

# Intermediaries & Investment Products

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## SIMPLIFIED LICENSING REGIME:

The single licensing system means less paperwork and lower costs for intermediaries engaging in more than one regulated activity.



Our mission is to work in partnership with the industry to safeguard investor interests, facilitate market development and encourage high standards of professionalism.

## ACHIEVEMENTS

- Prepared for the implementation of the new licensing regime and facilitated market transition
- Facilitated business with streamlined processes, exemptions in competence, and flexibility and choice in training requirements
- Took proactive regulatory actions on intermediaries to protect investors
- Strengthened the risk management of margin financing intermediaries
- Supervised a record 2,457 investment products
- Issued authorisation and disclosure guidelines for hedge funds
- Consulted the public on the offering of Real Estate Investment Trusts and Exchange Traded Index Tracking Funds

## THIS CHAPTER IS ABOUT

### Licensing Department

- Preparing the industry for the new licensing regime
- Reducing compliance costs
- Facilitating business and raising standards

### Intermediaries Supervision Department

- Supervision of intermediaries using a risk-based approach
- Devising balanced policies and regulations to promote market integrity
- On-going dialogue with the market to raise business standards

### Investment Products Department

- Product authorisation
- Facilitating product development and enhancing information disclosure
- Stepping up communication with the fund industry

## Licensing Department

### What We Do

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- Act as the gatekeeper of the industry, ensuring that only fit and proper individuals and organisations are allowed to deal with investors and other market participants.

### What We Did

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#### Preparing the Industry for the New Licensing Regime

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The Department undertook various initiatives to facilitate industry migration to the new licensing regime under the SFO. Apart from the related subsidiary legislation we also prepared new and revised guidelines, including the *Guidelines on Transitional Arrangements* and the *Guidelines on Waivers of Certain Licensing Fees*. Seminars were also conducted for industry practitioners as well as legal and accounting professionals (See more details in *Corporate Affairs* chapter).

The Department published on the SFC website new consolidated licensing application and notification forms, including abridged conversion forms for existing licensees. The public register of licensed persons, available on the website, has also been upgraded to enhance transparency. It displays additional information such as licensees' disciplinary records, licensing conditions and complaint channels.

As regards brokers' fidelity insurance, we worked with an industry group to ensure a smooth transition from a Stock Exchange-administered scheme to a new scheme established under the SFO. The new insurance scheme became effective on 1 April 2003.

To ensure level and consistent securities and futures regulation between SFC licensed firms and HKMA authorised institutions (mostly banks), the SFC and the HKMA in December 2002 signed a new MOU.

#### Reducing Compliance Costs

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To further reduce compliance costs, the SFC has lowered the licensing application and annual fees under the SFO by 3%. This is in addition to a 5% early bird discount for existing licensees seeking to migrate to the new licensing regime in the first year. To this end, we worked with HKEx to abolish the Stock Exchange's registration regime for its participants' sales representatives and replace the approval requirement for branches, branch managers, and change in shareholding not involving a change of control with a notification system.

The Department continued to streamline its internal processes, hence strengthening its ability to meet the performance pledges. In addition, we have substantially



## Single Licence

▶ The simplified single licensing regime offers greater convenience to brokers and investment advisers etc. They need only one licence to carry on all the regulated activities that they are eligible to conduct. The streamlined regime and compliance systems mean less paperwork and lower costs for intermediaries.

Only corporations and their individual representatives will be able to apply for a licence; for better investor protection, partnership or sole proprietor will not be permitted. Existing licensees and exempt persons have two years to migrate to the new system. Banks are required to be registered to carry on regulated activities (except securities margin financing and leveraged forex trading as these are core banking functions regulated under the Banking Ordinance).



reduced the normal processing time for representatives' change of accreditation application (which is required when they join a new firm) to one week.

### **Facilitating Business and Raising Standards**

The licensing competence requirements were modified to allow greater flexibility for new entrants to the industry without compromising investor protection. We issued the *Guidelines for Exemptions from the Recognised Industry Qualification and Local Regulatory Framework Paper Requirements* in December 2002, setting out the circumstances under which applicants with adequate industry experience may get exemptions.

