

Supervision of Markets

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

Achievements

- Approved HKEx rules to launch Callable Bull/Bear Contracts
- Formulated a Six-Point Plan on the derivative warrants market
- Approved HKEx rules to increase the position limits on stock options contracts and to reduce trading spreads
- Approved HKEx rule amendments for the migration of the Securities and Derivatives Network
- Co-ordinated market contingency planning for World Trade Organization's 6th Ministerial Conference and avian flu preparation
- Reviewed the Investor Compensation Fund levy
- Published research reports
- Strengthening market infrastructure
 - HKEx's new network and CCASS services
 - Implementation of market infrastructure enhancement recommendations
 - ETF market making infrastructure
- Co-ordinating market contingency planning
- Monitoring investor compensation
 - Compensation funds and Investor Compensation Company
 - Review of the Investor Compensation Fund levy
- Market research

This Chapter Is About

- Facilitating market development
 - Encouraging new product development
 - Review of the derivative warrants market
 - Position limits and trading spreads
 - Review of the disclosure of interests regime
 - Authorisation of Automated Trading Services providers
- Facilitate the development of and encourage participation in Hong Kong markets
- Strengthen market infrastructure
- Supervise and monitor activities of the exchange controller, exchanges and clearing houses
- Authorise Automated Trading Services providers
- Regulate approved share registrars
- Co-ordinate market contingency planning
- Supervise the Investor Compensation Company and manage investor compensation funds
- Conduct market research

What We Did

Facilitating market development

✓ Encouraging new product development

We worked closely with HKEx and the market to widen the product range available to investors and to ensure proper regulation of new products.

During the year, we discussed with HKEx its plans and measures to mitigate risks associated with the launch of Callable Bull/Bear Contracts (CBBCs). CBBC is a structured product that tracks the performance of an underlying asset. It expires at a fixed date or must be called by the issuers when the price of the underlying asset reaches the call price. We consulted potential issuers and the market on concerns regarding the potential liquidity impact of unwinding activities, the snowball effect of several CBBCs with similar call prices and the potential risk of market manipulation around a call event. The SFC emphasised to HKEx the importance of a proper monitoring system and contingency plans to address these concerns.

In October 2005, HKEx proposed to initially limit the underlying assets of CBBCs to the five most liquid stocks, Hang Seng Index, H-shares Index, overseas indices, commodities and currencies. HKEx also committed to implementing a surveillance programme to detect rules breaches, a monitoring system to track market activities and contingency measures to mitigate the risks under extreme market situations. We approved the proposals in November.

We will continue working with HKEx in its effort to educate market participants and the public, implement the systems and roll out the products.

With the growing demand for ETFs, in addition to the ETFs on the Asian Bond Fund 2, we also worked with HKEx and market participants to facilitate the launch of the Hang Seng FTSE/Xinhua China 25 ETF during the year.

The SFC worked with HKEx on the FTSE/Xinhua China 25 Index Futures and Options contracts, which were launched in May 2005. The underlying index tracks the 25 largest H-shares and red chips listed in Hong Kong.

✓ Review of the derivative warrants market

In August 2005, the SFC carried out a review of the derivative warrants market. We issued a Six-Point Plan in November 2005 to strengthen the regulatory regime and enhance investors' understanding, and invited the public to comment. In March 2006, we announced how we will proceed with the proposals to:

- tighten the liquidity provider provisions;
- facilitate further issues and identical issues of existing derivatives warrants to help alleviate price anomalies and enhance market competition;
- ban commission rebates and other incentive schemes offered by issuers;
- issue new marketing guidelines;
- require the use of plain language and summaries in listing documents; and
- enhance investor education and information dissemination.

Many of the proposals will require changes to the Listing Rules. We are working with HKEx to bring the proposals before the Listing Committee as early as possible.

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✔ Position limits and trading spreads

The SFC approved HKEx's proposal to increase the position limits on stock options contracts from 10 February 2006. The SFC will work with HKEx to review the position limits on the HSI and H-shares Index Futures and Options contracts.

In May 2005, the SFC approved HKEx's rule amendments to reduce trading spreads for securities with share prices above \$30. The new trading spreads became effective on 4 July 2005.

