

# Chairman's Statement

I am delighted, in my first year as Chairman, to report another record-breaking year for HKEx. Our financial and operating performance reflects the combined efforts of HKEx's Board, management and staff, as well as our business partners in successfully pursuing our mission to provide a world-class marketplace for securities and derivatives products of Hong Kong, Mainland and other enterprises.

## A Fruitful Year

2006 was a remarkable and fruitful year for HKEx. Our performance benefited from strong institutional and retail investor support, as indicated by the rise in HKEx's share price from \$32.15 on 30 December 2005 to \$85.50 on 29 December 2006, and the increase in HKEx's market capitalisation from \$34.2 billion to \$91.1 billion. With the aim of facilitating trading in our shares, HKEx reduced its board lot size effective 26 June 2006. HKEx became a HSI constituent with effect from 11 September 2006, and was rated the second favourite stock of retail investors in Hong Kong in a survey conducted by the Association of International Accountants Hong Kong Branch and a local securities firm last year. I would like to take this opportunity to thank all our Shareholders and the investing public for their support, and look forward to continuing to secure their trust in the years ahead.

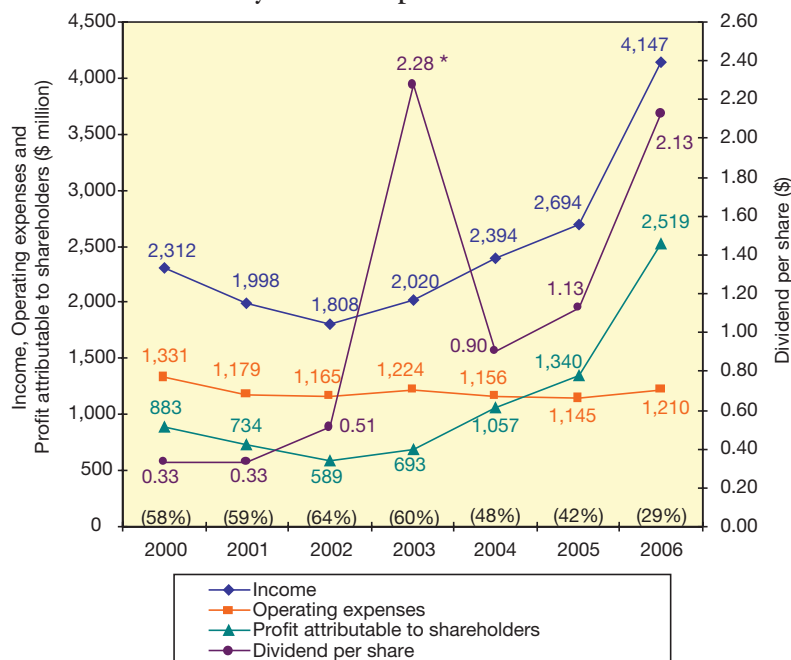
HKEx achieved the strongest income growth in 2006 since its listing in 2000. Income for the year amounted to \$4,147 million, representing an increase of 54 per cent compared to that of 2005. This was largely attributable to vigorous primary and secondary trading activities in the Cash and Derivatives Markets during the year, resulting in a significant increase in trading, clearing and settlement fees. With a sound investment strategy and robust capital markets, investment income from the Corporate Funds also rose substantially.

As a result of a rigorous effort to contain expenses, the cost to income ratio reduced from 42 per cent in 2005 to 29 per cent in 2006. Profit attributable to shareholders increased by 88 per cent from the previous year to \$2,519 million. The Board has recommended payment of a final dividend of \$1.19 per share. Together with the interim dividend of \$0.94 per share, the total dividend for the year amounted to \$2.13 per share.





Summary of HKEx's performance since 2000



( ) - Cost to income ratio. For the purpose of computation of cost to income ratio, income includes share of profits less losses of associates. The relevant figures are set out in the Financial Statistics since the Year of Merger on page 82 of this Annual Report.

