

# Chairman's Statement



»» How is the SFC going forward after 15 years?  
In short, we are here to regulate so we have better markets.

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## Introduction

2003 was a year of major social and economic drama and recovery. As part of the community, the Securities and Futures Commission, with its operations being so closely related to the market and the public, shared the concerns experienced by the Hong Kong people.

In the first half of 2003, the SARS epidemic took away many lives and disrupted many aspects of social and economic activities in Hong Kong and other affected places. Fortunately, Commission staff were not affected but many recognised how important it was to share as a community. Last year, we formed a volunteer service team and did our share to care for the community. You will read more of this later in the chapter on *Corporate Affairs*.

## The Market in 2003-2004

After more than three years of retreat from the technology bubble of March 2000, the outbreak of SARS added pressure to the securities and futures markets in Hong Kong. The Hang Seng Index reached a 54-month low of 8,409 on 25 April 2003; market turnover shrank to as low as \$5.4 billion on 22 April. However, as the summer months approached and the epidemic receded, market confidence recovered rapidly.

In addition, the local economy received a boost on the signing of the Closer Economic Partnership Arrangement (CEPA) between the Mainland and Hong Kong. The relaxation of Mainland travel rules also benefited the retail, hotel and other tourism related sectors. The Hong Kong market essentially recovered with global markets as they benefited from historically low interest rates.

The HSI rose to an intra-year high of 13,928 on 18 February 2004. At the financial year-end, the HSI closed at 12,682, rising 47% during the year. Average daily market turnover increased to \$17.1 billion in March 2004, from \$7.3 billion in April 2003.

Last year also saw strong investor interest in H-shares and IPO activities. The H-share index surged 118% during the year, while the average daily turnover of H-shares increased to \$4.3 billion in March 2004, from \$0.8 billion a year ago.

There were 75 IPOs last year raising \$76.4 billion - the largest amount after the \$132 billion in 2000-2001 - of which 61% was for H-share companies.

As of the end of March 2004, there were 1,048 companies listed on the stock exchange with a total market capitalisation of \$5,769.5 billion (US\$740.8 billion), soaring 68% from last year. Hong Kong was the eighth largest market in the world by market capitalisation, advancing three places when compared to a year ago.

In 2003-2004, the average daily turnover on the Hong Kong market more than doubled the previous year's to \$13.8 billion. About 11% was contributed by derivative warrants. Hong Kong was the second most active derivative warrants market in the world last year by turnover. Trading of futures and options was also robust, with a total of 16.2 million contracts traded, 37% higher than the year before.

## The Commission's Finances

After two years of deficit result, we turned in a surplus for 2003-2004. Improved stock market turnover, hence levy income which is our major source of revenue, lifted total revenue to \$551 million. This was an increase of 63% or \$213 million from the previous year. Nevertheless, we have not slackened in cost controls. Total operating expenditure after depreciation edged up by 7% to \$426 million, mainly because of one-off office relocation expenditure and additional staff costs for new functions. Excluding these expenditures, the increase was 2% or \$7.4 million.

The surplus contrasted with an original projected deficit of \$93 million. Reserves at the end of March 2004 stood at \$691 million.

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We have forecast an operating surplus of \$4 million for 2004-2005. This reverses a 10-year string of budgeted deficits. There are more financial details in the chapter on *Corporate Affairs*.

### 2003-2004 Operational Review

The single most important event that shaped the work of the Commission last year was the commencement of the Securities and Futures Ordinance (SFO) on 1 April 2003.

I am pleased to report that the primary law and the comprehensive body of subsidiary legislation underpinning it have been implemented successfully. The key achievements are set out in a special chapter in this Annual Report.

Last year, we promised to strengthen enforcement and combat corporate misconduct as a matter of priority. We had 60% more successful prosecutions of various offences, and started 10 new investigations into listed companies under extended powers of the SFO. Our efforts will continue with increasing emphasis on back-end enforcement in regulation of listing.

Moreover, the rising market and trading volume on the stock exchange improved the bottom line of intermediaries. Net profit for the 12 months to end-2003 for securities dealers and securities margin financiers jumped 3.6 times to \$6,788 million from the previous year. Total shareholders' funds rose by 23%, with return on shareholders' fund as of 31 December 2003 increasing to 10.7% from 3.6% in 2002. All categories of Stock Exchange Participants did better last year. 36 brokers left the industry in an orderly manner as part of the consolidation in the industry.

