

Supervision of Markets

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

[Achievements]

- Authorised three Automated Trading Services providers
- Completed the comprehensive review of HKEx's fees and charges
- Monitored the development and launch of advanced market infrastructure under SCEFI recommendations including the DCASS and Investor Participant Account service
- Consulted the public on the level and the funding of the Investor Compensation Fund and the operation of the investor compensation arrangements
- Consulted the public on the disclosure of interests regime
- Facilitated the launch of H-shares Index Options and the enhancement of the stock options market
- Revised the SFC Market Contingency Plan and assisted in the set up of the backup site for the SFC
- Participated in a successful market contingency rehearsal co-ordinated by the Government
- Commenced legislative drafting for enabling a scripless market

[This Chapter Is About]

- Facilitating market development
 - Encouraging product innovation and enhancement
 - Authorisation of Automated Trading Services
 - Review of HKEx's fees and charges
 - Review of the disclosure of interests regime
- Strengthening financial infrastructure
 - Rollout of DCASS
 - HKEx's network consolidation project
 - Implementation of SCEFI initiatives (scripless market, IP Account, Settlement Instruction matching)
- Market contingency planning
- Investor compensation
 - Managing compensation funds and processing claims
 - Review of the Investor Compensation Fund levy and claim limit
- Market research

Investors First



Housewife Ms Susana Wong says she only invests in unit trusts and mutual funds.



Mr David Xia De Liang surfs the Internet often to obtain financial and investment information.



Mr Chong Kin Wah, a secondary school teacher, holds stocks for long term investment.

What We Do

- Facilitate the development of and encourage participation in the Hong Kong markets;
- Strengthen market infrastructure;
- Supervise and monitor activities of the exchange controller, exchanges and clearing houses;
- Regulate approved share registrars;
- Regulate authorised ATS;
- Supervise and monitor activities of the independent Investor Compensation Company Limited; and
- Manage Hong Kong's investor compensation funds.

What We Did

Facilitating Market Development

■ Encouraging Product Innovation and Enhancement

The SFC assisted HKEx in widening its product range, enhancing its markets and streamlining the regulatory requirements for various products:

- Following the successful launch of the Hang Seng China Enterprises Index (H-shares Index) Futures contract in December 2003, the HKFE introduced the H-shares Index Options contract in June 2004. Six market makers were appointed by HKFE to provide liquidity for the contract. The open interest of H-shares Index Options contract quickly exceeded 10,000 contracts in just a few months.
- The SFC is working with HKEx on the proposed launch of callable bull/bear contracts.
- HKEx implemented a number of measures to enhance the competitiveness of the stock options market. These included the reduction of the strike price intervals, allowing market

makers to fulfil their obligations by providing continuous quotations, and the reduction of the standard trading tariff of Tier 1 stock options contracts.

- In response to the market, in August 2004 HKEx published a consultation paper on the reduction of minimum trading spreads by two phases. HKEx's view is that a reduction of minimum trading spreads would increase stock market competitiveness, improve market efficiency and enhance market liquidity. Based on the results of the consultation, HKEx is planning to implement Phase 1 in 2005. Under Phase 1, about 20 stocks with share price over \$30 will have their minimum trading spreads reduced. The SFC is considering HKEx's proposal.
- To cope with the recent growth of the market, HKEx discussed with the SFC on the possibility of raising the prescribed position limit for HSI Futures and Options contracts, unchanged since August 1999. HKEx also proposed to increase the prescribed position limits for Stock Options contracts and H-shares Index Futures and Options contracts. The SFC will continue to work with HKEx to review the prescribed limits.
- In November 2004, Hong Kong Securities Clearing Company Limited (HKSCC) introduced a settlement agent model. Under this model, a Settlement Agent may operate a CCASS Participant's CCASS terminal in the Settlement Agent's offices. The SFC worked closely with HKEx to ensure that the infrastructure and procedures were in place, and approved the HKSCC rule amendments.

