

Supervision of Markets

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ADDED LEVEL OF INVESTOR CONFIDENCE AND SECURITY:

The new single investor compensation scheme extends the coverage to a broader range of intermediaries, including both exchange and non-exchange participants, banks and securities margin financiers. The compensation limit is raised to \$150,000 per investor.



Our mission is to ensure that the regulation and development of Hong Kong's securities and futures markets meet international standards.

ACHIEVEMENTS

- Streamlined regulatory regime for derivative warrants and other structured products
- Relaxed short selling regulation
- Moved closer to a scripless market
- Oversaw the development of advanced market infrastructure, including the launch of CCASS/3 clearing system and the upgrade of AMS/3 and HKATS trading systems
- Finalised the new single investor compensation scheme under the SFO
- Developed procedures for authorisation of Automated Trading Services

THIS CHAPTER IS ABOUT

- **Facilitating market development**
 - Encouraging product innovation and enhancement
 - Relaxing short selling regulation
- **Strengthening financial infrastructure**
 - SCEFI II Report
 - Review of HKEx's systems
 - Upgrade of CCASS/3 and derivatives clearing system
- **Publication of ePO Guidelines**
- **Market research**
- **Processing investor compensation claims**

What We Do

- Supervise and monitor the activities of the exchanges and clearing houses;
- Facilitate the development of and encourage participation in the Hong Kong markets;
- Strengthen market infrastructure; and
- Oversee and manage Hong Kong's investor compensation funds.

What We Did

Facilitating Market Development

■ Encouraging Product Innovation and Enhancement

The SFC worked with HKEx to widen its product range and streamline the regulatory requirements for the following products:

- In May 2002, the Hong Kong Futures Exchange (HKFE) introduced Dow Jones Industrial Average (DJIA) Futures contract for trading. The underlying DJIA is recognised around the world and widely used to track the performance of the US market.

- Effective 27 May 2002, HKFE increased the contract size of the One-month and Three-month HIBOR Futures contracts to five times their original contract size. The Exchange and Settlement Fees increased by only 2.5 times, resulting in an effective fee reduction of 50%.
- The Division worked together with our Corporate Finance Division, HKEx and other market participants to streamline the regulatory regime for derivative warrants and other structured products. HKEx introduced a new chapter in its Listing Rules in July 2002 to provide a platform for the listing of all structured products. The products launched under the new rules included derivatives warrants and equity-linked instruments.
- In November 2002, the HKFE launched the Mini-Hang Seng Index (HSI) Options contract, with a contract size which is one-fifth of the standard HSI Options contract. To encourage trading of the contract, the Commission reduced the SFC levy from \$1 to \$0.2 and the Compensation Fund levy from \$0.5 to \$0.1 upon the commencement of the SFO.

■ Relaxing Short Selling Regulation

To maintain the competitiveness of our markets and to reduce the compliance burden of market participants, we proposed changes to legislation to relax short selling regulation. The Securities (Miscellaneous) (Amendment) Rules 2002, which commenced in November 2002, extended the current naked short selling exemptions to all market makers recognised by SEHK and HKFE in their performance of market making transactions and hedging transactions.

The Rules also provide alternative reporting mechanisms for covered short selling orders to enable timely execution of transactions. To complement these exemptions, we worked with HKEx to implement corresponding exemptions from the tick rule for various market making transactions.

Strengthening Financial Infrastructure

■ SCEFI II Report

The Steering Committee on the Enhancement of the Financial Infrastructure (SCEFI) II Report was released in December 2002. Taking into account the changing business environment since the release of the first SCEFI Report in 1999, the Steering Committee incorporated three strategic objectives into the SCEFI II report: ensuring an efficient and robust market infrastructure; improving connectivity and interoperability for foreign investors; and creating superior liquidity.

A High Level Forum chaired by the Permanent Secretary for Financial Services and the Treasury (Financial Services) has been set up to oversee the implementation of SCEFI II recommendations. The Division chairs two of the three Implementation Working Groups (IWGs), including the Scripless Market IWG and the Interoperability IWG. The third one, the Clearing and Settlement Infrastructure IWG, is chaired by HKEx.

□ Scripless Market

A consultation paper on the proposals for a scripless market was issued in February 2002. The Scripless Market IWG, consisting of representatives from the Government, HKEx, the Federation of Share Registrars and the SFC, was formed to implement a scripless market model for Hong Kong. Work is in progress to develop the technical and operational details, including the preparation for necessary legislative changes. Focus groups of legal experts, market participants and listed companies have been formed to advise on the issues that may arise from the implementation.

□ Interoperability

The Interoperability IWG focuses on cross-border linkage and integration. To identify the way forward for the Interoperability IWG, the SFC visited a number of major market participants to understand their back

office operations and features in the current clearing and settlement systems. We found that most of their operations were highly automated.

□ Clearing & Settlement Infrastructure

The Clearing and Settlement Infrastructure IWG focuses on issues related to clearing and settlement. HKEx engaged a consultant firm to conduct a business case study on the SCEFI II recommendations. A consultant report was presented to the High Level Forum. The SFC is reviewing the consultant's assessments and proposals.