However, they would be required to undertake additional Continuous Professional Training (CPT) hours. More relaxations are provided in the revised *Guidelines on Competence* and *Guidelines on CPT* issued in March 2003.

To facilitate the pursuit of professional training and compliance with the competence requirements by market participants, we worked with the Vocational Training Council in providing a recognised examination for leveraged foreign exchange trading for the first time. In line with the new licensing regime, we also worked with the Hong Kong Securities Institute to develop new examinations for each of the regulated activities in the securities and futures area. To ensure consistency and

maintain quality of the examinations, the Academic and Accreditation Advisory Committee (AAAC) endorsed a single examination body for each of the regulated activities. This will pave the way for developing mutual recognition of qualifications with other local or foreign regulators.

The AAAC also approved four additional institutions as CPT providers. They include the Hong Kong Investment Funds Association, Department of Accountancy of the Hong Kong Polytechnic University, School of Professional Education and Executive Development of the Hong Kong Polytechnic University, and School of Continuing Education of the Hong Kong Baptist University.

On the international front, the SFC has played an active role in the IOSCO Project Team on Securities Analysts that produced a report on analyst conflicts in January 2003. The SFC is also represented at an IOSCO Chairs' Committee which is now carrying the Project Team's work forward to develop guiding principles for securities analysts.

At the same time, we surveyed the securities investment research activities in Hong Kong to assess the state of the industry, particularly with regard to the possible conflicts of interests of securities analysts. The SFC is also surveying the views of investors on the same issue.

The Chairs' Committee will survey and assess the key regulatory issues relating to credit rating agencies in member jurisdictions and will consider developing guiding principles in this regard. The SFC has been

actively monitoring the developments in this area (See chapter on *Cross-Border Regulatory Co-operation* for more details on the SFC's participation in IOSCO's work).

On the whole, the number of licence applications, including securities dealers, increased noticeably across the board during the year (Table 1). In the securities sector, the number of applicants rose by 36% to 3,312, whereas, applicants in the commodity sector increased 57% to 827. Same as the year before, only one application was received from a leveraged foreign exchange trading firm and none were received on securities margin financing.

The increase in applications from advisers (53% for securities advisers and 44% for commodities advisers) and commodities dealers (60%) was most significant. This could be attributed to factors such as brokers diversifying into futures and advisory services, and other financial intermediaries entering into the corporate finance and financial planning segments.

The number of licensees (both businesses and individuals) decreased by 7% during the year, from 28,395 to 26,411 (Table 2). The number of exempt dealers fell from 153 to 135, while that of exempt investment advisers fell from 30 to 28. Apart from market conditions, insurance agents not renewing their investment representative licences might have contributed to the decline.

## Applications for Registration

for the period from 1 April 2002 to 31 March 2003

(Table 1)