■ Authorisation of Automated Trading Services (ATS)

During the year, we authorised three ATS providers, bringing the total number of authorised ATS to eight – seven overseas exchanges and entities and one local subsidiary of an international information provider. Particulars of the authorised entities and their authorisation conditions are listed on the Register of ATS on the SFC website.

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As at the year-end, the SFC was processing one application from a local company and considering submissions from an entity as to whether it needs to be authorised to provide ATS in Hong Kong.

■ Review of HKEx's Fees and Charges

Fees charged by HKEx in its capacity as a recognised exchange controller, by SEHK and HKFE in their capacities as recognised exchange companies and by the clearing houses in their capacities as recognised clearing houses must be specified in their respective rules and approved by the SFC.

In March 2005, a comprehensive fees review was completed. HKEx proposed a number of changes to its fee structure. These include the elimination of HKSCC's scrip fee in two phases, a reduction in HKSCC's minimum stock settlement fees for exchange trades and settlement instructions (SI) transactions, the elimination of HKSCC's SI input fee, a reduction of the SEHK Options Clearing House Limited's and HKFE Clearing Corporation Limited's accommodation charges for utilised non-cash collateral, abolition of HKCC and SEOCH's interest retention rates on margin deposits and the rebate of interest to participants at the prevailing bank savings deposit rate on cash margin deposits, the introduction of a new deposit fee by HKSCC and replacement of HKSCC's custody fee, dividend and debt securities interest collection service fee and corporate action service fee with a single custody fee.

Some of the changes will be implemented forthwith while others will be implemented with the scripless market proposals. The SFC will consider the requisite HKEx rule amendments.

Even during the review, many fees had been reduced or abolished: abolishing the requirements and charges for registration of SEHK participants; abolishing processing fees for certain HKFE applications; and a reduction of the derivative warrant listing fees. In January 2005, the SFC also approved fee reductions for network charges to AMS/3 users as a result of HKEx's network consolidation project, and the abolition of the DCASS Standard Instruction Input/Processing Fee.

■ Review of the Disclosure of Interests Regime

When the SFO commenced in 2003, the Government and the SFC committed to review the Part XV disclosure of interests regime at an appropriate time. We began the review last year after the SFO had been implemented for one year. The SFC first asked selected market participants if Part XV met its policy objectives. We also consulted on any need to update the law in light of market demands and developments. As a result, we identified some principal issues for public consultation. On 20 January 2005, the SFC issued a Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the SFO.

Principal areas of the consultation include disclosure forms and codes; disclosure of security interests; simplification of the de minimis exception; situations which should be caught as a change in nature of interests; and proposed changes in certain specialist areas. The consultation paper also contains proposed technical changes to address business practices or for more consistent applications of the law.

The consultation ended in February and 24 submissions were received. The SFC is preparing the conclusions and will continue to work with the Government to draft amendments to Part XV.

Strengthening Financial Infrastructure

■ Rollout of DCASS

The Derivatives Clearing and Settlement System (DCASS) was successfully launched in April 2004. It provides enhanced clearing and settlement functions for index futures and options, stock options and other derivatives market products. It integrates with the derivatives trading system HKATS (Hong Kong Futures Automated Trading System) under a common network infrastructure.

With DCASS, exchange participants can clear their derivatives transactions with their counterparts in a more reliable, robust and seamless electronic

platform. The system allows greater flexibility for exchange participants to connect with their back office systems to achieve clearing automation, improve operational efficiency and facilitate straight-through-processing. We had worked closely with HKEx and participants in various tests, rehearsals and contingency planning before the launch to ensure that the system was stable and reliable.

■ HKEx's Network Consolidation Project

HKEx is operating several networks that facilitate access to the core equity and derivatives systems for trading and clearing (i.e. AMS/3, CCASS/3, HKATS and DCASS), as well as the market data feed system. The four networks were built separately over the years and exchange participants have had to install different circuits to access different markets through the separate networks.

