

## Supervision of Markets Division



(left to right)  
Stella Leung, Director  
Gerald Greiner, Senior Director  
Keith Lui, Director  
David White, Executive Director

## Highlights

❖ Continued efforts to ensure rectification of the Year 2000 computer problem and related contingency planning within the regulated markets of Hong Kong

❖ Issued guidelines on internet regulation

❖ Implemented the compensation arrangements for the clients of C.A. Pacific Securities Ltd. and other defaulting brokers of SEHK

❖ Issued a public consultation paper for the restructuring of the Unified Exchange Compensation Fund and a platform for new compensation arrangements generally in Hong Kong

❖ Undertook a review of the floor trading on HKFE

❖ Advised on revisions to the selection criteria of Designated Securities for short selling

## FUNCTIONS

- ❖ supervises and monitors the activities of the exchanges and clearing houses;
- ❖ encourages the development of the securities and futures markets in Hong Kong and the increased use of such markets by investors in Hong Kong and elsewhere;
- ❖ promotes and develop self-regulation by market bodies in the securities and futures industries; and
- ❖ oversees and manages Hong Kong's investor compensation funds.

### 1. YEAR 2000 ISSUE

The Division has been working closely with the exchanges and clearing houses to ensure that the Year 2000 issues relating to the major-shared systems operated by them have been properly addressed. During the year, the SFC and the exchanges and clearing houses organised street-wide testing for the securities and futures industry. The Division also conducted on-site reviews of the exchanges and clearing houses to assess the progress of their work.

The first round of street-wide testing among the exchanges and clearing houses and their members was carried out in January 1999. Over 95% of member firms and participants declared no major exceptions in their test results. Follow-up action was taken with those firms that did encounter problems, with a small number of firms being asked to rejoin the next round of tests. A second round of testing was conducted in March 1999 and showed

encouraging results with no major incidents. A third round will be conducted in June 1999 if necessary. All member firms and relevant participants are required to participate in at least one of the street-wide tests.

Together with the FSB, the Division has been receiving monthly Year 2000 progress reports from the SEHK, HKSCC and HKFE. The reports summarise the Year 2000 status of each organisation in respect of their major operating systems and the supervision of their members. The Division will continue its efforts in monitoring the progress of these organisations to ensure that they will be able to complete the project as planned.

The Division will be focusing more of its efforts in 1999 on the formulation and implementation of contingency plans for the exchanges and clearing houses. These will cover the organisations' major-shared systems as well as the possibility of member failure. It is also co-ordinating the SFC's own contingency planning.



The Year 2000 working group in meeting

## 2. GUIDELINES ON INTERNET REGULATION

A SFC working group headed by the Division was formed to study the various activities carried out by market participants on the Internet. The working group's mandate was to develop guidance to users with regard to the SFC's regulatory

approach to Internet activities in light of the existing legislation. A Guidance Note has been published which draws to the attention of registered persons and financial services providers specific areas which may trigger regulatory concern. The objective is to ensure that Hong Kong's regulatory framework can keep pace with the evolution of technologies without impeding

market innovations, and that investors are protected while benefiting from the efficiency and cost-effectiveness of new technologies.

A limited consultation on the Guidance Note was conducted in February 1999. The final Guidance Note, which has incorporated comments from the consultation, was issued on 31 March 1999.

## 3. INVESTOR COMPENSATION SCHEMES

At 31 March 1999, the net asset value of the Unified Exchange Compensation Fund (UECF) was \$265.5 million and the Commodity Exchange Compensation Fund (CECF) was \$78.89 million.

During the year, payments totalling \$3,993,427.65 were made from the CECF to 21 claimants in respect of the default of Winton Commence Ltd. (Winton). Pursuant to its subrogated rights against the defaulting broker, the Division subsequently received from the liquidator of Winton on behalf of the CECF \$1,165,510.16 in recoveries. The pursuit of additional recoveries is continuing.

In light of the default of CA Pacific in January 1998, the Government, SFC and SEHK agreed to modify the compensation scheme arrangements of the UECF. In November 1998 the LegCo passed the Securities (Amendment) Ordinance 1998. This amendment allows the SEHK, after having due regard to the circumstances of a broker's default and considering it appropriate to do so, and after taking into account all ascertained and contingent liabilities of the UECF and with the prior approval of the SFC, to make payments from the UECF of such sum for compensation to the claimants as it thinks fit. The SFC thereafter approved an application of the SEHK to allow up to \$150,000 to each claimant of CA Pacific. Similar applications were approved in respect of the defaults of Foreground Securities Company Ltd. (Foreground) and Forluxe Securities Ltd. (Forluxe).

