

# Intermediaries & Investment Products



Madam Leung is renowned for her exquisite handiwork in making Chinese silk fabric buttons. She skillfully coils the insider patterns, frames them and sews them up. Like the buttonhole and the knot, the SFC and the industry work together to create a better market.



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



## Achievements

- Implemented the single licensing framework and achieved good progress in the migration of intermediaries to the regime
- Agreed with the CSRC to mutually recognise market practitioners' professional qualifications for licensing purpose
- Established a new fidelity insurance scheme for Stock Exchange Participants
- Completed the Report of the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations
- Approved 65 subordinated loans and 32 modifications and waivers of statutory requirements to facilitate brokers' operations
- Stepped up supervision of hedge fund managers
- Supervised 2,414 investment products and facilitated the growth of alternative investment products
- Issued the Code on REITs and the Guidelines for Regulating Index-tracking ETFs
- Signed a Declaration on Co-operation and Supervision of Cross-Border Investment Management Activity with ASIC

## This Chapter Is About

### >> Licensing Department

- Implementing the new licensing regime
- Upkeeping market standards
- Facilitating market development

### >> Intermediaries Supervision Department

- Monitoring intermediaries' financial soundness
- Conduct supervision

- Review of financial regulatory framework
- Flexible regulation and ongoing dialogue with intermediaries

### >> Investment Products Department

- Product authorisation
- Facilitating product and market development
- Strengthening regulatory co-operation on fund management activities
- Stepping up communication with the fund industry

### LICENSING DEPARTMENT

#### WHAT WE DO

>> **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

##### Implementing the New Licensing Regime

The Department continued to undertake various initiatives to ensure a successful switch-over by the industry to the new licensing regime under the SFO. Apart from devoting significant resources to conducting seminars and training sessions for various segments of the industry, we also:

- published the Licensing Information Booklet and posted on the SFC website sample completed licensing forms and Frequently Asked Questions and Answers;
- oversaw the roll-out of revamped licensing examinations for securities, futures, and leveraged foreign exchange trading intermediaries to align with the new licensing structure; and
- guided intermediaries on the new regime by issuing various circulars and guidelines.

The migration of licensees to the new regime has progressed smoothly and orderly. During the two-year transitional period provided under the SFO, all intermediaries previously registered under the former regime and intending to continue business are required to apply for a licence under the SFO. In the first year of the transitional period, 65% of the intermediaries (i.e. 520 corporations and 10,635 individuals) had applied to convert their old licences to new ones.

##### Upkeeping Market Standards

We continued to be vigilant in our gatekeeping duty. During the year, 144 applications were withdrawn because they failed to meet the licensing requirements. We also imposed licensing conditions on 1,839 new licensees as a means to limit their scope of activities, and revoked the licence of 115 bankrupt licensees to ensure that only fit and proper individuals are allowed to deal with investors.

To maintain the high standards of intermediaries and to protect investors, we:

- consulted the market on a policy proposal to address the analyst conflicts of interest issue. This followed the findings from our Securities Firm Survey and Investor Survey on Investment Research Activities conducted in 2003, where both the industry and investors had called for clearer and more specific regulations to address the issue.

Premised on the existing regulatory framework and the IOSCO principles as well as taking into account the local environment, the proposed guidelines aim to reduce analyst conflicts and mandate better management of conflicts by the firms and individuals (e.g. through disclosure). The SFC has also taken into account measures adopted in other leading markets in formulating these proposed guidelines.

We are mindful that the proposed measures should not constraint the free flow of market information or affect the quality of investment research. We will also step up investor education to enhance investor awareness of the issue; and

- worked with an industry group to appoint a new insurance broker to arrange and administer a more economical fidelity insurance scheme for securities brokers. The overall premium paid by Stock Exchange Participants has been substantially reduced by 35%. To further enhance investor protection, and market integrity and stability, we have also arranged for the futures brokers to subscribe to similar fidelity insurance in 2004-2005.