In October 2004, HKEx announced its plan to consolidate the four major networks into one single SDNet, or the Securities and Derivatives Network. It aims to improve service reliability, enable the consolidation of communication lines, allow for lower line rental charges and better scalability, and streamline network management. The first phase of consolidation started in early 2005. We will monitor the progress to ensure a successful rollout to the market.

■ Implementation of SCEFI Initiatives

■ Work Towards a Scripless Market

Following public consultations by the SFC in 2002 and HKEx in 2003 on the proposals and a model for a scripless securities market, HKEx issued its conclusions in May 2004. It proposed a revised Issuer Register Model and a progressive implementation approach.

The proposed model enables shares to be issued and transferred electronically. Key features are as follows:

- As at present, there will continue to be a single register of members for each listed company to be maintained by an approved share registrar on behalf of the issuer.

- Dematerialisation will be optional. Investors may continue to hold certificates, or may hold shares in uncertificated form on the register of members. This means the register will consist of both certificated and uncertificated shareholdings.
- As at present, HKSCC will continue to operate on a nominee basis and investors holding shares deposited in CCASS through brokers and custodians will continue to be beneficial owners.

HKEx has proposed adopting the changes progressively depending on market demand. In essence, dematerialisation would begin with the CCASS Depository, then gradually be made an option for other registered shareholders with eventual establishment of electronic linkages between CCASS and share registrars' systems.

Upon SFC's recommendation, HKEx and the Federation of Share Registrars have formed a working group to draft an implementation plan and devise an operational model as proposed by HKEx. The SFC has worked closely with the working group. We concentrate our efforts on the legislative changes to enable a scripless market, and have been working closely with the Financial Services and the Treasury Bureau (FSTB) on the legislative proposals.

■ Enhancing HKEx's Investor Participant (IP) Account Service

During the year, the SFC approved CCASS Rules amendments to enable HKSCC to enhance its IP Account service. HKSCC introduced the following in August 2004: (a) improved communication (e.g. allowing instructions by phone and via the Internet; providing SMS messages on account activities that require investor participants' actions); (b) improved access (allowing self-assigned user ID and password); and (c) simplified procedures for stock transfer if it does not involve money settlement.

In the second quarter of 2005, the SFC will work with HKSCC to introduce additional enhancement including an optional Investor SI on-hold mechanism for Broker Participants and allowing individual or joint IPs to appoint a third party to attend company meetings.

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Enhancing the Settlement Instruction (SI) Matching Process in CCASS

The SFC has been working with HKSCC to enhance the SI matching process in CCASS. In October 2004, HKSCC introduced enhancements to automate the pre-matching process through which brokers and custodian banks for institutional investors can confirm with their counterparts SI details by phone, fax or email before inputting them into CCASS.

Market Contingency Planning

In early 2004, the SFC participated in a very successful market contingency rehearsal co-ordinated by the FSTB. Nine organisations including Government departments, regulators and market operators participated in the rehearsal. The rehearsal was to test the responses to a range of high impact scenarios relating to the financial services area including those with cross-market implications.

To reflect the recent developments of the securities and futures markets in Hong Kong and overseas, the SFC revised its Market Contingency Plan last year. New contingency scenarios were added and a project team was established to carry out in-depth analyses on these scenarios.

We wish to provide useful information on market contingency and business continuity planning to market participants and the general public through the SFC website. A Contingency Information section will be available in mid-2005.

The SFC is drafting Business Continuity Planning Guidelines for intermediaries. Last year, we gave two presentations on the growing importance of business continuity planning to over 100 staff of Exchange Participants.

In October 2004, a permanent SFC backup office was established in rented premises in a building in Kowloon. In the event of evacuation or the SFC offices becoming inaccessible or uninhabitable, an external Co-ordination Centre will be set up in the backup office for monitoring of the market.

Investor Compensation

Managing Compensation Funds and Processing Claims

As at 31 March 2005, the net asset value (NAV) of the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF) were \$49.12 million and \$0.27 million respectively. During the year, compensation payments totalling \$2.85 million were made from the UECF to 42 claimants in respect of the default of C.A. Pacific Securities Limited (CAPS), Lawsons Securities Company, and Ying Kit Stock Company Limited. The claimants have received, or will receive, the amount allowed by the SEHK up to \$150,000 per claimant under the agreed compensation arrangement. No payments were made from the CECF during the year.

