities in connection with certain questions to make open-ended comments about their thoughts and concerns. Respondents also were asked for their comments after the set of questions concerning the ethical behavior of financial professionals and again after the set of questions concerning capital market systems. Furthermore, at the completion of the survey, respondents

were asked what additional or specific issues investors should be concerned about and, finally, were provided a general “catch-all” opportunity to relay any other comments.

Respondents provided more than 350 substantive comments. Those stating something to the effect of “no answer” or “nothing to add” were excluded.

Figure 8

Survey respondents commented most about conflicts of interest, regulations/regulatory systems, risk, and transparency.

Issues Raised Most Frequently

Client Interests	21 comments
Conflicts of Interest	46 comments
Education of Investment Professionals	22 comments
Regulation/Regulators	28 comments
Risk	33 comments
Shareholder Rights	26 comments
Transparency	47 comments

The various responses were examined and then categorized based on the main concern of each comment (e.g., corporate governance, transparency, fraud). The key areas of comment and the topics raised most often are highlighted in **Figure 8**. In instances where an individual raised more than one concern, we identified the primary concern for this Report and noted any secondary or tertiary concerns, although these do not appear in Figure 8. This is, of course, a nonscientific

method, but it still allowed us to better understand broad patterns of concern among financial professionals.

Transparency

We received nearly 50 comments concerning transparency in the Hong Kong market that focused on two main themes: transparency about products being offered to investors and the financial transparency of corporations in Hong Kong.

“
In my opinion, there is not yet complete transparency in market information. To a certain degree, the customer cannot yet sufficiently guarantee their interests.

— Survey Respondent

”

Comments of Survey Respondents

(continued)

Conflicts of Interest, Client Interests, and Risk

Conflicts of interest was among the issues respondents raised most frequently, which is in line with the comments received in all six markets surveyed. However, in the Hong Kong survey, two distinct groups of subtopical comments were provided wherever the issue of conflicts of interests emerged. A number of respondents

specifically commented on the need for more focus on the interests of clients, and others remarked that the risks of investments are not clearly communicated to investors. More than 25 percent of those who offered comments had something to say about conflicts of interest, client interests, and/or risk.

“
Agents need to give accurate and neutral advice to customers.

— Survey Respondent

”

“
Oversight entities need to be improved, especially areas such as corporate governance rules and rules regarding shareholder rights.

— Survey Respondent

”

Shareholder Rights

More than 25 individuals commented on the rights of shareholders in Hong Kong, and most of those focused mainly on minority shareholder rights.

“
You want to make sure that small shareholders' rights are not neglected when attention is paid to large shareholders.

— Survey Respondent

”

Demographics

The following figures indicate some of the key demographic information about the respondent base (please see complete methodology report at www.cfainstitute.org/centre for further details). It is interesting to note that

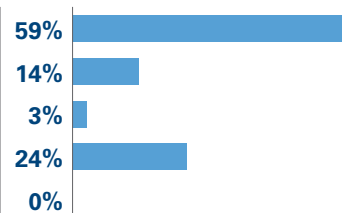
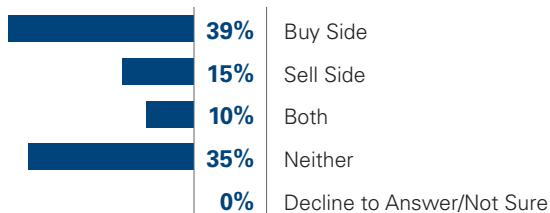
of the overall group of respondents, a large number indicated that they were working or employed in some capacity other than one of the practitioner categories identified in the survey.

Respondent Profiles for Hong Kong Market

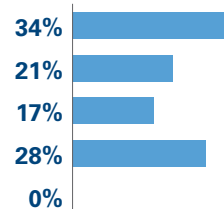
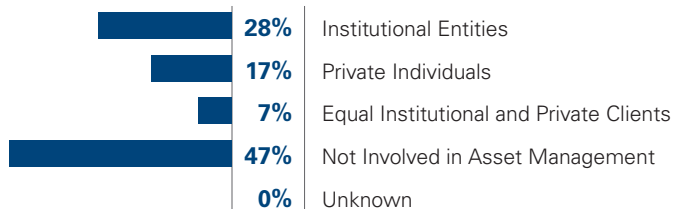
In Market (379 respondents)

Out of Market (44 respondents)