✔ Review of the disclosure of interests regime

In January 2005, the SFC consulted the public on proposed changes to Part XV of the SFO. There was support for most of the proposals including those on the disclosure forms and codes; 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 SFC has been working with the Government on related amendments.

There was however no consensus on the disclosure of share pledges. The SFC has set up a Working Group on Disclosure Requirements for Securities Interests to discuss this issue. The group consists of members from brokers, banks, investment banks, fund managers, listed companies and investors. It held its inaugural meeting last October. The SFC will continue to work with group members on ways to take this forward.

✔ Authorisation of Automated Trading Services providers (ATS)

During the year, we authorised one ATS provider, bringing the total number of authorised ATS to nine – eight 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.

As at the year-end, the SFC was considering four applications from overseas exchanges and one from a local company.

Strengthening market infrastructure

✔ HKEx's new network and CCASS services

The SFC has been working closely with HKEx to ensure the smooth implementation of the Securities and Derivatives Network (SDNet) project, under which the four major networks for its trading and clearing systems (i.e. AMS/3, CCASS/3, HKATS and DCASS) would be consolidated into one network, as well as the robustness and reliability of the network.

After the market rehearsal in August 2005 and the SFC's approval of the rule amendments in September, the first phase of migration for the derivatives trading, clearing and price dissemination networks into the new network was completed in October. The remaining two phases of the SDNet migration, which will cover the securities clearing and trading networks, are scheduled for the second quarter of 2006 and within 2007 respectively. We will monitor the process.

In April 2005, the Hong Kong Securities Clearing Company Ltd (HKSCC) introduced further enhancements to its Investor Participant (IP) Account services, including (i) an optional Investor Settlement Instruction on-hold mechanism for Broker Participants; and (ii) an option to allow individual or joint IPs to appoint a third party to attend company meetings.

HKSCC abolished the initial deposit requirement of \$1,000 when opening an IP Account in CCASS on 1 July 2005 after SFC's approval.

HKEx proposed enhancements to CCASS's nominee services that aim to improve efficiency in corporate announcements, facilitate CCASS participants in processing nominee instructions, reduce participants' costs on cancelling electronic IPO or tender instructions, facilitate distribution of scrip entitlements and improve the voting function for the non-book close period. These enhancements were implemented in early 2006. We will continue to work closely with HKEx in enhancing CCASS's services.

✓ **Implementation of market infrastructure enhancement recommendations**

Since the publication of the Steering Committee on the Enhancement of Financial Infrastructure's recommendations to improve the financial infrastructure in August 2002, most of the recommendations have been successfully implemented. HKEx has also upgraded all its trading and clearing systems in the past five years, which has made Hong Kong one of the most efficient markets in the world, with significant growth in market size.

We will continue to work on the remaining initiatives, such as third party clearing, cross-margining and migration of the existing HKEx trading and clearing networks to SDNet. They will be monitored together with other initiatives under the general mandate of improvement of market infrastructures.

Drafting of the legislative amendments to implement a scripless market in Hong Kong advanced considerably last year. However, the Government and the SFC agreed that

priority should be accorded to the SMLR project and the review of the disclosure of interests regime given their greater importance in strengthening the existing regulatory framework for listed companies.

Additionally, there is no strong demand for or urgency to hasten the implementation of the scripless initiative, as Hong Kong already has one of the highest settlement efficiency rates in the world.

✓ **ETF market making infrastructure**

The SFC approved HKEx's rule amendments to enhance its market making infrastructure for ETFs in May 2005. Amendments that took effect on 1 June 2005 set out new parameters, within which the SEHK may fix specific obligations for each ETF (including when a market maker must provide a quote, the minimum period of time a quote must be maintained by the market maker and the minimum response rate of the market maker). The SEHK will consult the market and the SFC prior to setting the specific obligations.

The Securities and Futures (Levy) Order and the Securities and Futures (Investor Compensation – Levy) Rules provide for the payment of SFC transaction levy and the compensation fund levy for transactions on the SEHK. Currently, there are separate exemptions for pilot programme market makers and ETF market makers as incentives for their taking on additional risk in their market making services. We are proposing housekeeping amendments to substitute exemptions for separate products with one exemption for holders of valid SEHK market making permits, to facilitate SEHK launch of new products with market making facilities.

