

Chairman's Statement

We have clear objectives laid down by law, and pledge to do our best to implement the law to protect the interests of investors.



THIS STATEMENT IS ABOUT:

- **The market in 2002-2003**
- **The Commission's finances**
- **Work in the past year**
- **Priority for 2003-2004**
- **A note of thanks**

Introduction

2002-2003 was a most eventful year. The year began shortly after the enactment of the Securities and Futures Ordinance on 13 March 2002 and ended with its commencement on 1 April 2003.

Comprising nearly 600 pages each in Chinese and English, the SFO is the largest statute in Hong Kong. It is the fruit of more than a decade of hard work by those

within and outside of the SFC, plus considerable work last year preparing the subsidiary legislation, codes and guidelines, and helping the industry and the public understand the new law.

I believe the new law strikes an appropriate balance between investor protection on the one hand, and encouraging and supporting the development of the market on the other. Our basic policy aim is a world-class regulatory framework for a fair, efficient and transparent market.

The 12 months under review saw other important market-wide developments. Market reaction to a Hong Kong Exchanges and Clearing Limited (HKEx) consultation last summer, which aimed to improve the quality of the stock market, led to a Government-commissioned independent Panel of Inquiry on the Penny Stocks Incident (PIPSI). The inquiry made constructive recommendations, which included thorough and early engagement of the market and the public when formulating policies.

The PIPSI report prompted the Government to appoint a three-member Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure. The Expert Group was led by former Australian Securities and Investments Commission (ASIC) Chairman Mr Alan Cameron, and comprised Dr Raymond Ch'ien and Mr Peter Clarke. The Expert Group completed its report in March 2003. The Government considers that the recommendations of the Expert Group are in the appropriate direction and would enhance the quality of the market. It will consult the public further on the recommendations.

The Market

Market conditions worldwide throughout 2002-2003 were affected by corporate scandals in the US and the threat of war in the Middle East.

Like the global markets post the bursting of the 2000 technology bubble, Hong Kong's Hang Seng Index (HSI)

continued a downtrend. Despite its intra-year peak of 11,975 in May 2002, the HSI retreated in line with major markets. The outbreak of atypical pneumonia in March 2003 in Hong Kong raised further concerns about local economic growth as tourism and retail consumption were badly affected. The HSI plunged to a 54-month low to close at 8,634 on 31 March 2003, falling 22% during the year. The Growth Enterprise Market index closed at 108, 47% lower.

There were 985 companies listed on the Stock Exchange, with a total market capitalisation of \$3,428.9 billion (US\$439.6 billion). This confirmed Hong Kong's position as the 11th largest market in the world by market capitalisation. Capital raised through initial public offerings jumped to \$53.3 billion, 3.5 times that of a year ago.

Average daily turnover on the Hong Kong market declined by 17% to \$6.4 billion in 2002-2003, compared with \$7.7 billion in the previous year. Futures and options trading were more active, with total transactions rising by 17% to 11.8 million contracts.

Keeping Expenditures Down

As a result of the adverse market environment, total Commission revenue for 2002-2003 dropped by 7% or \$25.8 million from the previous year to \$337.2 million. Declines were recorded in all categories of income. Please see details in *Corporate Affairs* chapter.

We continued to maintain stringent cost controls imposed since the second half of 2001. We reduced total operating expenditure after depreciation by 5% or \$21.6 million to \$395.6 million.

With capital expenditure also being kept to the minimum essential for efficient operations, our deficit for the current financial year was contained at \$58.4 million, 50% lower than the original budgeted deficit of \$117.6 million. This was roughly comparable with last year's deficit of \$54.2 million even though revenue was 7% lower. The reserves at the end of March 2003 totalled \$565.6 million.

Given our assessment that 2003-2004 market conditions will remain largely uncertain, with revenue estimated to increase marginally to \$339.9 million, the Commission forecasts an operating deficit of \$93.3 million.

After 12 years in the present premises, the Commission was given notice to vacate its existing offices by June 2003. After an extensive search of alternatives, the Commission selected Chater House as the new offices. The building is also centrally located to ensure effective discharge of our functions and maximum convenience to visitors. Because of the move, fitting out expenses will be unavoidable but kept to the minimum with modest standards of fittings, while existing furniture will be reused to the fullest extent.

Work in 2002-2003

The enactment of the SFO and its preparation for implementation rightly consumed a lot of our energies in the past year, particularly in passing the rules and regulations that underpin the primary Ordinance, as well as briefing market participants about the new law.