There are more details provided in the Divisional Reports. In addition, the Commission made progress in many initiatives and projects, such as:

- Move to strengthen regulation of sponsors and independent financial advisers;
- Mutual recognition with our Mainland counterpart of industry qualifications under CEPA;
- Consultation on analysts conflicts of interest;
- A new Code on Real Estate Investment Trusts and authorisation guidelines for index-tracking exchange traded funds;
- Completion of working group discussions on measures to address the risk of pooling and re-pledging of client securities by securities margin financiers; and
- Agreement with HKEx on the way forward for both scripless and investor participation account enhancements, including oversight of successful launch of new stock and derivatives clearing systems (CCASS/3 and DCASS) that significantly improved Hong Kong's market infrastructure.

### 15 Years of SFC

On 1 May 2004, the Commission would have celebrated its 15th anniversary of establishment. There is a Chinese saying that it takes 10 years to grow a tree, but 100 years to grow a man. Fifteen years are therefore a short history for an institution that was born out of a financial crisis. It has grown from strength to strength through broadly three five-year stages.

The SFC was established on 1 May 1989 based on the blueprint of the *Securities Review Committee Report*, written by the Committee chaired by Mr Ian Hay Davison, which was commissioned by the Hong Kong Government after the market crash of October 1987. The Report set out the organisation structure of a new independent market regulator and the broad regulatory framework of the securities and futures industry in Hong Kong. Mr Robert Owen led the SFC from its

provisional status to its formal establishment under the Securities and Futures Commission Ordinance, and became the first Chairman.

In the first five years (1989 - 1994), various major rules, codes and guidelines were introduced. These included those that set the standards for and governed the conduct and financial resources of industry practitioners and those that facilitated the development of products in the market (e.g. the Code on Unit Trusts and Mutual Funds). The Insider Dealing Tribunal began life in 1991 to tackle insider dealing offences. The Commission also established memoranda of understanding with the stock exchange and the central clearing body.

Under the second Chairman, Mr Robert Nottle, the Commission consolidated its position as the securities market regulator, working closely with the stock exchange, and signed the important regulatory co-operation agreement with the Mainland authorities in 1993 that marked the beginning of the H-share and red chip market.

The second stage (1994 - 1999), especially in its early part, was marked by the Commission's more active international participation and closer relationship with its counterparts in the leading markets, spurred partly by the Barings crisis.

Our third Chairman, Mr Anthony Neoh, was in 1996 appointed Chairman of the International Organization of Securities Commissions' (IOSCO) Technical Committee. He also led the initiatives in improving investor education in Hong Kong. In 1996, a consultation paper was issued on a draft composite Securities and Futures Bill, one of the core recommendations of the *Davison Report*.

1997 marked a year of booming markets, the return of Hong Kong to China, but also the beginning of the Asian financial crisis. The first half of 1998 witnessed the failure of Peregrine Holdings and C.A. Pacific, and

in August 1998, the HKSAR Government intervened in the stock market to prevent destabilisation by excessive speculative activities. The stage was set for a three-pronged reform of the securities and futures markets announced by the Government in March 1999.

I was privileged to become the fourth Chairman of the Commission in 1998 and my tasks were to implement these major reforms in the last five years (1999 - 2004). By March 2000, the stock and futures exchanges were demutualised and merged with their clearing houses to form Hong Kong Exchanges and Clearing Ltd (HKEx). Secondly, thanks to tremendous support from the Financial Services and the Treasury Bureau and the Department of Justice, as well as the input of market participants, the SFO successfully commenced operation a year ago. Thirdly, significant progress has also been made in the development of world class financial infrastructure through the implementation of fourth generation trading and clearing systems, as well as improved networks that make Hong Kong's financial infrastructure one of the most modern in major markets.

Perhaps one of the most significant changes since the launch of the GEM market in 1999, which coincided with the technology bubble, was the clarification of the role of the regulatory structure in the securities and futures markets to tackle financial and corporate misconduct. The Penny Stock Incident in 2002 led to a comprehensive and intensive public debate on the appropriate alignment of the regulatory structure in Hong Kong, against the background of major changes in the US, UK and Australia.

With the coming of the SFO, which introduced Dual Filing, and the recent announcement by the Government to give statutory backing to important listing requirements, the Commission has now a clear mandate as the statutory regulator of corporate disclosure.