## Facilitating Market Development

Pursuant to the CEPA commitments, the SFC worked with the CSRC to mutually recognise each other's market practitioners' qualifications for licensing purpose. In December 2003, the CSRC and the SFC signed the Arrangements relating to Qualifications of Securities and Futures Industry Practitioners, which offers a simplified alternative route for securities and futures professionals of both jurisdictions to work across the border.

Hong Kong professionals having passed the examination on relevant Mainland laws and regulations may be granted industry qualifications by Mainland's Securities Association of China (SAC) or China Futures Association. Mainland professionals may be deemed by the SFC as having satisfied the requirements for industry qualifications in Hong Kong. Such arrangement has helped facilitate the flow of qualified personnel and expertise between the two jurisdictions, contributing to the further development of both markets.

In the first examination on Mainland securities regulations conducted by the SAC in Shenzhen on 20 March 2004, 348 Hong Kong professionals took part and 169 (about 50%) of the candidates passed.

To dispense with the licensing examination for former practitioners to re-enter the industry while not compromising intermediary standards and investor protection, we relaxed the re-entry competence requirements.

Former licensees who had left the industry for three to eight years would not need to sit for the competence examination but would be required to complete five Continuous Professional Training hours for each year of absence from the industry, or attend a specialised course to be provided by the Hong Kong Securities Institute in respect of securities and futures or the Vocational Training Council in respect of leveraged foreign exchange. Former practitioners who had left the industry for less than three years are exempt from the examination requirement.

During the year, we:

- granted 13 modifications or waivers in respect of statutory requirements to 21 licensed persons and applicants under circumstances where investor protection would not be compromised;
- pledged faster processing of licensing applications. New performance pledges for the processing of provisional licence and change of accreditation applications (seven business days) were introduced. We also pledged to process normal representative licence and responsible officer (formerly dealing director and supervisory director) applications faster (Please see details in *Our Performance Pledges* section);
- worked with HKEx to dispense with its requirements for sales representative registration and simplify its procedures for dealing director applications; and
- encouraged new product development. In collaboration with the Investment Products Department, we published the licensing guidelines for specialised fund managers of REITs, ETFs, and financial intermediaries of the Capital Investment Entrant Scheme.

## Licensing Statistics

Under the new single licence regime, the number of applicants for licences decreased by 18% to 3,732 (Table 1). This might be because applicants no longer need to apply for several licences to carry out different regulated activities. Instead, there was a 40% surge in the number of applications for approval to carry out additional regulated activities. Similar to the previous years, applications for dealing in securities remained the most significant, followed by advising on securities.

## Intermediaries & Investment Products

| Applications for Licence / Regulated Activity |              |                    |                 |                    |                      |                    |         | Table 1            |
|---|--------------|--------------------|-----------------|--------------------|----------------------|--------------------|---------|--------------------|
| 1 April 2003 to 31 March 2004                 |              |                    |                 |                    |                      |                    |         |                    |
| Applications                                  | Businesses   |                    | Individuals     |                    |                      |                    | Total   |                    |
|   | Corporations |                    | Representatives |                    | Responsible Officers |                    | Licence | Regulated Activity |
|   | Licence      | Regulated Activity | Licence         | Regulated Activity | Licence              | Regulated Activity |         |                    |
| Received                                      | 61           | 118                | 3,396*          | 5,673              | 275                  | 619                | 3,732   | 6,410              |
| Approved                                      | 46           | 90                 | 2,962           | 4,995              | 243                  | 512                | 3,251   | 5,597              |
| Refused                                       | 0            | 0                  | 0               | 0                  | 0                    | 0                  | 0       | 0                  |
| Withdrawn                                     | 11           | 32                 | 117             | 218                | 16                   | 33                 | 144     | 283                |

\* 1,511 applicants also applied for provisional licence.

