

Regulatory challenges and responses

The SFC has outlined the regulatory challenges and risks and the strategies to address them in the next three financial years.

As a result of a comprehensive analysis of the environment in which the SFC and the market operate, we have released a strategic document, Regulatory Challenges and Responses. This is the first time in recent years that the SFC has articulated at a high level the regulatory challenges and published co-ordinated responses to them.

Four major challenges identified are:

- 1 Improving standards of corporate governance and behaviour;
- 2 Tackling risks arising from complex and structured products, and mis-selling to retail investors;
- 3 Addressing the consequences of a market or economic downturn if and when it happens; and
- 4 Keeping Hong Kong at the forefront of international financial markets and promoting regulatory best practice

A total of 21 initiatives have been mapped out to address the challenges and associated risks. Some initiatives are already in place and ongoing.

We will work with the Government, other agencies and market participants to achieve the plan's objectives.

For details, please see press release issued on 29 March 2006, available on the SFC Website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/!kqupNewsCode/06PR53?openDocument>.

Message from SFC Chairman

Dear Reader,

Over the past two months, the SFC has been busy engaging in several major regulatory initiatives.

We have moved forward on the Six-Point Plan for enhancing the derivative warrants market (page 3) and concluded the consultation on strengthening sponsors' regulation (page 2). We have also drafted rules to set securities collateral re-pledging limits to protect investors (page 2).

Most importantly, we have released a document setting out the strategic framework to cope with the regulatory challenges for the next three years. We look forward to working with you to achieve our objectives.

Meanwhile, our colleagues are earnestly preparing for the 31st IOSCO Annual Conference, which will be hosted by the SFC in Hong Kong in just six weeks. I sincerely invite you to participate in this major annual event of the global securities sector.

Martin Wheatley

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SFC Chairman Mr Martin Wheatley visited Shanghai on 23 February and met Mr Geng Liang (right), Chairman of the Shanghai Stock Exchange, and Mr Jiang Yang, Chief Executive Officer of the Shanghai Futures Exchange. They discussed the development of Shanghai's financial market and Hong Kong's role in the continuing development of the Mainland capital market. Mr Wheatley invited the exchanges and market practitioners in Shanghai to come to Hong Kong in June to join the IOSCO Annual Conference (please see page 2 for more about the conference).

Higher standards for sponsors

The SFC will adopt new eligibility criteria and ongoing obligations for sponsors to raise practitioners' standards in Hong Kong. This is a key response to the regulatory challenge to promote high standards of corporate governance and maintain Hong Kong's status as a fund raising centre.

Under the new regime, only corporate finance advisory firms that meet the stringent eligibility criteria may act as sponsors.

Firms' management are also reminded that they will be held responsible for their work. The SFC will inspect on a regular and an ad hoc basis to review firms' compliance with the regulations, and will take action against firms for substandard work.

We will introduce the requirements in the Guidelines for Sponsors and Compliance Advisers, which will become effective on 1 January 2007.

According to the Guidelines, a sponsor must have sufficient expertise and resources including a minimum paid-up capital of \$10 million, and effective internal controls and supervision.

A sponsor shall appoint at least two Principals and ensure that each transaction team is supervised by at least one Principal.

A sponsor must also carry out annual assessments of its internal systems and keep proper and updated records. Staff undertaking sponsor work need to have sufficient relevant continuous professional training.

The SFC will assist the industry in transition and co-operate with HKEx to streamline the relevant Listing Rules requirements in order to minimise any regulatory duplication in sponsor regulation.

For details, please see press release issued on 10 April 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/lkupNewsCode/06PR65?openDocument>.

Reducing margin financing risks

The SFC will implement new measures to address risks arising from securities margin financing. The measures offer better protection to investors, while minimising impact on the industry.

Following a public consultation and thorough discussions with the industry on the reform proposals, we seek to

- introduce repledging limits in two stages, set at 180% initially effective in October and after 12 months reduced to 140%;
- make moderate changes to some financial resources rules haircut percentages; and
- improve transparency by providing margin clients with better disclosure about the pooling and repledging risks

As pooling risks will be reduced by the measures, we also propose to relax certain financial requirements imposed on firms.