Applications		Businesses			Individuals				
<b>Securities Dealers</b>		<b>Individuals</b>	<b>Corporations</b>	<b>Partnerships</b>	<b>Dealing Directors</b>		<b>Representatives</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)	22 (30)	0 (0)	296 (207)	1,466 (1,169)	1,784 (1,406)		26.9	
approved	0 (0)	29 (40)	0 (0)	271 (279)	1,452 (2,348)	1,752 (2,667)			
refused	0 (0)	0 (0)	0 (0)	0 (0)	2 (2)	2 (2)			
withdrawn	0 (0)	5 (7)	0 (0)	30 (29)	43 (105)	78 (141)			
<b>Securities Investment Advisers</b>		<b>Individuals</b>	<b>Corporations</b>	<b>Partnerships</b>	<b>Investment Adviser Directors</b>		<b>Representatives</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)	75 (49)	0 (0)	358 (203)	1,080 (735)	1,513 (987)		53.3	
approved	0 (0)	81 (57)	0 (0)	341 (249)	1,029 (2,347)	1,451 (2,653)			
refused	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)			
withdrawn	0 (0)	5 (10)	0 (0)	31 (27)	39 (120)	75 (157)			
<b>Commodity Dealers</b>		<b>Individuals</b>	<b>Corporations</b>	<b>Partnerships</b>	<b>Accredited Dealers</b>		<b>Representatives</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)	5 (9)	0 (0)	71 (63)	640 (375)	716 (447)		60.2	
approved	0 (0)	9 (10)	0 (0)	72 (78)	605 (538)	686 (626)			
refused	0 (0)	0 (0)	0 (0)	0 (2)	0 (0)	0 (2)			
withdrawn	0 (0)	1 (2)	0 (0)	4 (3)	37 (51)	42 (56)			
<b>Commodity Trading Advisers</b>		<b>Individuals</b>	<b>Corporations</b>	<b>Partnerships</b>	<b>Accredited Advisers</b>		<b>Representatives</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)	13 (9)	0 (0)	42 (22)	56 (46)	111 (77)		44.2	
approved	0 (0)	18 (8)	0 (0)	45 (26)	59 (59)	122 (93)			
refused	0 (0)	0 (0)	0 (0)	0 (1)	0 (0)	0 (1)			
withdrawn	0 (0)	1 (1)	0 (0)	3 (15)	0 (3)	4 (19)			
<b>Leveraged Foreign Exchange Traders</b>		<b>Traders – Discretionary A/C</b>	<b>Traders – Non-Discretionary A/C</b>	<b>Traders – Introducing Agent</b>	<b>Representatives Responsible Directors</b>		<b>Non-Responsible Directors</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)	1 (1)	0 (0)	4 (1)	411 (357)	416 (359)		15.9	
approved	0 (0)	1 (1)	0 (0)	4 (1)	419 (320)	424 (322)			
refused	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)			
withdrawn	0 (0)	0 (0)	0 (0)	0 (0)	22 (39)	22 (39)			
<b>Securities Margin Financiers</b>		<b>Securities Margin Financiers</b>			<b>Representatives Approved Directors</b>		<b>Non-Approved Directors</b>	<b>Total</b>	<b>% Change</b>
<b>Applications</b>									
received	0 (0)			0 (1)	15 (29)	15 (30)		-50	
approved	0 (0)			0 (1)	18 (36)	18 (37)			
refused	0 (0)			0 (0)	0 (0)	0 (0)			
withdrawn	0 (0)			0 (0)	0 (3)	0 (3)			
<b>Total number of applications received</b>							<b>4,555 (3,306)</b>	<b>37.8</b>	

Note: 31 March 2002 data in brackets

## Number of Registered Intermediaries

as at 31 March 2003

(Table 2)