During the year, payments totalling \$118,098,657.04 were made from the UECF to 1,339 claimants in respect of the defaults of CA Pacific (\$98,027,979.14 to 1,174 claimants), Foreground (\$5,491,613.78 to 58 claimants), Forluxe (\$6,579,064.12 to 75 claimants) and Cheong Woon Securities Company (\$8,000,000.00 to 32 claimants).

In September 1998, the SFC issued for public consultation proposals for new investor compensation arrangements, including for clients of members of the SEHK. In developing the proposals, a number of objectives have been set:

- ❖ to enhance the existing investor compensation arrangement and increase investor confidence while keeping costs commensurate with benefits. It is also important to avoid creating moral hazards;
- ❖ to provide a secure per investor level of compensation for retail investors under a formal and transparent structure that is easy to understand;

- ❖ to provide the compensation arrangement through a new independent entity that includes industry and public interest representatives and is subject to checks and balances;
- ❖ to protect and leverage existing compensation fund assets, including use of insurance, while minimising any additional cost to the industry;
- ❖ to employ market-based commercial risk management mechanisms and incentives within the arrangement; and
- ❖ to initially provide a new compensation arrangement in relation to members of the SEHK, but within a flexible structure that will allow additional arrangements to be developed for other segments of the market, such as securities margin finance providers and members of the HKFE.

19 written submissions on the proposals were received. The Division is reviewing the submissions that have been received from the consultation. A working group has also been formed to assess the impact of the merger of exchanges and clearing houses on the proposed compensation fund arrangements.

#### 4. REVIEW OF HKFE FLOOR TRADING

Trades executed by open outcry on the trading floor of the HKFE constitute over 90 percent of the exchange's daily trading. Although the HKFE announced in the second quarter of 1998 its intention to migrate all trading on the floor to its Automated Trading System (ATS) within a proposed timeframe of 18 to 24 months, the Division considered that a review of the trading floor was appropriate, as many of the areas to be covered in the review would still be relevant to the future trading of Hang Seng Index (HSI) contracts after the proposed migration.

In the third quarter of 1998, Division staff conducted a review of the trading floor focussing on its procedures, practices and surveillance. This included such matters as examining the handling,

execution, crossing and reporting of proprietary and client orders by member representatives, the establishment of opening and closing prices,

price capture and dissemination, the response to quote requests by registered option traders, market surveillance of floor trading, the handling of disputes as well as other associated functions.

After the review the Division put forward a number of recommendations to the HKFE to improve the operational efficiency and transparency of the trading operation of the exchange.

#### 5. MODIFICATION OF THE SEHK SHORT SELLING REGIME

In view of the Asian market turmoil and its subsequent effect on the Hong Kong market, in August 1998 the Division requested the SEHK to review the list of securities designated for short selling (Designated Securities), to ensure that only stocks with reasonable liquidity and underlying derivative products be allowed for such trading. Such a revision to the selection criteria for Designated Securities was intended to minimise the opportunities for short squeezing and other trading malpractices while still providing a hedging alternative for derivatives traders.

The SEHK subsequently proposed to the SFC new selection criteria which included:

- ❖ constituent stocks of the five major indices disseminated by HSI Services Limited;
- ❖ stocks underlying SEHK-listed derivative warrants; and
- ❖ stocks that meet the listing requirements for issuance of derivative warrants.



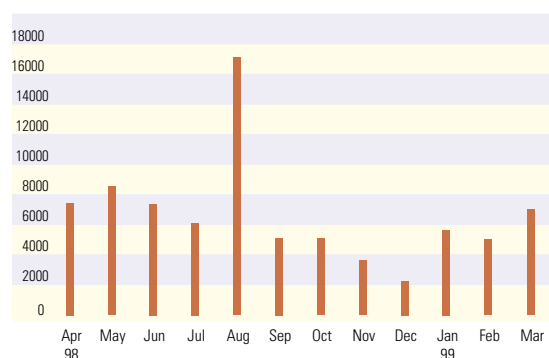
HKFE trading floor

Notwithstanding the above criteria, stocks, which are under current investigation by the SFC's Enforcement Division, will not be admitted as Designated Securities. The SFC approved the proposal in October 1998. Under the revised criteria the number of Designated Securities for short selling has declined, from 325 to 195.

Separately, in September 1998 the SFC approved an SEHK proposal to reinstate the "uptick" rule applicable to short selling, which had been abolished in March 1996. The rule prohibits a short sale at a price below the current best ask price. It was re-implemented on 7 September 1998.