The number of licensees (both businesses and individuals) decreased by 22% during the year, from 26,411 as of 31 March 2003 to 20,510 as of 31 March 2004 (Table 2). There were 97 registered institutions at

year-end. The decline in the number of licensees might be attributed to business consolidation under a single licence, as intermediaries could reduce their compliance costs.

| Number of Licences                            |              |                 |                      |               | Table 2 |
|---|--------------|-----------------|----------------------|---------------|---------|
| as at 31 March 2004                           |              |                 |                      |               |         |
|   | Corporations | Representatives | Responsible Officers | Total         |         |
| <b>By Licensee</b>                            |              |                 |                      |               |         |
| SEHK Participants                             | 448          | 7,390           | 1,130                | 8,968         |         |
| HKFE Participants                             | 122          | 404             | 45                   | 571           |         |
| SEHK and HKFE Participants                    | 5            | 217             | 24                   | 246           |         |
| Non-Participants                              | 723          | 8,750           | 1,252                | 10,725        |         |
| <b>Total</b>                                  | <b>1,298</b> | <b>16,761</b>   | <b>2,451</b>         | <b>20,510</b> |         |
| <b>By Regulated Activity</b>                  |              |                 |                      |               |         |
| Type 1 — Dealing in Securities                | 668          | 12,126          | 1,461                | 14,255        |         |
| Type 2 — Dealing in Futures Contracts         | 153          | 3,733           | 340                  | 4,226         |         |
| Type 3 — Leveraged Foreign Exchange Trading   | 16           | 975             | 45                   | 1,036         |         |
| Type 4 — Advising on Securities               | 980          | 9,574           | 1,532                | 12,086        |         |
| Type 5 — Advising on Futures Contracts        | 217          | 1,472           | 306                  | 1,995         |         |
| Type 6 — Advising on Corporate Finance        | 839          | 7,651           | 1,200                | 9,690         |         |
| Type 7 — Providing Automated Trading Services | 76           | 1,222           | 130                  | 1,428         |         |
| Type 8 — Securities Margin Financing          | 8            | 22              | 13                   | 43            |         |
| Type 9 — Asset Management                     | 973          | 7,676           | 1,321                | 9,970         |         |
| <b>Total</b>                                  | <b>3,930</b> | <b>44,451</b>   | <b>6,348</b>         | <b>54,729</b> |         |

## INTERMEDIARIES SUPERVISION DEPARTMENT

### WHAT WE DO

- Continuously monitor the financial positions of intermediaries and supervise their conduct;
- Raise the standards of control and risk management of intermediaries; and
- Carry out policy reforms to enhance investor protection and foster market development.

### WHAT WE DID

#### Monitoring Intermediaries' Financial Soundness

##### ➤ Financial Positions of Intermediaries

Hong Kong's financial market made a significant rebound as the local economy began to recover in the latter part of 2003. Fuelled by the rising market and increased trading volume on the SEHK, licensed intermediaries' reported financial positions improved substantially when compared to the previous year. Table 3 summarises the securities market's statistical information and financial highlights for 2003.

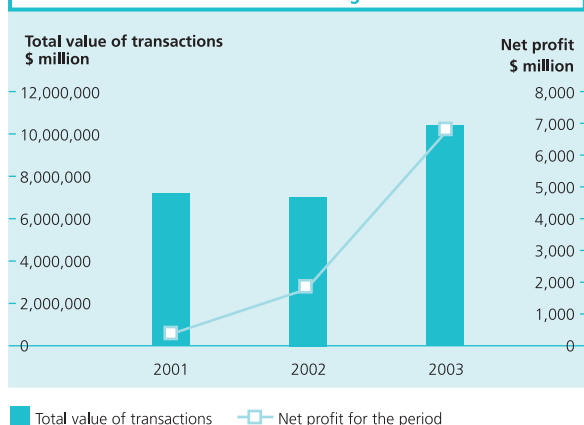
As a whole, the Hong Kong securities industry had a very strong year. Although there was a slight decrease in the number of intermediaries, their financial positions were solid. Net commission income from securities dealing rose (by 32% from a year ago) with the increase in other income such as proprietary trading and income from other financial activities. With the firms continuing to exercise tight controls over their expenditure, the securities industry's net profit more than tripled that in the previous year. The changes in total transaction values and net profit of securities dealers and securities margin financiers from 2001 to 2003 are shown in Chart 4.