Businesses	Sole Proprietors		Partnerships		Corporations		Total	% Change	
<b>Securities Ordinance</b>									
<b>Dealers</b>									
SEHK Participants	51	(60)	1	(1)	433	(433)	485	(494)	
Non-SEHK Participants	3	(7)	0	(0)	206	(216)	209	(223)	
<b>Sub-total</b>	<b>54</b>	<b>(67)</b>	<b>1</b>	<b>(1)</b>	<b>639</b>	<b>(649)</b>	<b>694</b>	<b>(717)</b>	
Advisers	13	(15)	0	(0)	683	(652)	696	(667)	
Margin Financiers	0	0	0	(0)	8	(8)	8	(8)	
<b>Commodities Trading Ordinance</b>									
<b>Dealers</b>									
HKFE Participants	0	(0)	0	(0)	130	(132)	130	(132)	
Non-HKFE Participants	0	(0)	0	(0)	21	(23)	21	(23)	
<b>Sub-total</b>	<b>0</b>	<b>(0)</b>	<b>0</b>	<b>(0)</b>	<b>151</b>	<b>(155)</b>	<b>151</b>	<b>(155)</b>	
Advisers	1	(1)	0	(0)	127	(125)	128	(126)	
<b>Leveraged Foreign Exchange Trading Ordinance</b>									
Discretionary A/C	-	-	-	-	7	(7)	7	(7)	
Non-Discretionary A/C	-	-	-	-	4	(4)	4	(4)	
Introducing Agent	-	-	-	-	0	(0)	0	(0)	
<b>Sub-total</b>					<b>11</b>	<b>(11)</b>	<b>11</b>	<b>(11)</b>	
<b>Grand Total</b>	<b>68</b>	<b>(83)</b>	<b>1</b>	<b>(1)</b>	<b>1,619</b>	<b>(1,600)</b>	<b>1,688</b>	<b>(1,684)</b>	
<b>Individuals</b>									
	Directors		Representatives				Total	% Change	
<b>Securities Ordinance</b>									
<b>Dealers and Representatives</b>									
SEHK Participants	1,013	(1,114)	7,573	(8,350)			8,586	(9,464)	
Non-SEHK Participants	378	(322)	4,656	(4,946)			5,034	(5,268)	
<b>Sub-total</b>	<b>1,391</b>	<b>(1,436)</b>	<b>12,229</b>	<b>(13,296)</b>			<b>13,620</b>	<b>(14,732)</b>	
Advisers and Representatives	1,194	(1,122)	4,468	(5,277)			5,662	(6,399)	
Margin Financier's Representatives	15	(17)	139	(193)			154	(210)	
<b>Commodities Trading Ordinance</b>									
<b>Dealers and Representatives</b>									
HKFE Participants	283	(301)	3,319	(3,490)			3,602	(3,791)	
Non-HKFE Participants	27	(27)	243	(262)			270	(289)	
<b>Sub-total</b>	<b>310</b>	<b>(328)</b>	<b>3,562</b>	<b>(3,752)</b>			<b>3,872</b>	<b>(4,080)</b>	
Advisers and Representatives	178	(171)	212	(209)			390	(380)	
<b>Leveraged Foreign Exchange Trading Ordinance</b>									
Trader's Representatives	38	(35)	987	(875)			1,025	(910)	
<b>Grand Total</b>	<b>3,126</b>	<b>(3,109)</b>	<b>21,597</b>	<b>(23,602)</b>			<b>24,723</b>	<b>(26,711)</b>	
<b>Total number of registrants (businesses and individuals)</b>							<b>26,411</b>	<b>(28,395)</b>	<b>-7.0</b>

Notes: "Directors" included approved directors of margin financiers and responsible directors of leveraged foreign exchange traders  
31 March 2002 data in brackets

## Intermediaries Supervision Department

### What We Do

- Monitor and supervise the financial viability and business conduct of intermediaries;
- Raise the standards of control and risk management of intermediaries to protect investors;
- Devise balanced policies and regulations to promote market integrity and development; and
- Maintain ongoing dialogue with market participants to uplift industry standards.

### What We Did

#### Supervision of Intermediaries Using a Risk-Based Approach

##### Financial Viability of Intermediaries

In the past year, the economic downturn and low volume of transactions put tremendous pressure on intermediaries. However, many of them took various cost-cutting measures – such as streamlining their operation or procedures – to strengthen their competitiveness.

We understand the importance of prudent management of intermediaries' financial viability in protecting the investing public and mitigating potential systemic risk. During the year, we critically assessed the financial positions of intermediaries based on their monthly financial reports.

The statistical information and financial highlights of the securities market for 2002 are summarised in Table 3.

Statistical Information on Securities Market <sup>1</sup> (Table 3)		
	As at 31/12/02	As at 31/12/01
Total number of securities dealers & securities margin financiers	696	719
Total number of active cash clients	565,585	624,700
Total number of active margin clients	56,787	63,568
	(HK\$ Million)	(HK\$ Million)
<b>Balance Sheet</b>		
Cash in hand and at bank <sup>2</sup>	56,998	57,721
Amounts receivable from margin clients <sup>3</sup>	12,242	12,004
Amounts receivable from clients and other dealers arising from dealing in securities	24,986	21,192
Other assets	34,511	24,667
<b>Total assets</b>	<b>128,737</b>	<b>115,584</b>
Amounts payable to clients and other dealers arising from dealing in securities	50,055	41,568
Total borrowings from financial institutions	5,380	5,762
Other liabilities	21,690	19,889
Total shareholders' fund <sup>4</sup>	51,612	48,365
<b>Total liabilities and shareholders' fund</b>	<b>128,737</b>	<b>115,584</b>
	<b>12 months to 31/12/02</b>	<b>12 months to 31/12/01</b>
	(HK\$ Million)	(HK\$ Million)
<b>Profit and loss</b>		
Total value of transactions <sup>5</sup>	7,066,624	7,248,805
Net commission income from securities dealing	10,109	11,915
Gross interest income	2,139	3,243
Other income <sup>6</sup>	15,691	16,474
Total overheads and interest expense	-26,075	-31,203
<b>Net profit for the period</b>	<b>1,864</b>	<b>429</b>