Average daily short selling on the SEHK for the twelve-month periods ending 31 December 1996, 1997 and 1998 was \$35.13 million, \$185.86 million and \$297.72 million respectively.

Figure 1  
**Stock Exchange of Hong Kong**  
**Monthly Turnover of Short Selling**  
 April 1998 - March 1999  
 \$million



#### 6. THIRD GENERATION OF THE AUTOMATIC ORDER MATCHING & EXECUTION SYSTEM (AMS/3)

The SEHK is developing its third generation trading system, AMS/3, which will provide improved facilities to cater to the exchange's future market development needs. AMS/3 will greatly enhance members' and investors' access to the central market and will also provide a platform for the

implementation of straight-through trading. The SEHK intends to introduce AMS/3 in mid 2000. The Division will work closely with the SEHK to ensure a smooth implementation of the new system.

#### 7. HONG KONG INTERBANK OFFERED RATE FUTURES CONTRACTS

Last year the HKFE revitalised its Three-Month Hong Kong Interbank Offered Rate (HIBOR) futures contracts, by migrating trading from open outcry to its ATS and introducing registered traders to enhance the market's liquidity. In order to meet the increased demand of market participants to hedge their interest rate uncertainty with contracts of different durations, the HKFE subsequently proposed to the SFC that it also begin trading One-Month HIBOR futures contracts.

The One-Month HIBOR futures contract is traded on HKFE's ATS. Terms and conditions are similar to those of the Three-Month HIBOR futures contract. The Division believes that the new contract is a complement to the three-month contract for the management of short-end interest rate risk. The one-month contract will enable market participants to manage their interest rate exposure more effectively and efficiently. In September 1998 the SFC approved the proposed contract specifications, amendments to regulations and trading procedures for the introduction of the One-Month HIBOR futures contract.

The new contract was launched on 20 October 1998. For the five month period ending 31 March 1999, average daily volume was 56 contracts. To date, the HKFE has granted 36 exchange members the right to trade in the HIBOR futures contract.

Figure 2  
**Hong Kong Futures Exchange**  
**Three-Month HIBOR Futures Contracts**  
**Monthly Turnover and Average Daily Open Interest**  
 April 1998 - March 1999  
 number of contracts (thousand)

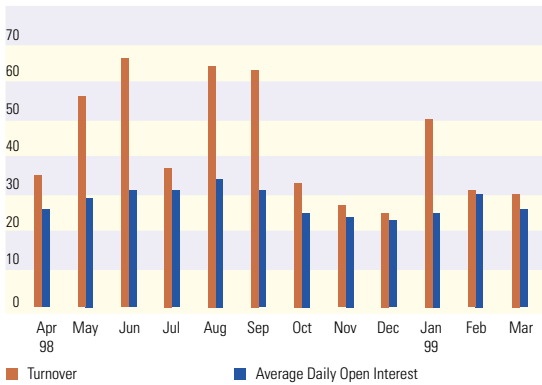
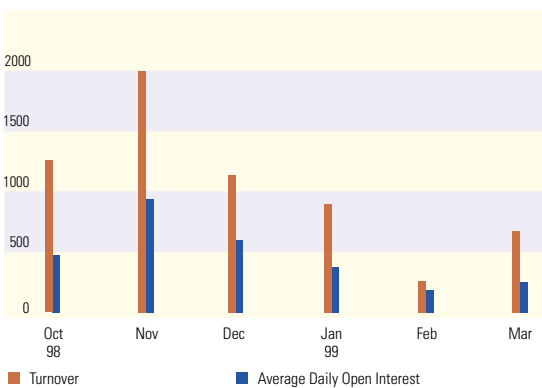


Figure 3  
**Hong Kong Futures Exchange**  
**One-Month HIBOR Futures Contracts**  
**Monthly Turnover and Average Daily Open Interest**  
 20 October 1998 - March 1999  
 number of contracts



**8. MIGRATION OF FLOOR TRADING TO THE AUTOMATED TRADING SYSTEM**

As part of its commitment to the future of electronic trading, the HKFE has resolved to migrate the trading of its successful HSI futures and options contracts from the open outcry environment used on the trading floor to the electronic order-matching environment used in its ATS. HSI and Sub-Indices futures and options are the only products presently trading through the open outcry system of the HKFE. The Division will work closely with the HKFE on the migration project to ensure a smooth transition.