Statistical Information on Securities Market <sup>1</sup> Table 3

|  | As at<br>31/12/2003                        | As at<br>31/12/2002                        |
|--|--|--|
| Total number of securities dealers and securities margin financiers                  | 673  | 696  |
| Total number of active cash clients (up 22%)   | 687,802                                    | 565,585                                    |
| Total number of active margin clients (up 25%)                                       | 71,240                                     | 56,787                                     |
| <b>Balance Sheet</b>   | (\$ million)                               | (\$ million)                               |
| Cash in hand and at bank <sup>2</sup>  | 88,209                                     | 56,998                                     |
| Amounts receivable from margin clients <sup>3</sup>                                  | 15,327                                     | 12,242                                     |
| Amounts receivable from clients and other dealers arising from dealing in securities | 63,261                                     | 24,986                                     |
| Other assets   | 105,003                                    | 34,511                                     |
| <b>Total assets (up 111%)</b>  | <b>271,800</b>                             | <b>128,737</b>                             |
| Amounts payable to clients and other dealers arising from dealing in securities      | 109,517                                    | 50,055                                     |
| Total borrowings from financial institutions   | 36,786                                     | 5,380                                      |
| Other liabilities  | 62,066                                     | 21,690                                     |
| Total shareholders' fund <sup>4</sup>  | 63,431                                     | 51,612                                     |
| <b>Total liabilities and shareholders' fund (up 111%)</b>                            | <b>271,800</b>                             | <b>128,737</b>                             |
|  | 12 months to<br>31/12/2003<br>(\$ million) | 12 months to<br>31/12/2002<br>(\$ million) |
| <b>Profit and loss</b>   |  |  |
| Total value of transactions <sup>5</sup>   | 10,456,801                                 | 7,066,624                                  |
| Net commission income from securities dealing  | 13,329                                     | 10,109                                     |
| Gross interest income  | 2,034                                      | 2,139                                      |
| Other income <sup>6</sup>  | 20,369                                     | 15,691                                     |
| Total overheads and interest expense   | -28,944                                    | -26,075                                    |
| <b>Net profit for the period (up 264%)</b>   | <b>6,788</b>                               | <b>1,864</b>                               |

- The above data were extracted from the monthly FRR returns submitted by securities dealers and securities margin financiers.
- Cash in hand and at bank includes trust monies held on behalf of clients amounting to \$41,126 million (2002: \$20,647 million).
- 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 31/12/03: 4.2      As at 31/12/02: 3.4
- The value of shareholders' fund includes value of redeemable shares.
- The value of transactions includes trading in equities and bonds both in Hong Kong and overseas.
- Other income mainly comprises corporate finance income, fund management income, net profit/loss on proprietary trading, intercompany charges and others.

Total Transaction Values and Net Profit of Securities Dealers and Securities Margin Financiers<sup>1</sup> Chart 4



- The value of transactions includes trading in equities and bonds both in Hong Kong and overseas.

| Financial Performance of Stock Exchange Participants <sup>1,2</sup> |            |           |            |           |            |         | Table 5                   |           |
|---|------------|-----------|------------|-----------|------------|---------|---------------------------|-----------|
| (\$ million)  |            |           |            |           |            |         |                           |           |
|   | Category A |           | Category B |           | Category C |         | All Exchange Participants |           |
|   | 2003       | 2002      | 2003       | 2002      | 2003       | 2002    | 2003                      | 2002      |
| <b>TOTAL</b>  |            |           |            |           |            |         |                           |           |
| Total value of transactions   | 2,605,007  | 1,995,041 | 2,173,651  | 1,387,553 | 1,137,154  | 730,540 | 5,915,812                 | 4,113,134 |
| Total operating income  | 7,310      | 7,437     | 5,536      | 3,574     | 3,280      | 2,658   | 16,126                    | 13,669    |
| Total overheads and interest expense                                | 5,709      | 6,163     | 3,475      | 3,474     | 2,784      | 3,189   | 11,968                    | 12,826    |
| Net profit for the year   | 1,601      | 1,274     | 2,061      | 100       | 496        | -531    | 4,158                     | 843       |

1. The above data were extracted from the monthly FRR returns submitted by securities dealers.

2. Categories A, B and C Participants are identified on a monthly basis, based on their turnover on the SEHK. Category A Participants refer to the top 14 brokers by market turnover, whilst Category B Participants refer to those ranked 15 - 65 and the remainders are grouped under Category C. The categories of Stock Exchange Participants listed in Table 5 are classified based on the December 2002 and 2003 turnover data.