<sup>1</sup> The above data were extracted from the monthly FRR returns submitted by securities dealers and securities margin financiers.

<sup>2</sup> Cash in hand and at bank includes trust monies held on behalf of clients.

<sup>3</sup> Average collateral coverage (the number of times the aggregate market value of securities collateral deposited by clients covers the amounts receivable from margin clients on a given date on an industry-wide basis).

As at 31/12/02	As at 31/12/01
3.4	3.8

<sup>4</sup> The value of shareholders' fund includes value of redeemable shares.

<sup>5</sup> The value of transactions includes trading in equities and bonds both in Hong Kong and overseas.

<sup>6</sup> Other income mainly comprises corporate finance income, fund management income, net profit/loss on proprietary trading, intercompany charges and others.

Table 3 illustrates that the securities industry as a whole had strengthened its total shareholders' fund by 6.7% as compared with 2001. Despite a significant drop in total income, the improved aggregate profit was mainly attributable to the low base in 2001 and the efforts of non-exchange participants. Due to this diversified income and market base, these intermediaries were less impacted by the local economic downturn or the shrinkage in market turnover. The industry as a whole was able to cut overheads and finance costs substantially during the year.

**Proactive Regulatory Actions on High Risk Intermediaries**

Intermediaries with weak internal controls and risk management are generally more vulnerable in difficult market environment. Although a significant portion of our resources has been allocated for preparation and implementation of the SFO, the Department continued to evaluate intermediaries' standards of controls and risk management through onsite reviews and prudential meetings throughout the year. The inspections commenced during the year and the summary of breaches by intermediaries identified during inspections are set out in Tables 4 and 5 respectively.

The risk-based approach we have adopted allows flexible use of our resources. We effectively monitor the high risk intermediaries and proactively take appropriate regulatory measures to manage down the identified risks. These measures include:

- Discussing with senior management of intermediaries about the financial risks;
- Proposing risk mitigation measures such as reducing excessive credit exposures;
- Where necessary, taking restrictive actions to ring-fence investors' assets and minimise systemic risks.



**Breaches by Dealers, Traders and Advisers Noted from the Completed Inspections during April 2002 to March 2003 (Table 5)**

Nature of Breaches	SEHK	Non-SEHK	HKFE	Non-HKFE	LFE	Share	Investment	Commodity
	Participant	Participant	Participant	Participant	Trader	Margin	Investment	Trading
		Dealer		Dealer		Financier	Adviser	Adviser
Failure to comply with Financial Resources Rules	24	3	2	0	0	2	8	2
Failure to safekeep clients' securities	37	2	1	1	0	0	3	0
Failure to maintain proper books	19	2	0	0	0	0	3	0
Failure to safekeep clients' money	26	2	1	1	0	0	2	0
Unregistered dealing & other registration issues	8	2	1	0	0	0	8	0
Breach of licensing conditions	1	1	0	0	0	0	2	1
Breach of contract note and statement of account requirements	14	1	2	0	0	1	2	0
Failure to make filing/notification	4	4	1	1	0	1	5	0
Breach of margin requirement	1	0	5	1	0	1	0	0
Marketing of unauthorised funds	0	0	0	0	0	0	1	0
Illegal short selling of securities	3	0	0	0	0	0	0	0
Internal control weaknesses	86	18	8	3	0	1	30	7
Breach of Code of Conduct	65	10	5	1	0	2	19	2
Breach of Code on Unit Trusts & Mutual Funds	0	2	0	0	0	0	2	1
Breach of Fund Manager Code of Conduct	0	4	0	0	0	0	8	3
Non-compliance with money laundering guidelines	6	1	0	0	0	0	2	1
Breach of other rules and regulations of the Exchanges	6	0	1	1	0	0	1	0
Breach of Guidance Note on Competence	1	0	0	0	0	0	0	0
<b>Total</b>	<b>301</b>	<b>52</b>	<b>27</b>	<b>9</b>	<b>0</b>	<b>8</b>	<b>96</b>	<b>17</b>