\* - Including a special dividend of \$1.68 per share

### Strong Economic Backdrop

Following the economic rebound in 2005, Hong Kong's investment environment continued to improve in 2006 with resilient domestic demand, strong investor confidence and falling unemployment rate. Hong Kong recorded GDP growth of 6.8 per cent for 2006, which marked the third consecutive year of above-trend growth. The approval of the proposal to abolish estate duty and exempt offshore funds from profits tax in early 2006 helped attract offshore funds to invest in Hong Kong. Hong Kong was ranked as the world's freest economy for the 13th consecutive year according to the Economic Freedom 2007 Index released by the Heritage Foundation and retained the highest rating for economic freedom according to the Economic Freedom of the World: 2006 Annual Report released by the Fraser Institute. The improved economic fundamentals create a better investment environment inducing a substantial inflow of funds.

#### Number of Listed Mainland Enterprises and Market Capitalisation

	2003	2004	2005	2006
Number of listed Mainland companies	249 (24)	304 (28)	335 (30)	367 (31)
Number of newly listed Mainland companies	33 <47>	44 <63>	37 <55>	39 <63>
Market capitalisation (at year-end) (\$ billion)	1,680 (30)	2,021 (30)	3,192 (39)	6,714 (50)

( ) – percentage to total listed companies  
< > – percentage to total newly listed companies

#### Performance of Mainland Enterprises from 2003 to 2006

	2003	2004	2005	2006
Total equity funds raised (\$ billion)	56 (26)	114 (40)	198 (66)	385 (73)
Funds raised by IPOs (\$ billion)	51 (87)	77 (79)	151 (91)	304 (91)
Funds raised in secondary market (\$ billion)	5 (3)	37 (20)	47 (35)	81 (42)
Average daily equity turnover (\$ million)	4,242 (46)	6,687 (49)	6,708 (46)	15,706 (60)

( ) – percentage to total equity market

#### Ranking of HKEx Among Global Exchanges

	2002		2006	
	Value/ Volume	World Ranking	Value/ Volume	World Ranking
Equity funds raised (USD billion)	6.7	8th	67.2	3rd
Market capitalisation at year-end (USD billion)	463.1	10th	1,710.0	6th
Share trading value (USD billion)	194.0	19th	829.1	14th
Stock Index Options volume (million contracts)	1.1	17th	4.9	14th
Stock Index Futures volume (million contracts)	6	14th	19.7	10th
Stock Options volume (million contracts)	3.7	16th	18.1	10th

The 'World Ranking' above is based on information from the World Federation of Exchanges

The economy of Hong Kong is closely tied with that of the Mainland. The Mainland's economy grew by 10.7 per cent for the year, despite a raft of tightening measures imposed by the Central Government to tame investment growth and to prevent the economy from overheating in the second half of 2006. Hong Kong has benefitted from the rapid growth in the Mainland economy as evidenced by the successful introduction of 39 new listings (2005: 37) of Mainland enterprises in Hong Kong, which accounted for 63 per cent (2005: 55 per cent) of the total number of new listings in 2006. The market capitalisation of Mainland enterprises listed in Hong Kong surged to \$6,714 billion at the end of December 2006 (2005: \$3,192 billion), accounting for 50 per cent (2005: 39 per cent) of the total market capitalisation of the Cash Market. The average daily turnover of Mainland enterprises reached \$15.7 billion in 2006 (2005: \$6.7 billion), accounting for 60 per cent (2005: 46 per cent) of the total average daily turnover of equities traded. As illustrated, the listings of Mainland enterprises have provided enormous growth momentum to the Hong Kong securities market in the past few years.

### Capital Market Achievements

Hong Kong's capital market enjoyed a strong year in 2006, setting several remarkable milestones and records. The benchmark HSI shattered the 20000-point barrier for the first time on 28 December 2006, the day before trading ended for 2006, with a heavy turnover of \$54.4 billion, 60 per cent more than the average daily turnover of \$33.9 billion for the year.

- The total market capitalisation of the companies listed on the Stock Exchange surpassed \$10 trillion for the first time on 3 May 2006 and hit a new high of over \$13 trillion on 28 December 2006. With a market capitalisation of \$13,337.7 billion (USD1,710.0 billion) as at the end of December 2006, Hong Kong ranked 6th among the world's exchanges and 2nd among Asian exchanges, after the Tokyo Stock Exchange.