Table 5 shows the increase in market turnover/value of transactions benefited all Stock Exchange Participants whose main source of income derives from the trading of local equities. In addition, Stock Exchange Participants continued to control their costs effectively, which resulted in better profitability.

All categories of the Stock Exchange Participants did better in 2003 in terms of turnover and net profit. In particular, the turnover of Category B Participants increased by more than 50% in 2003, while their expenditure remained at 2002 level. Likewise, Category C Participants as a whole were able to return to profitability after a loss-making 2002.

### ➤ Additional Regulatory Measures

The SFO has standardised the regulatory capital framework for all licensed intermediaries in the form of a liquid capital requirement to strengthen prudential regulation over advisers and asset managers. Advisers and asset managers are now required to regularly submit their financial returns to the SFC. In addition, to obtain information about their business operation and risk management measures, all licensed corporations and associated entities are required to submit annually a Business and Risk Management Questionnaire with their audited accounts.

During the year, we continued to take proactive actions to manage down targeted risky intermediaries with weak internal controls and risk management, including ring-fencing their business activities, in order to protect investors' assets and minimise systemic risk.

## Conduct Supervision

### ➤ Assessing Intermediaries' Compliance with Rules and Regulations

Inspection of intermediaries is another major function performed by the Department to protect the interests of the investing public. The Department inspected 201 intermediaries and made prudential visits to 76 intermediaries, an overall increase of 15% from the previous year. There were more inspections, resulting in the identification of more breaches, in particular those of conduct regulation. A summary of breaches by intermediaries identified during our inspections is listed in the Table 6.

| Breaches by Licensed Corporations Noted During SFC Inspections              |                          |            | Table 6 |
|---|--------------------------|------------|---------|
| Nature of Breaches  | Total Number of Breaches |            |         |
|   | 2003-2004                | 2002-2003  |         |
| Failure to comply with FRR  | 38                       | 41         |         |
| Failure to safekeep clients' securities                                     | 34                       | 44         |         |
| Failure to maintain proper books and records                                | 21                       | 24         |         |
| Failure to safekeep clients' money  | 33                       | 32         |         |
| Unlicensed dealing and other registration issues                            | 14                       | 19         |         |
| Breach of licensing condition   | 3                        | 5          |         |
| Breach of requirements of contract notes / statements of account / receipts | 72                       | 20         |         |
| Failure to make filing / notification                                       | 3                        | 16         |         |
| Breach of margin requirements   | 8                        | 8          |         |
| Marketing malpractices  | 4                        | 1          |         |
| Illegal short selling of securities   | 2                        | 3          |         |
| Breach of Code of Conduct   | 253                      | 104        |         |
| Breach of Code on Unit Trust and Mutual Funds                               | 0                        | 5          |         |
| Breach of Corporate Finance Adviser Code of Conduct                         | 2                        | 0          |         |
| Breach of Fund Manager Code of Conduct                                      | 18                       | 15         |         |
| Non-compliance with anti-money laundering guidelines                        | 30                       | 10         |         |
| Breach of other rules and regulations of the Exchanges                      | 5                        | 9          |         |
| Internal control weaknesses   | 226                      | 153        |         |
| Others  | 44                       | 1          |         |
| <b>Total</b>  | <b>810</b>               | <b>510</b> |         |

### ➤ **Stepping up Regulation of Hedge Fund Managers**

In light of the growing popularity of hedge funds in Hong Kong, we carried out special inspections to examine whether hedge fund managers adhere to the relevant regulations. Special attention was paid to their internal due diligence procedures and risk management policies.

### **Review of Financial Regulatory Framework**

In May 2002, a Working Group on Review of the Financial Regulatory Framework for Licensed Corporations was formed to develop a robust risk-focused financial regulatory framework for licensed corporations. The Working Group comprising representatives from the industry, academia and the Consumer Council had held 14 meetings since its inception.