Investors have fast and easy access to the stock market through electronic channels.

■ Review of HKEx's Systems

During the year, HKEx encountered certain system problems, including interruption to the Hong Kong Futures Automated Trading System (HKATS) of HKFE. The SFC requested HKEx to conduct a series of comprehensive reviews on the technical architecture of its critical systems, the related operational procedures and the overall IT quality framework.

These reviews aim to identify areas for improvement in the technical architecture; ensure the implementation of proper operational procedures and checks and balances; and strengthen the quality of HKEx's IT system so that it will be in line with industry best practices. Independent consultants were engaged to conduct the reviews. The SFC has been closely monitoring the progress of these reviews and HKEx has largely followed and implemented the consultants' recommendations.

Following a system interruption of HKATS in late January 2003, we requested HKEx to engage an independent consultant, who will report to the SFC, to retest HKATS by using a standard higher than the industry best practice. We further requested the oversight of the retesting by a Board level committee. We will continue to work with HKEx on the matter.

■ Upgrade of CCASS/3 and Derivatives Clearing System

The next generation of the Central Clearing and Settlement System (CCASS/3) - with its open architecture, accessibility via the secured network FinNet, new collateral management functions and upgraded security functions - was successfully introduced in phases throughout 2002. We conducted regular reviews and monitored management of implementation as well as development of contingency plans to facilitate the introduction of stages 1 and 2 in May 2002 and December 2002 respectively. Stage 3 of CCASS/3, which will allow participants' supplied systems to directly access to CCASS/3 through an open gateway, is expected to be launched in 2003.

The implementation of an integrated derivatives clearing system, known as Derivatives Clearing and Settlement System (DCASS) and the upgraded trading system is under way. We continue to monitor the implementation and introduction of these new systems.

Publication of ePO Guidelines

We published the *Guidelines for Electronic Public Offerings (ePO)* in April 2003. The new Guidelines update the previous *Guidelines for Registered Persons Using the Internet to Collect Applications for Securities in an Initial Public Offering* and extend the scope to cover all public offerings (including IPOs and follow on offerings). The Guidelines explain the SFC's position in respect of the different forms of electronic public offerings via the Internet and other electronic means which have emerged since the initial Guidelines were published in 2000. Issues of hyperlinking and electronic prospectuses are also addressed.

Market Research

The Division conducts extensive research on the developments in the securities and futures markets of Hong Kong and other major markets, with a view to assisting the formulation of policies and the monitoring of market performance. We provide support to the Commission to achieve our regulatory objectives by analysing information and identifying the latest trends. To better communicate with the market and to provide more timely information, we launched a research paper series and revamped the statistical section of our website last year. We also worked with other regulators, academia and other divisions to publish the *SFC Quarterly Bulletin*.

Processing Investor Compensation Claims

As at 31 March 2003, the net asset values of the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF) were \$872 million and \$129 million respectively. During the year, payments totaling \$25.6 million were made from the UECF to 265 claimants in respect of the default of Win Successful Securities Ltd, Chark Fung Securities Co. Ltd, C.A. Pacific Securities Ltd, Lawsons Securities Company, Ying Kit Company Ltd and Foreground Securities Co. Ltd. Claimants of these defaulting brokers have received, or will receive, the amount allowed by the SEHK of up to \$150,000 per claimant under the agreed compensation arrangement. No payments were made from the CECF during the year.

In addition, we continued to work with the liquidators and HKEx on the preparation work of the distribution of the remaining assets of C.A. Pacific Securities Ltd to the claimants, for which the Court's decision on the classification of certain clients (as to whether they were cash clients or margin clients) was pending during the year. The Court made a judgment in March 2003.

Payments totaling \$1.7 million and \$0.1 million were made to eight clients of Wei Xin Securities Ltd and 24 clients of HW Securities Co. Ltd respectively after the liquidators' dividends of the firms were received.



New Investor Compensation Arrangement

- ▶ A new investor compensation arrangement has streamlined the previous arrangement and provided better protection to investors. Under the new arrangement, an independent Investor Compensation Company Limited (ICC) has been set up to administer and manage a single Investor Compensation Fund.

Compensation coverage is now extended to investors dealing with a broad range of intermediaries trading HKEx's products, including exchange and non-exchange participants, banks and securities margin financiers. The compensation limit is also raised to \$150,000 per investor. ICC was incorporated on 11 September 2002.

Automated Trading Services

- ▶ The SFO clearly sets out the legislative framework for the approval of Automated Trading Services (ATS) in Hong Kong. Different procedures apply depending on the nature of the services. Where they resemble stockbroking, the licensing regime will apply; and where they are more reminiscent of a stock exchange, a separate authorisation regime will apply. This flexible framework caters for the emergence of electronic trading networks and future market development.

The SFC has developed procedures for the authorisation of ATS and handling of applications.