Figure 4  
**Hong Kong Futures Exchange**  
**Hang Seng Index Futures Contracts**  
**Turnover 1988 - 1999**  
 Year ended 31 March  
 number of contracts (million)

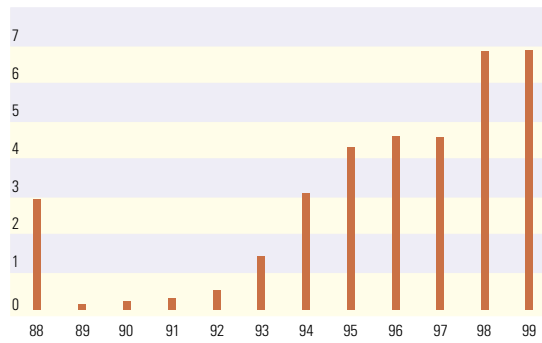


Figure 5  
**Hong Kong Futures Exchange**  
**Hang Seng Index Futures Contracts**  
**Monthly Turnover and Average Daily Open Interest**  
 April 1998 - March 1999  
 number of contracts (thousand)

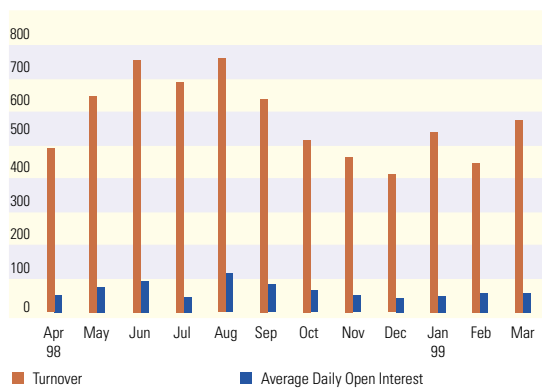
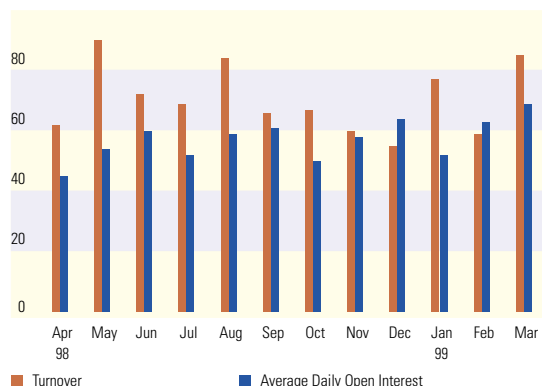
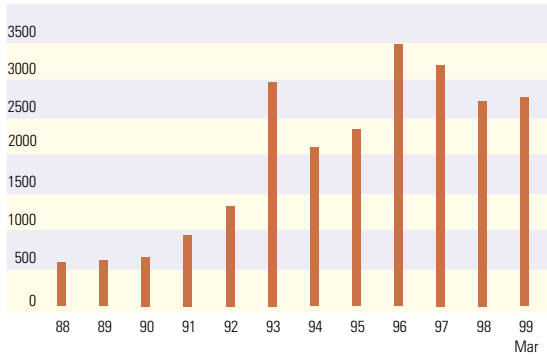


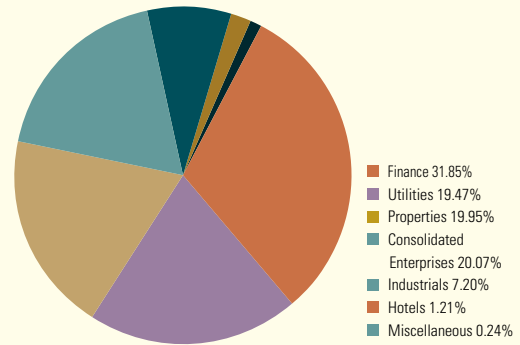
Figure 6  
**Hong Kong Futures Exchange**  
**Hang Seng Index Options Contracts**  
**Monthly Turnover and Average Daily Open Interest**  
 April 1998 - March 1999  
 number of contracts (thousand)



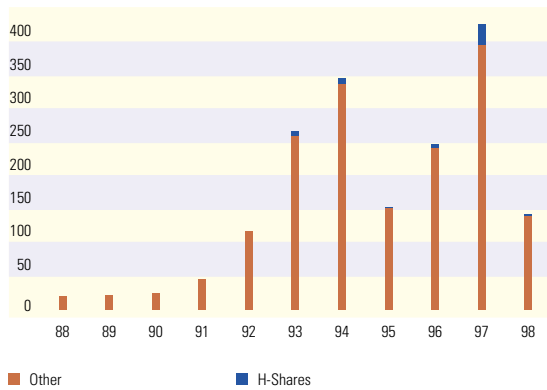
Annex I  
**Stock Exchange of Hong Kong**  
**Market Capitalisation 1988-1999**  
 Year ended 31 December  
 \$ billion