The SFC considers that this is the right time for reform as the market has been doing well in last two years and brokers have generally benefited from such market environment. Also, increased market volatility and recent reported cases of misappropriation may add risks to investors and the industry (please see "Caution against misappropriation" on page 4).

The measures will become effective on 1 October, subject to negative vetting by LegCo.

For details, please see press release issued on 7 April 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/lkupNewsCode/06PR63?openDocument>.

Register early for IOSCO meeting

Eminent speakers from around the world will gather at the 31st IOSCO Annual Conference hosted by Hong Kong on 5-8 June. Interested parties are encouraged to register early.

Mr Michel Prada, Chairman, Autorité des marchés financiers, France, Mr Martin Wheatley, SFC's Chairman, Mr Arthur Docters van Leeuwen, Chairman, The Netherlands Authority for the Financial Markets and

Dr Doğan Cansızlar, Chairman & CEO, Capital Markets Board of Turkey will moderate four panels. Also, Mr Shang Fulin, Chairman of China Securities Regulatory Commission will be a panelist.

These panels, to be held on 7 and 8 June, are open to market practitioners. Non-IOSCO member participants can also join the Opening Ceremony and a Closing Press Conference.

We have received several hundred registrations. The conference is expected to draw regulators and market practitioners from over 100 jurisdictions.

Interested parties can visit the IOSCO Conference website at <http://www.iosco2006.org> for online registration and programme details, and check out What's New about the conference.

Taking forward the Six-Point Plan for warrants

The SFC will proceed with the Six-Point Plan proposed last November to strengthen and enhance Hong Kong's derivative warrants market.

Given the general support of our proposals, we will progress all of them but with some modifications to those that triggered varied views.

In short, we will

- 1 tighten liquidity provider minimum service levels and require the disclosure of information of their performance. Issuers may appoint external liquidity providers if they retain full control over

liquidity provision;

- 2 facilitate further issues and identical issues of existing warrants;
- 3 ban commission rebates and other incentives schemes offered by issuers. Issuers are not expected to enter into new rebate contracts or renew old ones in the meantime;
- 4 issue new marketing guidelines to prevent misleading promotion and to ensure disclosure of conflicts of interest. We are inviting comments by the end of April;
- 5 require plain-language listing documents. We will finalise the content

and format of summary documents and common definitions and standard terms for standard products; and

- 6 continue to enhance investor education. HKEx will enhance its webpages on derivatives warrants.

We will work with HKEx on the related Listing Rules changes.

For "Hong Kong's Derivative Warrants Market - the Way Forward, Results of the Consultation on the SFC's Six-Point Plan", please visit http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/06/conclusions_dw_060331.pdf.

Investors consider warrants risky

The SFC conducted a survey early this year to look at warrant investors' risk perception, knowledge about derivative warrants and trading results.

We found that nine out of 10 warrant investors considered warrants risky and 76.8% traded consciously based on their own analysis.

Nearly half of respondents made a loss but close to 50% of them said they would continue to trade.

Other findings include:

- 76% hoped to make short-term gains
- 76% understood that the underlying asset's price is not the only factor affecting a warrant's price
- 30.8% made a net gain in the past 12 months and 47.2% made a net loss
- 47.5% of loss-making investors would continue to trade

Risk awareness and product understanding are important areas of our investor education work. We urge all parties to work together.

Please also see findings of our retail investor survey on page 5.

For details, please see press release issued on 10 March 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/1kupNewsCode/06PR43?openDocument>.

Comparing the Asian markets...

Hong Kong's derivative warrants market was the most active in the world in 2005 while other Asian markets also grew rapidly, an SFC research finds.

The local derivative warrants market turnover rose six times during 2002-2005. The recent rise was mainly due to trading of warrants issued on Mainland stocks.

The Mainland became the most active warrants market last December. Although trading has retreated since January 2006, there are still factors for growth.

The Singapore market is developing fast. Derivative warrants on certain securities were listed in Singapore as soon as the underlying were listed on HKEx. Nevertheless, trading concentrated in Hong Kong after warrants of the same underlying were also listed on HKEx.

The Korean warrants market was launched in late November 2005. Within three months of its launch, it became Asia's third most active market.