The following two cases illustrate our regulatory approach.

#### Lawsons Securities Company

The Department identified internal control deficiencies in the firm and instructed Lawsons to appoint an independent accountancy firm in May 2002 to confirm account balances directly with Lawsons' clients. The accountants reported significant discrepancies between Lawsons' stock records and the records of CCASS. To protect clients' interests, on 7 June, the Commission served a restriction notice on the sole proprietor, Law Siu Kong Christopher, prohibiting him from dealing in securities and disposing of or dealing with any assets held by himself or Lawsons.

In discovering Law's attempt to breach the restriction notice, the Commission immediately applied to Court for an injunction to preserve and protect the assets. A mareva injunction was obtained in the High Court on 18 July. On the same day, the Commission obtained a Court order appointing two administrators to deal with the assets of Law and Lawsons.

In order to deliver a clear regulatory message to the industry that the Commission will not tolerate any breach by registered persons of their fiduciary duties to hold and protect client assets, the Commission filed a petition for bankruptcy against Law on 22 January 2003, as it appeared to be expedient in the public interest to do so. The Commission obtained a bankruptcy order against Law on 19 March 2003.

#### Pacific Pearl Securities Limited (PPSL)

PPSL had been under the SFC's close risk-based monitoring due to its vulnerable financial position. During a detailed review of the firm's financial position in October 2002, the Department discovered unusual fund transfer activities in the accounts of PPSL. We further found that PPSL had failed to meet the minimum liquid capital requirement under the Financial Resources Rules (FRR). The Department requested the owner of the firm to rectify the shortfall of funds.

Upon our request, the unusual fund transfer stopped in mid-October and the problem appeared to have been temporarily resolved. However, our continuous monitoring identified further breaches of the FRR by the firm since 1 November 2002.

We gave an urgent deadline to the owner to meet the capital requirement and requested it not to transfer funds out of PPSL to other related parties. On 4 November, the owner finally confirmed that it was unable to rectify the shortfall and PPSL voluntarily suspended trading on the SEHK on 5 November 2002.

The Department's staff closely worked with PPSL to ensure the orderly return of assets to all its clients. All assets were returned to clients subsequently.

## Devising Balanced Policies and Regulations to Promote Market Integrity

### ■ Rules and Regulations for New Regulatory Regime

The Department was involved in developing subsidiary legislation, codes, guidelines and forms under the SFO which are related to supervision of intermediaries. When preparing these, we consulted the market widely including industry representatives, professional bodies and other regulatory bodies.

We also issued 47 circulars during the year to continuously update intermediaries about current regulatory issues and developments such as implementation of the SFO, reinforcement of regulatory requirements and reminders about market misconduct cases.

### ■ Financial Resources Rules

We were concerned about the potential risks resulting from imprudent risk management policies adopted by certain intermediaries who provide securities margin financing to clients. In order to promote proper risk management practice, two amendments to the FRR were made to contain the financial risks arising from acceptance of excessive illiquid stock collateral and over-borrowing from banks by re-pledging margin clients' stock collateral. We have had no reports of material problems since these amendments became effective on 1 October 2002.

To facilitate market development and enhance flexibility of our regulatory requirements, the Department during the year approved 29 applications for subordinated loans, one application for redeemable shares for the FRR computation, and granted 19 modifications and waivers of certain regulatory requirements to intermediaries where investors' interest is not compromised.