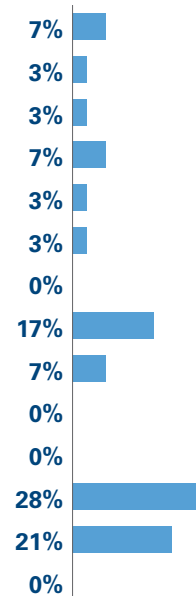
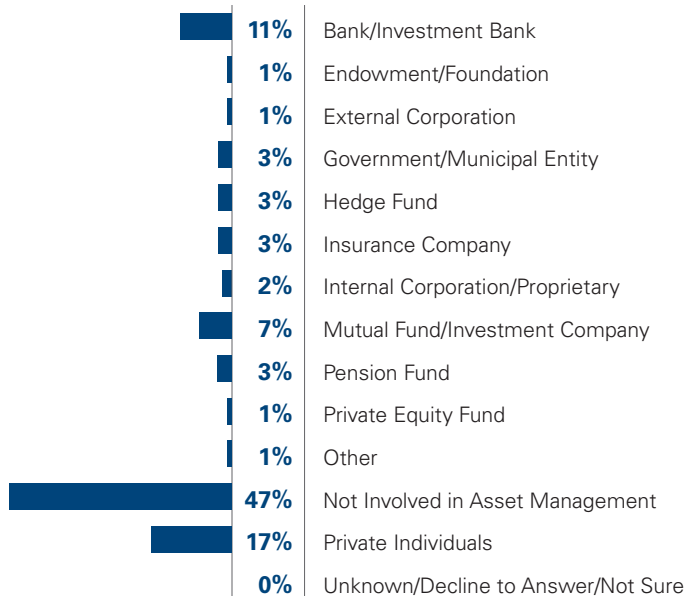
Buy/Sell Side



Client Asset Base



Institutional Asset Client Type

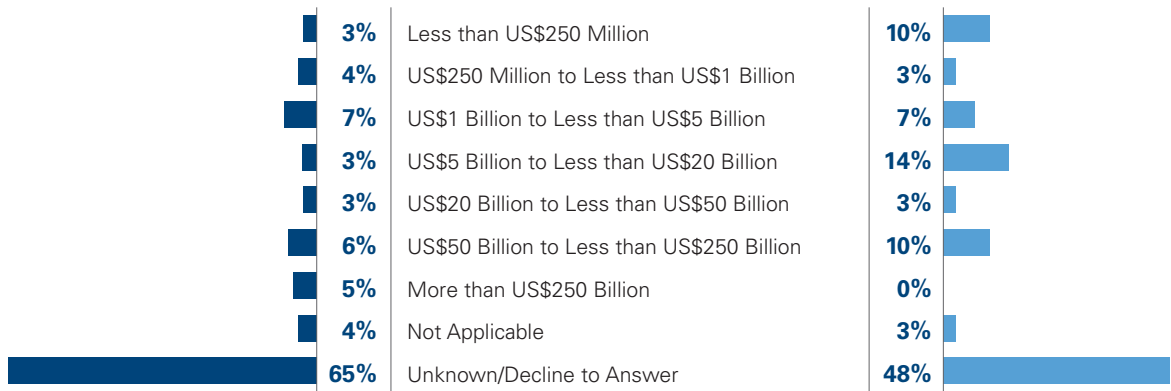


Respondent Profiles for Hong Kong Market (continued)

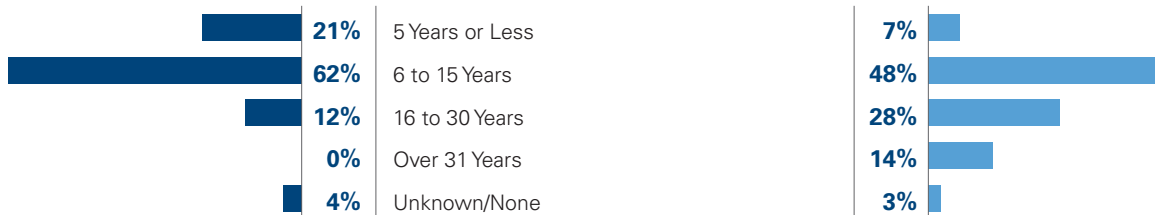
In Market (379 respondents)

Out of Market (44 respondents)

Assets Under Management



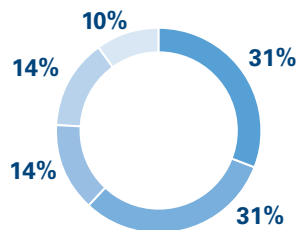
Years in the Investment Industry



Overview of Out-of-Market Respondents

Market

- 31% Canada
- 31% United States
- 14% Switzerland
- 14% United Kingdom
- 10% Japan



*May not add to 100% because of rounding.

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