- Total equity funds raised attained a record high of \$524.5 billion (USD67.2 billion) with a 74 per cent increase from 2005. HKEx ranked 3rd in the world and 1st in the Asia-Pacific region by this measure. The funds raised from IPOs more than doubled to \$333.9 billion (USD42.8 billion) from \$165.7 billion (USD21.2 billion) in the previous year. This placed Hong Kong second in terms of total IPO fund raising, behind only London.
- HKEx was host to the mammoth IPO of the Mainland's largest bank, ICBC, on 27 October 2006. The bank raised \$124.9 billion (USD16.0 billion) in Hong Kong. The bank attracted a total of about 970,000 subscribers with its public offering tranche, the highest ever IPO subscriber number in Hong Kong. A total of about 1.77 billion shares were set aside for the public offering tranche. This attracted applications for over 134 billion shares, which translated into a 75.7 times oversubscription rate, tying up \$425 billion (USD54.5 billion). ICBC was also the first enterprise to simultaneously issue and list A and H shares in Shanghai and Hong Kong respectively.

- A number of other records were also set in the Cash and Derivatives Markets during the year as summarised in the above tables.

The records achieved reflect Hong Kong's popularity among issuers and increasing investor interest in our markets. Aside from local investors, we have been able to attract more and more overseas investors from all over the world. In the five years since 2000/01, the market share of overseas investor trading in our Cash Market was between 36 and 40 per cent, compared to 33 per cent or below in the preceding five years. The influx of offshore funds has provided great momentum to trading activity. The Stock Exchange recorded an average daily turnover of \$33.9 billion in 2006, from \$18.3 billion in 2005. The number of trades on Main Board and GEM increased substantially to more than 64 million in 2006 (2005: 37 million).

Hong Kong's exchange-traded derivative products, in particular index futures and stock options have also enjoyed strong growth albeit not as fast as that in some overseas exchanges and in the over-the-counter market. Following the revamp of the Stock Options market in 2005 coupled with the relief of position limits in February 2006, the total turnover of the Stock Options market rose 108 per cent from 2005. In 2006, the Derivatives Market's total trading volume was about 43 million contracts. In terms of notional value traded, Hong Kong ranked 6th and 7th in the world for stock index options and stock index futures respectively.

New Records in the Securities Market		
	2006	Pre-2006 Record (All in 2005)
Total Market Capitalisation	\$13,339.9 bil (28 Dec 2006)	\$8,260.3 bil (21 Dec 2005)
Total Market Turnover	\$8,376.3 bil	\$4,520.4 bil
Turnover of H shares	\$2,536.6 bil	\$953.3 bil
Turnover of Derivative Warrants	\$1,790.1 bil	\$856.6 bil
Number of newly listed Derivative Warrants	2,823	1,682
Total IPO funds raised *	\$333.9 bil	\$165.7 bil
IPO funds raised by H shares	\$291.8 bil	\$137.4 bil
Funds raised by the largest IPO	\$124.9 bil	\$71.6 bil

\* The figures exclude funds raised by REITs, which are classified as Unit Trusts

New Records in the Derivatives Market		
	Number of Contracts in 2006	Pre-2006 Record Number of Contracts (All in 2005, except otherwise stated)
Total Futures	19,863,299	13,433,386
HSI Futures	12,718,380	9,910,565
Mini HSI Futures	2,140,242	1,501,342
H-shares Index Futures	4,880,470	1,978,673
Stock Futures	102,010	21,006 (2002)
Total Options	23,042,616	12,089,621
HSI Options	4,095,679	3,071,822
Mini HSI Options	53,456	30,595
H-shares Index Options	758,247	257,425
Stock Options	18,127,353	8,722,393
Total Futures and Options	42,905,915	25,523,007

## Market Integrity

Good corporate governance is an important factor to Hong Kong's success as an international business and financial centre. HKEx, being the exchange controller, has the responsibility to provide an orderly, informed and fair market, and to protect the public interest and the interest of the investing public. The listing mechanism is an integral part of any financial market as it serves to ensure market quality and investor confidence. The Listing Committees and the Listing Division remain focused on implementing and administering the Listing Rules and reviewing them to ensure that they are at all times on a par with evolving international standards and best practices.