### On-Going Dialogue with the Market to Raise Business Standards

#### ■ Market Participants

The Department formed a Working Group in May 2002 to develop a robust risk-focused financial regulatory framework for intermediaries. The Group comprises industry representatives, academics and the Commission.

In addition, the SFC and the Joint Financial Intelligence Unit (JFIU) co-organised two seminars on prevention of money laundering in June 2002. The seminars successfully reinforced intermediaries' understanding of their anti-money laundering obligations under the law and regulations.

The SFC in November 2002 began a monthly forum with representatives of brokers' associations to discuss issues of common interest and involve them in the

early stages of policy consultation. The regular meetings have helped deepen understanding between the regulator and the practitioners.

#### ■ Regulatory Counterparts and Professional Bodies

We co-operated on many issues with the securities regulators in other jurisdictions including Mainland China, Taiwan and Korea. These issues included joint reviews on intermediaries and exchange of views on regulatory matters.

We recognise that auditors play a significant role in assessing the financial position and monitoring the compliance status of intermediaries. In May 2002, the Department, with the support of the Hong Kong Society of Accountants (HKSA), organised a discussion forum to share our regulatory views and concerns with more than 100 audit practitioners. In addition, the Department worked closely with the HKSA in the implementation of the SFO.



#### Codes and Rules

▶ The SFO accords greater flexibility to the SFC by giving it powers to prescribe financial and operational requirements and business conduct standards for intermediaries through rules and codes. This will enable the SFC to quickly respond to changing market conditions by making the necessary changes to the rules and codes rather than having to amend the SFO itself. There is now a clear and transparent process of market consultation in formulating these rule and code changes.



## Investment Products Department

### What We Do

- Authorise investment products for sale to the Hong Kong public in accordance with product codes and industry standards;
- Monitor marketing materials and disclosures of funds;
- Formulate policies for the development of new products;
- Strengthen international regulatory co-operation in relation to collective investment schemes and their operators; and
- Conduct annual survey on the fund management activities in Hong Kong.

### What We Did

#### Product Authorisation

As of 31 March 2003, the total number of authorised products reached a record high of 2,457. During the year, 443 products were authorised and the total number of applications and withdrawals that were processed increased by 18%. There was sustained growth in the retail fund market. Details are shown in Table 6.

	As at 31/03/03	As at 31/03/02
Unit trusts and mutual funds	1,965	1,890
Investment-linked assurance schemes	129	100
Pooled retirement funds	37	39
MPF master trust schemes	47	49
MPF pooled investment funds*	241	217
Others	38	21
<b>Total</b>	<b>2,457</b>	<b>2,316</b>

\* There are 98 funds included in this category that are offered both as retail unit trusts as well as pooled investment funds for MPF purpose.

The demand for a diversified range of investment products by the public continued to grow. While standard bond and equity funds still comprised the bulk of the funds population, guaranteed funds experienced the largest growth. The aggregate net asset value of all authorised unit trusts and mutual funds as at December 2002 amounted to US\$342 billion (Table 7). Funds authorised in Hong Kong continued to exhibit a strong international flavour (Table 8).

	Total		NAV*	
	Number	%	(US\$ Million)	%
Bond	311	17	77,702.9	22.7
Equity	1,030	57	143,289.9	41.9
Diversified	124	7	28,841.8	8.4
Money Market	65	4	69,739.1	20.4
Fund of Funds	63	4	2,375.5	0.7
Index	21	1	7,869.7	2.3
Guaranteed	181	10	11,733.7	3.4
Hedge	4	0	160.3	0.1
Other specialised#	4	0	421.3	0.1
	1,803	100	342,134.2	100
Umbrella structures	162			
<b>No. of Authorised Funds</b>	<b>1,965</b>			