The SFC has been working with the liquidators of CAPS and HKEx on the asset distribution to claimants. Up to 31 March 2005, the UECF has paid out compensation amounts of about \$300 million to the claimants of CAPS. As of 31 March 2005, the UECF has recovered assets of net value around \$108 million from the liquidators as a result of its subrogation rights, excluding \$31.8 million being the return of the paid compensation amounts from claimants who opted to receive allocated shares.

During the year, the UECF and CECF have transferred assets of about \$995 million and \$108 million respectively to the new Investor Compensation Fund (ICF). The net asset size of ICF was \$1.46 billion as at 31 March 2005. The ICF provides extended coverage to all investors transacting through licensed intermediaries dealing in HKEx's products, including securities and futures dealers, registered institutions under the Banking Ordinance and securities margin financiers.

The Commission has been regulating and monitoring the operations of the Investor Compensation Company Limited (ICC) since its inception in 2003. We will continue to assist the ICC in enhancing its operational procedures, claims

handling process, public awareness, corporate governance and technical infrastructure.

During the year, ICC received four claims. There were six outstanding claims at the year-end.

■ Review of the Investor Compensation Fund Levy and Claim Limit

The new ICF is mainly funded by transfers from the two old compensation funds (i.e. UECF and CECF), and by a 0.002% levy on securities transactions executed on SEHK and also \$0.5 (\$0.1 for smaller size contracts) contract levy on futures transactions executed on HKFE.

At the time of the passage of the Securities and Futures (Investor Compensation – Levy) Rules through the Legislative Council in December 2002, the Government undertook to review the size of the ICF, in light of its operational experience and prevailing circumstances.

According to an SFC consultation paper last December, with \$1.4 billion in asset and estimated annual expenditure and compensation of \$60 million, the ICF would become self-funding if an investment rate of return of 4.3% can be achieved in the long run.

In order not to accumulate amounts beyond what is necessary for the ICF and to reduce the burden on investors, the SFC proposed an automatic levy triggering mechanism. Under the proposal, the current investor compensation levies would be suspended if the NAV of the ICF exceeds \$1.4 billion. The levies would be imposed if the NAV falls below \$1 billion, which is the minimum prudent level which the ICF should maintain in order to cover its potential obligations.

The consultation paper examined the adequacy of the current \$150,000 per investor limit, first adopted in 1998, and concluded that the limit, which has provided a similar level of coverage to that in and since 1998, should be maintained.

The consultation paper also reviewed three suggestions to improve the existing procedures in

handling broker defaults (i.e. for the ICF to advance funds to liquidators for the purpose of facilitating the return of clients' shares pledged by a broker to a bank as security for a loan; to give power to liquidators to sell securities and distribute money; and use of ICF funds to pay for an administrator). It concluded that they should not be pursued because the suggestions would introduce additional financial exposure to the ICF, involve alterations to the existing individual proprietary rights of investors in securities held by brokers and have implications for the current law dealing with trust property and insolvency.

We received 12 submissions at the end of the consultation period in February 2005. Most of the respondents supported the SFC's recommendations. The SFC published the conclusions on 31 March 2005. We are working with the FSTB to amend the rules.

Market Research

The SFC conducts research on developments in the securities and futures markets of Hong Kong and major overseas economies. We monitor market and industry performance. Apart from providing support to the Commission to achieve our regulatory objectives by analysing information and identifying the latest trends, we provide timely information to the Government.

To better communicate with market participants and investors and to share with them industry knowledge, we launched a new research paper series, namely Profile of Exchange-traded Securities and Derivative Products in Hong Kong, on our website during the year. The SFC has continued to work with other regulators and academia on the publication of the SFC Quarterly Bulletin, in which we publish some of our research work and report our assessment of the financial stability of the securities market and industry.