The Working Group's recommendations were presented to the LegCo Panel on Financial Affairs in March 2004. The proposals aim to address the risks arising from pooling and re-pledging of client collateral by securities margin financiers. The principal measures proposed include introducing a cap on the amount of client collateral that a firm can re-pledge as security for its borrowings at a percentage of the aggregate amount of all its margin loans outstanding at the time; and increasing the haircut ratios prescribed under the Financial Resources Rules (FRR). These measures are supplemented by additional disclosure requirements under the Code of Conduct. A public consultation paper on the proposals is expected to be issued in the second quarter of 2004.

### **Flexible Regulation and Ongoing Dialogue with Intermediaries**

The SFC understands the need to facilitate the market and be flexible in enforcing its regulations, codes and guidelines. The following two cases illustrate our commitment to helping our intermediaries comply with our requirements without compromising investor protection:

#### **Approval of Subordinated Loans**

As the Hong Kong stock market rose and turnover increased towards the end of 2003, intermediaries' business volume expanded rapidly. In order to ensure that they had sufficient working capital to keep up with the pace of business growth, many intermediaries applied to the SFC for the approval of subordinated loans to meet the capital requirements under the FRR.

During the year, the Department approved 65 applications for subordinated loans, amounting to \$8,564 million. Only 29 applications were approved in the previous year. The processing time of subordinated loans for the purpose of IPO financing was as short as two business days.

#### **Modifications and Waivers of Regulatory Requirements**

During the year, we received an application for modification of FRR requirements from a licensed corporation principally engaged in proprietary trading of equity and equity derivatives. Given its unique business scope, the intermediary was granted modification allowing it to apply an alternative model to calculate its market risk capital requirement of proprietary positions in its trading book in lieu of haircuts and financial adjustments under the FRR.

Including the above modification, the Department granted a total of 32 modifications and waivers of regulatory requirements to intermediaries, an increase of 68% over the 19 cases in the previous year.

## INVESTMENT PRODUCTS DEPARTMENT

### WHAT WE DO

- >> Authorise investment products for sale to the Hong Kong public and their advertisements in accordance with product codes and industry standards;
- >> Monitor disclosures and ongoing compliance;
- >> 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 at 31 March 2004, the total number of authorised products stood at 2,414, comparable to last year's 2,457 (Table 7). During the year, 277 products were authorised and 320 products were withdrawn. We witnessed continuous fund restructuring and amalgamation by the fund sponsors and managers as part of their efforts to improve existing product ranges to better meet investors' needs.

|                                     | As at 31/03/2004 | As at 31/03/2003 |
|-------------------------------------|------------------|------------------|
| Unit trusts and mutual funds        | 1,872            | 1,965            |
| Investment-linked assurance schemes | 160              | 129              |
| Pooled retirement funds             | 37               | 37               |
| MPF master trust schemes            | 46               | 47               |
| MPF pooled investment funds*        | 255              | 241              |
| Others#                             | 44               | 38               |
| <b>Total</b>                        | <b>2,414</b>     | <b>2,457</b>     |

\* There are 108 funds included in this category that are offered both as retail unit trusts as well as pooled investment funds for MPF purpose.

# Other schemes comprise 38 equity-linked deposits and 6 paper gold schemes.

Table 8 shows that standard bond and equity funds still comprised the bulk of the funds population. Specialised investment products had become increasingly popular, with guaranteed funds and hedge funds experiencing the largest growth. As at 31 March 2004, there were 244 guaranteed funds and 10 hedge funds, compared to 181 guaranteed funds and four hedge funds a year ago. Innovative product concepts such as guaranteed funds linked to hedge funds or a hedge fund index also emerged during the year.

The market for both investment-linked assurance schemes and MPF pooled investment funds also expanded during the year. The revival of interest in common stocks also gave rise to renewed focus on equity-linked products. There were 38 authorised equity-linked deposits in 2003-2004, representing a 36% increase from 2002-2003 and continuing the growth trend.