\* Net Asset Value as at 31 December 2002

# Includes: Futures & Options Funds & Leveraged Funds.

	Origin			Total			
	Umbrella Number	Sub-funds Number	Single Funds Number	Number	%	(US\$ Million)	%
Hong Kong	13	37	41	91	5	5,350.8	1.6
Jersey	2	23	0	25	1	2,810.5	0.8
Luxembourg	58	933	12	1,003	51	211,165.8	61.7
Ireland	37	278	14	329	17	70,050.8	20.5
Guernsey	5	67	4	76	4	2,471.9	0.7
United Kingdom	2	38	14	54	3	20,854.6	6.1
Other Europe	1	4	16	21	1	11,037.2	3.2
Bermuda	2	19	8	29	1	1,486.7	0.4
British Virgin Islands	4	7	11	22	1	883.3	0.3
Cayman Islands	37	221	47	305	15	15,589.2	4.6
Others	1	1	8	10	1	433.4	0.1
<b>No. of Authorised Funds</b>	<b>162</b>	<b>1,628</b>	<b>175</b>	<b>1,965</b>	<b>100</b>	<b>342,134.2</b>	<b>100</b>

\* Net Asset Value as at 31 December 2002 (excluding "umbrella funds")

The market for both investment-linked assurance schemes and Mandatory Provident Fund (MPF) pooled investment funds also continued to expand during the year as the public became more accustomed to saving up for retirement (Table 6).

In addition to authorising collective investment schemes, we monitor the marketing materials and the information reported by authorised funds to ensure high standards of disclosure.

#### Facilitating Product Development and Enhancing Information Disclosure

The Department has facilitated the development of a wide range of investment products in Hong Kong. We have also taken steps to enhance the disclosure standards. These initiatives are part of our continuous efforts to reinforce Hong Kong’s position as a premier regional fund centre.

In May 2002, we released the Hedge Fund Guidelines, which set out the regulatory requirements for the authorisation of hedge funds that are offered to the Hong Kong public. This was followed by the Guidelines on Hedge Fund Reporting Requirements in November. Both sets of Guidelines took into consideration the views from the market after extensive consultation.

Hong Kong is one of the first jurisdictions in the world to approve the sale of hedge funds to the retail public. Subsequent to the release of the guidelines, both single strategy hedge funds and fund of hedge funds have been authorised for sale. And to ensure a level playing field for all financial intermediaries in the marketing of retail hedge funds, the Commission and the HKMA issued a *Circular to Registered Persons Regarding the Marketing of Hedge Funds*. This collaborative effort reminded SFC licensees and banks alike of their obligations to assess the suitability of hedge funds for their clients.



#### Collective Investment Scheme

▶ A new term “Collective Investment Scheme” is introduced in the SFO to embrace the slightly overlapping concepts of unit trusts, mutual funds and investment arrangements. This term will be flexible enough to capture new products and ensure they are regulated appropriately without the need to change the law.



In response to requests for Real Estate Investment Trusts (REITs) to be introduced in Hong Kong, we issued a consultation paper on the proposed guidelines for the authorisation and regulation of REITs in early March 2003. Given the unique features and investment characteristics of this product, the proposed regulatory requirements will be set out in a separate code (i.e. not within the existing *Code on Unit Trusts and Mutual Funds*). We expect to publish this Code by the third quarter of 2003.

We have undertaken other initiatives to facilitate the fund authorisation process without compromising investor protection. Last year, we introduced an annotation requirement for fund offering and constitutive documentation for compliance with the *Code on Unit Trusts and Mutual Funds*. We also launched *Frequently Asked Questions* on the SFC website to help the market understand the requirements of the Code. A hedge funds application checklist was published to assist preparation of supporting documents.

REITs may broaden the choice of investment products available to the public.



To further improve the existing regulatory framework for the offering of passively managed index tracking funds in Hong Kong, we published in March 2003 a consultation paper on the draft guidelines for regulating Exchange Traded Funds. We expect to issue a set of guidelines also by the third quarter of 2003.

### **Stepping Up Communication with the Fund Industry**

During the year, we conducted seminars for industry participants to increase transparency of our regulatory functions. Nearly half of these engagements were about hedge funds. Presentations were also given on fund authorisation and REITs, especially during the consultation period to raise public awareness of the key policy proposals. Our longer term objective is to enhance understanding of our policies; maintain a productive exchange of views with the industry; and assist market practitioners to achieve best practices and standards.