For the research paper, please see press release issued on 6 April 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/1kupNewsCode/06PR62?openDocument>.

Caution against misappropriation

In view of recently reported cases involving the misappropriation of clients' assets by broker firm staff, the SFC has reminded investors to stay vigilant to protect their own interests.

Investors should verify any errors noted in the trading documents directly with the back office of the their broker firm and settle transactions by cheques crossed to or by depositing money into the bank accounts specified by the firm.

They should alert the firm if the money they have paid to the firm or the shares they should have received are not booked into their accounts, or the sale proceeds or dividends due are not received.

They should not allow any third parties to handle their trading documents and trade in their accounts.

The SFC has also asked stockbrokers to strengthen anti-fraud controls and supervision to protect themselves and their clients.

For details, please see press release issued on 8 March 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/lkupNewsCode/06PR38?openDocument>.

In brief

The Wisdom of Investing, a credit-based course organised by the SFC and Lingnan University, was held in March 2006. 100 undergraduates studied listed company corporate activities and alternative investment products, and visited a bank.

The SFC and the **Israel Securities Authority** have signed a Memorandum of Understanding for co-operation in the enforcement of securities law and the exchange of information.

From October to December 2005, the SFC received, via the Stock Exchange, 14 listing applications and commented on eight cases under the **Dual Filing** arrangements. In several cases, we noted serious deficiencies in the disclosure of key factual information in the draft prospectuses submitted with the initial applications, which suggested that the preparation or due diligence performed was not sufficiently advanced.

Appointment

- The SFC has re-appointed **Mr Kevin Westley** as Chairman, and **Mr Henry Fan, Mr Clifton Chiu, Mr Stephen Clark, Mr David Graham** and **Ms Teresa Ko** as Deputy Chairmen of the Takeovers and Mergers Panel, and **Mrs Angelina Lee** and **Ms Teresa Ko** as Chairman and Deputy Chairman of the Takeovers Appeal Committee for a year from 1 April 2006 to 31 March 2007. **Mr Ian Boyce** and **Mr Alfred Li** have retired from the Panel and the Appeal Committee.
- The SFC has appointed **Ms Teresa Ko** and **Mr Michael Lee**, and re-appointed **Mr Stephen Clark, Mr Carlson Tong** and **Mr V-Nee Yeh** as market representatives of the SFC (HKEC Listing) Committee for a year from 1 April 2006 to 31 March 2007. Mr Keith Lui has been appointed as a new SFC representative on the Committee. **Mr Thaddeus Beczak** and **Ms Patricia Shih** have retired from the Committee.
- The SFC has appointed **Mr Raymond Lee, Mr Gavin Nesbitt** and **Mr Terry Ng**, and re-appointed **Mr Ashley Alder, Mr Dennis Cassidy, Mr David Cheung, Mr W Gage McAfee, Mr Mike Scales, Mr James Siu, Mr Frank J Slevin, Mr Carlson Tong** and **Mr V-Nee Yeh** as members of the Dual Filing Advisory Group for a year from 1 April 2006 to 31 March 2007. **Ms Teresa Ko, Mr Peter P W Tse** and **Mr Tony Tsoi** have retired from the Advisory Group.
- The SFC has appointed **The Hon Choy So Yuk, Mr Anthony Espina, Mrs Francine Fu, Mr Lam Yim Nam, David**, and re-appointed **Mr Mark Fong, Mr Eric Fu, Ms Connie Lau, Mr Henry Law, Mr Siu Sai Wo, Professor Raymond So** and **Mr Howard Sou** as members of the Investor Education Advisory Committee for a year from 1 April 2006 to 31 March 2007.
- The SFC has appointed **Mr Anthony Espina, Mr Andreas Mondovits** and **Ms Judy Vas**, and re-appointed **Professor Raymond So** as members of the Academic and Accreditation Advisory Committee (AAAC) for two years from 19 February 2006 to 18 February 2008. **Mr Stephen Chiu Chung Hui, Ms Sandra Yuen Man Lee** and **Mr Vincent Marshall Kwan Ho Lee** have retired from the AAAC.