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### Going Forward

How is the SFC going forward after 15 years? In short, we are here to regulate so we have better markets.

The SFO has been smoothly implemented for just over a year. Through extensive soft and formal consultations with the market, we will continue to ensure that the new regulatory framework will give an appropriate level of protection to the investing public, without undue regulatory burden on market intermediaries and issuers. A review of the SFO is underway to make improvements where necessary.

It is vitally important that we must improve the quality of the market for Hong Kong to maintain its position as an international financial centre and capital raising hub of China. The responsibility for a high quality market depends on vigilance at all levels: investors, issuers, intermediaries, regulators and the media.

Information is a market fundamental. Investors must be given material, accurate, full and timely information to make investment decisions. Listed company disclosure should carry statutory liabilities with credible sanctions. In this regard, the Commission is pleased that the Government has decided on measures to improve the regulation of listing that gives statutory backing to important listing requirements.

A primary task for the Commission in the next few months is to work with the Government and HKEx to ensure that the reform can be achieved as quickly as practicable. This includes the drafting of rules under the SFO to codify certain important listing requirements, and implementation of administrative measures to improve the accountability and transparency of the listing regime.

This year, we demonstrate support for the market's effort in improving corporate governance by upgrading our own corporate governance disclosure.

Meanwhile, the SFC will continue to contribute towards IOSCO's activities in the run up to and no doubt after its

Annual Conference in 2006, which will be held for the first time in Hong Kong. I was honoured to be appointed Interim Chairman of its Technical Committee last October.

### The SFC Tree

The SFC, like any institution, is like a tree. The roots, branches and leaves are its people. Their talent, energy and creativity are what make the tree grow and prosper. But the tree derives its nourishment from the ground, the community it grows in. Hence, at the 15th anniversary of its history, the SFC cannot forget the contributions of its staff, nor the community that it has responsibility to.

I would therefore like to pay tribute to the dedication and hard work of all staff, who rode out of the SARS threat stronger and more united. Their health condition and peace of mind, and their well being in the workplace, remain a top priority.

Since his arrival last May, our new Chief Operating Officer/Executive Director, Mr Peter Au-Yang, has ably helped to strengthen internal governance and administration. One of his major responsibilities is to develop training, career building and staff incentives programmes to ensure that the SFC continues to be an attractive place to retain and attract the right blend of regulatory and market expertise that delivers its services to the community efficiently and cost-effectively.

The staff strength at the end of March 2004 was 416, rising from 403 in the previous year to cope with increased workload and new functions.

We were sorry to lose two Senior Directors, Ms Stella Leung and Mr Gerald Greiner, in the past few months. Ms Leung left us to spend more time with her family abroad and Mr Greiner left to become the Deputy Chief Operating Officer of HKEx.

Two Directors on short term secondment assisted the World Bank last year on a technical assistance programme to India on capital market development. We continued to exchange staff with the China Securities Regulatory Commission in order to strengthen our ties and deepen understanding of each other's regulatory functions and work.

The Commission is pleased that our administration senior manager, Mr Patrick Cheung, was awarded the Bronze Bauhinia Star last July by the HKSAR Government for his dedicated and meritorious service in the Civil Aid Service. Mr Cheung oversaw the seamless relocation of our offices of the last 12 years to our new premises in Chater House. We would like to place on record our appreciation to all staff, contractors and our landlord for their efforts in moving with no interruption to our normal operations and services. From our staff opinion survey, staff are happy with the modern and user-friendly environment.

With respect to the Board, Dr York Liao was appointed in May as a new Non-Executive Director (NED), resulting in a Board with NEDs in majority, as required under the SFO.

Our longest serving NED, Mr Henry Fan, retired from his SFC position last November. He was succeeded by Mr Christopher Cheng. I want to pay tribute to the dedicated services of Mr Fan, who has unstintingly provided to the Commission the breadth and depth of his corporate and legal experience since 1995. Much of the achievements of the Commission is owed to the selfless wisdom of the NEDs, who have contributed to more market-oriented policies and strengthening of the institution as a whole.

We would also like to record our appreciation and thanks to the members of the Advisory Committee and all other SFC Committees, Panels, and Groups, who have contributed their experience and insights into helping the Commission achieve its regulatory goals.



**Andrew L T Sheng**  
Chairman