HKEx, as the front-line regulator, has also put immense effort into the promotion of awareness of good corporate governance among our listed issuers. HKEx welcomes the enactment of the Financial Reporting Council Ordinance in July 2006 and is one of the four initial contributors of funds to support the establishment and operation of the FRC to enhance the accounting and reporting standards of listed companies and to help safeguard the public interest. We believe that to ensure that the FRC functions effectively, proper funding arrangements should be put in place in the not too distant future.

As a public body, corporate governance is particularly important in our relationship with our stakeholders and the community at large. HKEx is accountable to our Shareholders for the proper use of funds, and has to assure stakeholders of quality and ethical standards in order to earn their trust and support. HKEx is committed to preserving integrity and adhering to the highest standards of corporate governance when conducting business, with the aim of being an exemplary corporation in the upholding of the interests of Shareholders and stakeholders. Our work in promoting good corporate governance has continued to be recognised by a number of local and overseas professional institutions. We are particularly pleased that in addition to the Gold Award in the General Category in the 2006 HKMA Best Annual Reports Awards, HKEx was also the Winner in the Citation for Achievement in Corporate Governance Disclosure (General Category) organised by The Hong Kong Management Association. Other achievements on corporate governance can be found in the Corporate Governance Report in the latter part of this Annual Report.

## Reaching out to the Community

The emergence of CSR in the public arena has drawn attention to the care shown by companies for all their stakeholders in all aspects of business operations. CSR is a relatively new initiative for Hong Kong and one of the key elements affecting the performance of a corporation. HKEx has gradually developed CSR strategies and adopted systematic processes and formal structures to deliver, manage and oversee such initiatives and objectives.

At HKEx, CSR has been embodied in our business philosophy – ethical business, a supportive workplace, community involvement and sustainable environmental protection, ultimately, to create tangible long-term value for our Shareholders. Details of our CSR approach can be found in the new Corporate Governance Section on HKEx's corporate website as well as the Corporate Social Responsibility Report of this Annual Report.

To meet our increasing focus on community-based initiatives, HKEx and our employees established a volunteer team in 2006 to organise and take part in charitable activities, to give back to the communities in which we work and live, and to cultivate a caring spirit within the Group. A volunteer orientation workshop was also organised to strengthen the skills and knowledge of our volunteers in serving people with different needs. HKEx's commitment to contributing to the community has earned the accolade of "Caring Company Award" from the Hong Kong Council of Social Services for two consecutive years (2005/2006 and 2006/2007). I am very proud that our employees are actively serving the community on their own time and promoting a culture of caring and giving.

### Prospects

The improving local economy and rapid economic growth of our country should continue to drive the development of the financial markets in Hong Kong. The increasing economic integration between the Mainland and Hong Kong provides favourable conditions for our business growth and development.

China's 11th Five-Year Plan laid down the roadmap for the sustainable economic development of the Mainland in the coming five years. Mainland enterprises of all sizes are seeking to raise additional capital for their expansion plans and they, after their primary offerings, are expected to continue their fund-raising activities in order to buttress their business development. Meanwhile, through listing in Hong Kong, improvement in their governance structure has been escalated by the adoption of international standards and best practices, and it also raises their international profile. Mainland listings will remain an important source of growth for the Hong Kong securities market in the foreseeable future although the need for equity funding may come from different sectors of the economy, and may be of a different scale and complexity.

The relaxation of limitations on offshore investments through the Qualified Domestic Institutional Investor (QDII) scheme in April 2006 is likely to induce capital outflow from the Mainland to overseas markets. As Hong Kong has a geographical advantage, and is in the same time zone, a substantial portion of the Mainland funds is expected to be invested in our financial products. As a result, Hong Kong's role as the Mainland's global investment platform will grow further.