On the back of the recovery of the global markets, the aggregate net asset value of all authorised unit trusts and mutual funds as at 31 December 2003 amounted to US\$534 billion, a rise of 56% compared to last year (Table 8). Funds authorised in Hong Kong continued to show a strong international flavour (Table 9).

|                               | Total        |     | NAV*           |       |
|-------------------------------|--------------|-----|----------------|-------|
|                               | Number       | %   | (US\$ million) | %     |
| as at 31 March 2004           |              |     |                |       |
| Bond                          | 294          | 17  | 112,048.3      | 21.0  |
| Equity                        | 891          | 52  | 270,581.5      | 50.6  |
| Diversified                   | 110          | 7   | 41,094.6       | 7.7   |
| Money Market                  | 58           | 3   | 81,471.8       | 15.3  |
| Fund of Funds                 | 76           | 5   | 3,863.3        | 0.7   |
| Index                         | 22           | 1   | 8,139.4        | 1.5   |
| Guaranteed                    | 244          | 14  | 15,998.9       | 3.0   |
| Hedge                         | 10           | 1   | 404.9          | 0.1   |
| Other specialised#            | 6            | 0   | 685.4          | 0.1   |
|                               | 1,711        | 100 | 534,288.1      | 100.0 |
| Umbrella structures           | 161          |     |                |       |
| <b>No of Authorised Funds</b> | <b>1,872</b> |     |                |       |

\* Net Asset Value as at 31 December 2003

# Includes: Futures & Options Funds & Leveraged Funds

**Origin/Net Asset Value of Authorised Unit Trusts and Mutual Funds** **Table 9**

| as at 31 March 2004           |                  |                     |        | Total      |                     |            |              |
|-------------------------------|------------------|---------------------|--------|------------|---------------------|------------|--------------|
| Umbrella Number               | Sub-funds Number | Single Funds Number | Number | %          | NAV* (US\$ million) | %          |              |
| Hong Kong                     | 15               | 50                  | 34     | 99         | 5                   | 6,792.5    | 1.3          |
| Luxembourg                    | 55               | 838                 | 11     | 904        | 48                  | 305,463.8  | 57.2         |
| Ireland                       | 40               | 285                 | 15     | 340        | 18                  | 151,561.6  | 28.4         |
| Guernsey                      | 4                | 40                  | 1      | 45         | 2                   | 2,470.2    | 0.4          |
| United Kingdom                | 2                | 39                  | 13     | 54         | 3                   | 28,098.9   | 5.3          |
| Other Europe                  | 1                | 4                   | 13     | 18         | 1                   | 10,337.3   | 1.9          |
| Bermuda                       | 2                | 22                  | 7      | 31         | 2                   | 2,237.6    | 0.4          |
| British Virgin Islands        | 4                | 8                   | 9      | 21         | 1                   | 1,614.3    | 0.3          |
| Cayman Islands                | 37               | 261                 | 53     | 351        | 19                  | 24,073.9   | 4.5          |
| Others                        | 1                | 1                   | 7      | 9          | 1                   | 1,638.0    | 0.3          |
| <b>No of Authorised Funds</b> |                  |                     |        | <b>161</b> | <b>1,548</b>        | <b>163</b> | <b>1,872</b> |
|                               |                  |                     |        | <b>100</b> | <b>534,288.1</b>    | <b>100</b> |              |

\* Net Asset Value as at 31 December 2003 (excluding "umbrella funds")

## Facilitating Product and Market Development

The SFC facilitated the development of a wide range of investment products, as part of our continuous efforts to reinforce Hong Kong's position as a premier regional fund centre. The guidelines on guaranteed funds, hedge funds, index funds, index-tracking ETFs, as well as the Code on REITs have laid the regulatory foundation for the development of specialised investment funds in Hong Kong.

- After extensive industry consultation, we released the Code on REITs in August 2003, which sets out the regulatory requirements for the authorisation of real estate investment trusts for sale to the public.

The introduction of REITs is part of the SFC's continuous efforts to broaden the choice of investment products available to the public. Retail investors will be able to invest in large-scale income-generating real estate in a cost effective manner, with a relatively transparent and well-defined investment strategy.