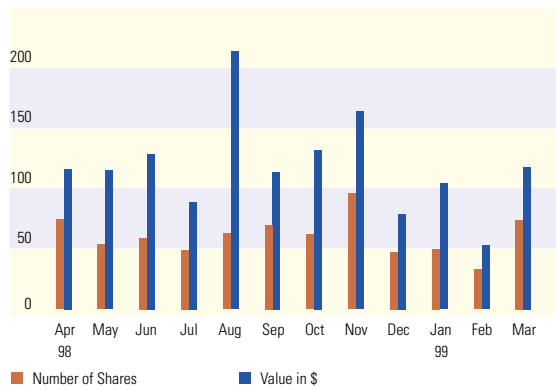
Annex II  
**Stock Exchange of Hong Kong**  
**Market Capitalisation**  
 by sector as at 31 March, 1999



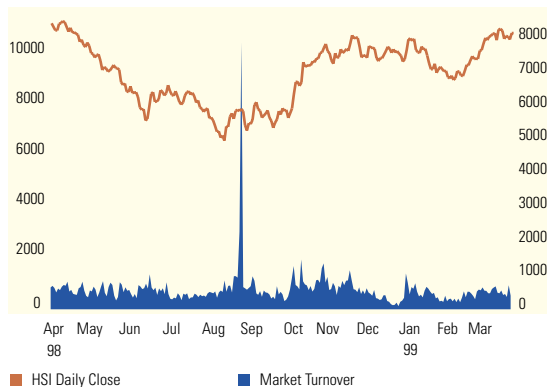
Annex III  
**Stock Exchange of Hong Kong**  
**Funds Raised 1988-1998**  
 Year ended 31 December  
 \$ billion



Annex IV  
**Stock Exchange of Hong Kong**  
**Monthly Market Turnover**  
 April 1998 - March 1999  
 billion



Annex V  
**Hang Seng Index Daily Close & Market Turnover**  
 April 1998 - March 1999  
 Index Turnover (\$million)



Annex VI  
**Hang Seng 100 Index Daily Close**  
 April 1998 - March 1999  
 Index



Annex VII

**Hang Seng China Enterprises Index (HSCEI) & Hang Seng China - Affiliated Corporations Index (HSCCI) Daily Close**

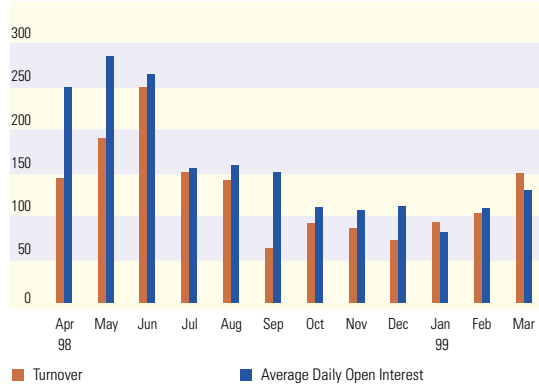
April 1998 - March 1999  
Index



Annex VIII

**Stock Exchange of Hong Kong Stock Option Contracts Monthly Turnover and Average Daily Open Interest**

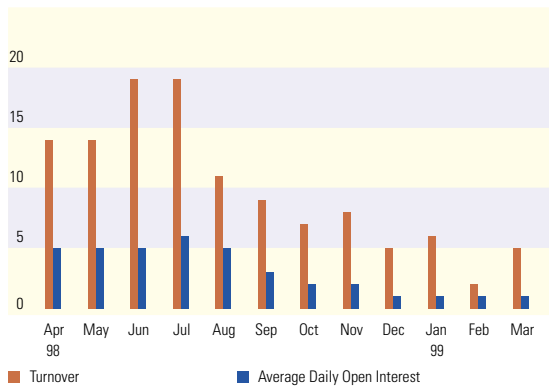
April 1998 - March 1999  
number of contracts (thousand)



Annex IX

**Hong Kong Futures Exchange Hang Seng China - Affiliated Corporations Index Futures Contracts Monthly Turnover and Average Daily Open Interest**

April 1998 - March 1999  
number of contracts (thousand)



Annex X

**Hong Kong Futures Exchange Hang Seng China - Affiliated Corporations Index Options Contracts Monthly Turnover and Average Daily Open Interest**

April 1998 - March 1999  
number of contracts