As the convenor of the Securities Market Sub-group under the Focus Group on Financial Services of the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong", I am pleased to have the support of my group members who are experts and professionals in the Cash and Derivatives Markets in Hong Kong. The Sub-group conducted an in-depth examination of specific issues relating to the development of our markets, and submitted its recommendations to the Government in December 2006.

While China's continued economic ascension offers us the opportunity to further prosper, we have to prepare well for keener competition arising from the further opening of the Mainland markets. In tandem with share structure reforms and progressive moves towards international regulatory and accounting standards, the Mainland has revived the A-share market to provide capital formation services. However, some concerns have been expressed over the price differential between A and H shares in the same listed company, which in some instances see the A share price some 60 per cent higher than its H equivalent. This difference may well account for some of the volatility that we have experienced in our market as well as the calls for products or mechanisms to enable arbitrage between the Hong Kong and Mainland markets. Obviously any move in that direction will require agreement in both markets particularly as the Renminbi is not yet freely convertible. Furthermore, doubts have also been expressed as to the effectiveness of any such measures. In the end, each market will be left to decide what may be in its own best interest that may of course include measures to avoid excessive volatility and price differentials. In addition, the gradual liberalisation of the Renminbi, the resumption of financial futures trading in a dedicated exchange on the Mainland and the potential launch of a new growth enterprise market all point to the need for Hong Kong not to be complacent.

Competition for Mainland listings from overseas exchanges is also intensifying, and there is a growing trend for the listing and trading of derivatives and structured products based on China's underlying securities in the global market. Additionally, consolidation or formation of alliances among international exchanges is actively underway, with the aim of creating cross-border synergies. While HKEx will closely monitor the development of exchange mergers and acquisitions, we remain focused on our existing core businesses and expansion of our international profile by allowing overseas companies, particularly those incorporated in other Asian countries, to list in Hong Kong.

However, we must not forget that beyond the Mainland and Hong Kong there are other potential IPO issuers that may find Hong Kong attractive as an international financial centre, including for post IPO fund-raising. We believe that in the Asian time zone Hong Kong's capital market is fair, transparent and properly regulated and governed, and has the depth to make it comparable to the markets of New York and London.

Our mission is to be a leading international marketplace for securities and derivatives products focused on Hong Kong, Mainland China and the rest of Asia. The Strategic Plan for 2007-09 lays down the direction for HKEx ahead in pursuing our mission. We look forward to the continuing active involvement and crucial support of market participants and the investing community in our plan to further develop Hong Kong's financial markets and reinforce Hong Kong's status as an international financial centre.

### Appreciation to Directors and Staff

While I am greatly honoured to have the opportunity to serve HKEx, on behalf of the Board, the management and staff of HKEx, I want to extend our special thanks to our ex-Chairman, Mr Charles Lee, for his assiduous efforts in paving the way to success for HKEx in his six years as Chairman. Under Mr Lee's steadfast leadership, HKEx grew to become a sophisticated and mature global exchange, providing world-class financial services.

On behalf of the Board, I would like to express our sincere appreciation to Mr Tim Freshwater, Mr Dannis Lee Jor Hung and Dr Lo Ka Shui for their invaluable contributions and guidance rendered to HKEx during their term of service as Directors.

I would also like to thank our Shareholders and stakeholders for their continued support. My gratitude also goes to my fellow Directors and the executive management for their capable leadership and valuable advice.

At the end of 2006, I was delighted that Mr Paul Chow, our Chief Executive Officer, agreed to renew his contract for a further two-year term from 1 May 2007 to 30 April 2009. Mr Chow has contributed significantly to HKEx's evolution and led the executive management to the successful delivery of the Strategic Plan 2004-06. I am confident that under Mr Chow's executive management, HKEx will continue to build on its record of success in future.

Last but not least, I want to express my heartfelt thanks to each of our dedicated staff for their hard work, high ethical standards and contribution to the success HKEx enjoyed in the past year, and I look forward to working with them in the coming year.

**Ronald Joseph ARCULLI**

*Chairman*

Hong Kong, 8 March 2007