The SFC appreciates the importance of diversification into overseas properties for the longer-term development of REITs. Hence, we have set up a Task Force on Overseas Real Estate Investment by REITs to conduct research on overseas regulatory framework and perform case studies on overseas investments by REITs in foreign countries. Upon completion of its research, the Task Force will make recommendations on the minimum benchmarks that REITs should set for themselves if and when they invest in overseas properties. The market will be consulted on the Task Force's recommendations.

- We also worked with the SEHK in streamlining the listing process for authorised collective investment schemes and amending the related rules under Chapter 20 of the Main Board Listing Rules. This new Chapter 20 came into effect on 1 September 2003.
- In October 2003, we released the Guidelines for Regulating Index-tracking ETFs. The first ETF under the new guidelines was authorised in November 2003. This fund was also the first ETF authorised for listing pursuant to the streamlined listing regime as mentioned above.
- The SFC also assisted the Government in the implementation of the new Capital Investment Entrant Scheme (CIES). Based on the investment criteria released by the Department of Immigration, 16 authorised funds managed by our licensees were included as permissible investment under the scheme as of the end of March 2004.

## Strengthening Regulatory Co-operation on Fund Management Activities

The SFC signed a Declaration on Co-operation and Supervision of Cross-Border Investment Management Activity with ASIC in June 2003. There are now seven overseas jurisdictions officially recognised as acceptable inspection regimes under the Code on Unit Trusts and Mutual Funds. Five of them are also officially recognised as acceptable inspection regimes under the Code on

## Intermediaries & Investment Products

REITs. Under the terms of the various MOUs, the SFC and the overseas regulators would be able to exchange information with and offer assistance to each other concerning activities of fund managers licensed in their own jurisdictions.

### Stepping Up Communication with the Fund Industry

In our ongoing effort to enhance regulatory transparency, we published Frequently Asked Questions and Answers on our website to help the market understand the requirements of REITs and the investment related aspects of funds that seek to qualify for the CIES. A REITs application checklist was also published to assist preparation of supporting documents.

We conducted seminars for industry participants and a majority of these engagements concerned the new Code on REITs, our authorisation process, hedge funds requirements and issues arising from hedge funds applications.

Furthermore, we have been monitoring closely the international development on mutual fund trading malpractices including market timing and late trading. We are in dialogue with overseas regulators in this respect.

In order to gather information about the current fund industry trading practices in Hong Kong, the Department and the Intermediaries Supervision Department conducted a market-wide survey in early February 2004 with 176 licensed fund management or advisory companies. The survey aims to collect information about the fund managers' internal controls to prevent market timing and late trading. Such information will be used to facilitate our formulation of regulatory approach towards the conduct of fund managers and the operations of investment funds.

## Facilitating Market Development

To sum up, the following are initiatives of the Intermediaries and Investment Products Division to facilitate market development and their results:

### >> Cost Savings for the Market

- Industry saved \$4.6 million in SFC's lower licensing fees.
- Stockbrokers save \$14 million in fidelity insurance premium for 2004-2005 - a 35% reduction from last year.

### >> Launching New Services and Products

- We worked closely with the market to facilitate new investment products such as hedge funds, REITs and index-tracking ETFs so intermediaries can offer diversified products and services to customers.
- Private data survey sources suggested that Hong Kong is the largest centre in Asia (ex-Japan) in terms of assets under management by Asian-focused hedge funds. Moreover, Hong Kong attracted the most money in the Asian region for new hedge funds start-ups in 2003.

### >> Faster Handling of Applications

- We have pledged to process licensing applications faster - for representatives and responsible officers the processing time is substantially reduced to eight weeks (previously 10 weeks) and 10 weeks (15 weeks) respectively. Provisional licence and change of accreditation may be approved in seven business days.

### >> Continuous Industry Dialogue

- We meet regularly with the five brokers associations. Moreover, we met with various industry groups 23 times during the year to exchange views on policy issues, such as CEPA, analysts' conflicts of interest, brokers' fidelity insurance scheme, and risks arising from securities margin financing.
- We issued 64 circulars to intermediaries and provided 13 training and briefing sessions, covering operational areas. More than 300 FAQs were posted on the SFC website to help the market better understand our regulation.