More investors, but *not savvy* enough

About 470,000 more Hong Kong adults had invested in financial products during the previous two years but investors' investment knowledge needs boost, according to the SFC's Retail Investor Survey 2005.

The survey interviewed 5,210 adults and found 1,915 of them were retail investors. This represented a participation of 36.8%, or about 2.10 million adults, up from 29.8%, or about 1.63 million adults, in a similar survey in 2003.

Hong Kong stocks remained the most popular investments with a 28.3% participation, up from 23.8%. Managed funds ranked second with the participation

rate doubling to 18.1%.

The Survey also tested retail investors' level of financial understanding of basic investor rights and common investment tools. The average score was 3.39 out of 7.

Over 90% of retail and potential investors agreed that the whole securities industry should do more to educate people about how to make informed decisions. 73.6% favoured TV programmes as a means to get education messages, followed by newspapers and radio programmes.

For details, please see press release issued on 9 March 2006, available on the SFC website at: <http://eapp01.sfc.hk/apps/cc/PressRelease.nsf/eng/ikupNewsCode/06PR40?openDocument>.

Six investors have won the SFC's **My Investment Story** competition, with the vivid narration of their memorable investment experience. The competition was jointly organised with Radio 5 of the Radio Television Hong Kong and The Salvation Army. 100 investors sent in their stories.

The 10 best stories have been adapted into Cantonese radio dramas which are being broadcast on Radio 5 and published in the Singtao Investment Weekly.



SFC Executive Director Mr Peter Au-Yang (right) presents a first prize to winner Mr Hsuen Kei.

FAQs

Q: Recently, many people have been talking about the superb performance of emerging market funds and BRIC funds. What are these funds?

A: Emerging markets refer to financial markets in developing economies, where economic and political conditions may be more volatile. BRIC is the acronym for four emerging markets: Brazil, Russia, India and China.

Investors must not judge a fund simply by its short-term performance. Unsustainable surge might indicate economic overheating. Assess the long-term growth potential of the investments of a fund. Always remember that past performance is not indicative of future performance.

Investments in emerging market funds may offer high return potential, but are more risky due to the markets' relatively unstable political environment, currency fluctuation and other risks. They are only suitable for investors who are willing to accept very high risk.

Investor resources

The following items of investor resources have been made available to the investing public or updated recently. They can be found on the InvestEd website at the URLs provided.

Investor Alert Updates (<http://eapp01.sfc.hk/apps/ie/eIRCAAlertList.nsf/eng/alert?openpage>):

11 unlicensed companies have been added to the Alert List: "Concordant Group Ltd", "Legacy Holdings International Ltd", "Safecoe Holdings International Ltd" (23.03.2006); "World Trade Financial Group" (21.03.2006); "Sino Options Trading Limited" (03.03.2006); "Donovan & Yung Partners" (01.03.2006); "APTFund", "e.gotrade", "Innova Equity", "Nova Corporate Services" (22.02.2006); "Magna Capital Research" (20.02.2006). Information of four entities including "Merit Capital Group" (23.03.2006); "Magna Capital Research", "APTFund" (16.03.2006); "Irving Horowitz Mergers and Acquisitions" (22.02.2006) has been updated on the list.

Dr Wise's Column (<http://www.invested.hk/invested/html/EN/features/index.htm>):

"Understanding Capital Restructuring Before You Vote" (25.04.2006), "Keeping an Eye on Your Investments" (28.03.2006), "Danger in Jumping on the Bandwagon" (14.03.2006) and "Trading Stocks in a 'Wise' Way" (28.02.2006)

Circulars

The following recently published circulars are available on the SFC website under "Legislation & Regulatory Handbook" - "Regulatory Handbook" - "Codes, Guidelines and Circulars" at: <http://eapp01.sfc.hk/apps/cc/RegulatoryHandbook.nsf/eng/GenerateHTMLTB?openAgent>.