Supervision of Markets**Co-ordinating market contingency planning**

As mentioned earlier, the SFC made preparations last year for any potential impact that the World Trade Organization's MC6 might bring to the markets. A cross-divisional MC6 Task Force co-ordinated contingency measures for the market and within the SFC. We met with HKEx, selected licensed corporations and share registrars that were located near the MC6 conference area to understand their contingency measures. Internally, we raised staff awareness on personal and office safety.

The SFC also took steps to alert staff and stakeholders to the risks of an avian flu and other epidemics. The SFC arranged talks conducted by the Department of Health and doctors from private sector to its staff, representatives from HKEx, Financial Services and the Treasury Bureau (FSTB) and Hong Kong Securities Institute, and to other market participants.

We also discussed with HKEx and share registrars their contingency measures to deal with avian flu.

To ensure that intermediaries meet the standards of business continuity planning, the SFC is drafting a set of best practice guidelines for public consultation.

Monitoring Investor Compensation**☑ Compensation funds and Investor Compensation Company**

As at 31 March 2006, the net asset values of the Unified Exchange Compensation Fund (UECF), the Commodity Exchange Compensation Fund (CECF) and the Investor Compensation Fund (ICF) were \$51.26 million, \$0.81 million and \$1.67 billion respectively.

During 2005-06, the UECF paid \$559,566 to nine claimants of Lawsons Securities Company and \$388,320 to seven claimants of C.A. Pacific Securities Ltd.

The UECF and CECF received a recovery amount of \$1,464,218 and \$548,932 from the liquidators of Foreground Securities Co Ltd and Winton Commence Ltd respectively.

The SFC has been regulating and monitoring the operations of the Investor Compensation Company Ltd (ICC) since its inception in 2003. ICC is a wholly owned subsidiary of the SFC and it is charged with the duty to process and determine claims lodged with the ICF. During the year, the ICC received four new claims. As at 31 March 2006, six claims were outstanding.

We assist the ICC in enhancing its operational procedures, claims handling process, public awareness, corporate governance and technical infrastructure.

In March 2006, we recommended changes to enhance administrative efficiency within ICC and improve the working environment for its staff. Currently, ICC has a relatively small operation with only two staff. The streamlining of the structure of the organisation would enable staff to focus more on the critical task of investigating claims. The specific changes that will be implemented in the coming year include:

- to reduce the size of ICC's board from 10 members to five;
- to restructure ICC's Claims Committee so that it is made up of four people from the industry (including at least two brokers), one from HKEx, one from the SFC and four from the ICC board; and

- to incorporate the responsibilities of ICC's other four existing committees (i.e. the Management Committee, Audit Committee, Remuneration Committee and Public Relations and Investor Education Committee) within the restructured board.

To ensure that the changes do not compromise good corporate governance, ICC's board will provide half-yearly status reports to the SFC regarding its operations.

✔ Review of the Investor Compensation Fund levy

We worked with the FSTB to prepare amendments to the Securities and Futures (Investor Compensation – Levy) Rules to provide for an automatic ICF levy triggering and suspension mechanism. The mechanism helps to reduce the transaction costs borne by investors while ensuring that the ICF will be maintained at a level sufficient for potential claims and operating expenses. An exemption notice gazetted by the Government in November 2005 declared that no person is required to pay investor compensation levies on securities and futures transactions on or after 19 December 2005. The suspension will remain in force until the net asset value of the ICF falls below \$1 billion.

Market research

The SFC researches the securities and futures markets of Hong Kong and other major markets. We monitor market developments and industry performance. We conduct research to assist policy formulation, and provide timely information and analysis to the Government.

During 2005-06, we developed a market risk monitoring system, which enables us to better monitor the risks associated with the trading in the securities and derivatives markets and assess how they may affect market stability.

To better communicate with market participants and to share industry knowledge with the public, we published more research papers on topical issues, and enhanced the statistics section on our website. The SFC will continue to work with other regulators and academia on the publication of the SFC Quarterly Bulletin.



Investors have been exempted from paying a 0.002% levy per securities transaction and \$0.5 or \$0.1 per futures contract since 19 December 2005.