In addition, the Commission achieved considerable progress in a number of initiatives and projects, which are detailed in the Divisional Reports. To name a few:

- We implemented the Government-led Financial Market Development Task Force initiative to facilitate the public offering of shares and debentures, with new guidelines and proposed changes to the Companies Ordinance.
- Our risk-based supervision of intermediaries enabled us to take timely actions to protect investors in several cases, while preserving sufficient flexibility to deal with minor infractions.
- We became one of the first jurisdictions to allow hedge funds to be made available to retail investors. We also consulted the market on Real Estate Investment Trusts, so that a broader choice of investment products may be made available to the public.

investment products may be made available to the public.

- With more focused enforcement, more cases were completed within a shorter period of time. A record number of new investigations and disciplinary inquiries were achieved. With priority on corporate misconduct, we doubled the number of listed company investigations.
- The Steering Committee on the Enhancement of Financial Infrastructure II (SCEFI II) completed and published its report last December. A High Level Forum comprising the Government, SFC, Hong Kong Monetary Authority (HKMA), and HKEx would co-ordinate the implementation of SCEFI II's recommendations.

Priority in 2003-2004

Under the new SFO, the SFC's priority is clear. We must protect investors by enforcing against securities market misconduct.

The SFO has given us new powers to pursue crimes. Throughout this Report, readers will find the range of different regulatory tools that the Commission will use: dual filing which establishes the SFC as the statutory regulator of listed company disclosure; a more transparent disclosure of interests regime; "dual route" of possible criminal and civil action against market misconduct; proportionate sanctions on intermediaries including heavy fines, and many others.

We will implement the law, operating within the checks and balances that have also been enhanced. The Commission is subject to the best international standards of transparency and accountability, and checks and balances. In addition to the appeals to the Securities and Futures Appeals Tribunal on decisions of the Commission, which are also subject to judicial review, the independent Process Review Panel reviews the processes and completed investigations of the Commission to ensure that the Commission has followed due diligence and due

process in its work. The chapter on *Corporate Governance and the SFC* has the details.

Corporate Governance and the Market

For Hong Kong to continue its status as an international financial centre and the preferred capital market for external listing of Mainland enterprises, we must improve the quality of our market. Hong Kong is continually learning from international developments in corporate governance. There have been plenty: the US Sarbanes-Oxley Act, the UK Higgs Report on Non-Executive Directors, the Smith Report on Audit Committees, and the Australian Financial Services Reform Act.

The Commission has also been active in the work of the International Organisation of Securities Commissions (IOSCO). I was honoured to co-chair with my counterpart from Italy a group that developed International On-going Disclosure Standards. We also helped draft the IOSCO standards on audit independence and oversight.

The Hong Kong Government has adopted a Corporate Governance Action Plan to upgrade the quality of corporate governance in Hong Kong. Working closely with the community, particularly HKEx and the Government, we believe that the Commission can play a significant role in raising the quality of our markets.

A Note of Thanks

The achievements of the past year could not have been made without the dedication and hard work of each and every staff member, with active support of the independent Non-Executive Directors. The staff endured the atypical pneumonia concerns with quiet strength and fortitude. They continued to work, under contingency conditions, with a renewed sense of public service that has been a source of pride to the Commission.

The staff strength at the end of March 2003 was 403, a decrease from the 415 staff in the previous year despite an increased workload. Sadly, last August we lost a staff member who passed away while at work. She was a kind,

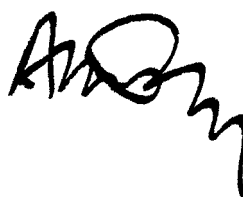
helpful and dedicated person with a strong sense of public service.

Under such work conditions, I felt I should communicate better with staff. The need for this could probably not be more vividly illustrated than by an incident last summer, when anonymous letters making allegations on certain personnel matters were circulated among the SFC, the community and the media. The Commission asked its Audit Committee, comprising independent Non-Executive Directors, to investigate, assisted by independent consultants PricewaterhouseCoopers. The inquiry found that the allegations were not substantiated.

The Audit Committee nevertheless recommended improving the human resources and related procedures, including introducing an internal complaints mechanism for staff and conducting regular staff opinion surveys. The Commission has adopted all proposals. A new Chief Operating Officer/Executive Director is expected to be appointed shortly. The Audit Committee inquiry report is published in full on our website.

I want to put on record our deep appreciation of the Non-Executive Directors, several of whom were re-appointed during the year. The Commission also thanks members of the Advisory Committee and all its various Committees, Panels, and Groups, whose advice guided us through difficult issues in difficult times.

On the occasion of the new SFO, we understand the high expectations of the market and the public on the Commission. We have clear objectives laid down by law, and pledge to do our best to implement the law to protect the interests of investors.



Andrew L T Sheng
Chairman