1. Circular to Licensed Corporations which are Participants of the Stock Exchange of Hong Kong Limited and/or Hong Kong Futures Exchange Limited - Fidelity Insurance for Exchange Participants (12.04.2006)
2. Circular to All Licensed Corporations - Importance of Prudent Risk Management (31.03.2006)
3. Circular to Fund Managers of SFC Authorized Funds and Other Relevant Parties - FAQ on Presentation of Benchmark Performance in Advertising Materials (31.03.2006)
4. Guidance Note on Cooperation with the SFC - March 2006 (17.03.2006)
5. Circular to All Licensed Corporations Licensed for Dealing in Securities Continuous and Close Supervision of Firm's Operations (08.03.2006)
6. Circular to Licensed Corporations and Associated Entities - Anti-Money Laundering / Combating Terrorist Financing United Nations (Anti-Terrorism Measures) Ordinance (06.03.2006)
7. Circular to Licensed Corporations which are Engaged in Asset Management and/or Giving Advice on Funds/Portfolios - Fund Management Activities Survey 2005 (28.02.2006)



Investor focus

Are your securities re-pledged?

When you trade on margin, your brokerage would usually ask for a written authorisation to re-pledge your securities in your margin account as collateral for the brokerage to secure bank borrowings.

Should your brokerage encounter any cashflow problems to redeem the re-pledged securities, the bank may liquidate the securities collateral in order to discharge the brokerage's indebtedness. As a result, you may not get back all the securities in your margin account. This is known as the "pooling risk" of margin trading.

You should note that once you have

given an authorisation allowing your brokerage to re-pledge your securities, all the securities in your margin account may be pooled even if you have not used the margin facility.

Also, depending on the terms of the authorisation and the pooling arrangement, all the securities in your margin account may be re-pledged regardless of whether their value exceeds your margin position.

On the other hand, if you open a cash account, your brokerage is not allowed to re-pledge your securities. Your brokerage should place your securities in safe custody in a segregated trust

account, or face penalty.

Therefore, you should consider carefully whether to open a cash account or margin account. For your own good, don't choose a margin account or sign the pooling and re-pledging authorisation if you don't intend to use such a facility.

If you trade in a margin account, avoid leaving more securities than required to cover the margin requirement.

For details, please refer to the animation flash video and the article entitled "What is Pooling?" at the "Features & Dr Wise/Dealing With Intermediaries" section on the InvestEd website at http://www.invested.hk/invested/html/EN/features/frame_deal_margin.htm.

Other publications



The following publications have been published since the release of the last *SFC Alert*. They are available on the SFC website under "Speeches, Publications & Consultations" - "Publications" at: <http://www.sfc.hk/sfc/html/EN/speeches/public/public.html>.

1. Consultation Conclusions to the Consultation Paper on the Regulation of Sponsors and Compliance Advisers (10.04.2006)
2. Consultation Conclusions on Proposed Measures to Address Risks Arising from Securities Margin Financing (07.04.2006)
3. Hong Kong's Derivative Warrants Market - the Way Forward, Results of the Consultation on the SFC's Six-Point Plan (31.03.2006)
4. Regulatory Challenges and Responses (29.03.2006)
5. SFC Enforcement Reporter - March 2006 (14.03.2006)
6. Warrant Investor Survey (10.03.06)
7. Retail Investor Survey 2005 (09.03.2006)
8. SFC Quarterly Bulletin - Winter 2005 (28.02.2006)



Recruitment

The following SFC positions are open. For application and details of the openings, please visit the SFC website at: <http://www.sfc.hk/sfc/html/EN/aboutsfc/employment/employment.html>.

- Director - Intermediaries Supervision
- Senior Managers / Managers - Intermediaries and Investment Products Division
- Senior Manager - Investor Education & Communications
- Executive Trainee - Research
- Summer Vacation Trainees



Subscription information

The bi-monthly *SFC Alert* forms part of our range of regular publications; others include the monthly *SFC Enforcement Reporter*, the *Quarterly Report*, the *Quarterly Bulletin* and the *Annual Report*. All these publications are posted on the SFC website.

Free subscription to the electronic version of the *SFC Alert* (and other publications) can be made to sfcalert@sfc.hk.



Feedback

Tell us what you think of the *SFC Alert*. Questions and comments can be sent to sfcalert@sfc.hk.

Securities and Futures Commission

Office: 8/F Chater House, 8 Connaught Road Central, Hong Kong

Phone: (852) 2840 9222

Fax: (852) 2521 7836

Investor Hotline: (852) 2840 9333

Media: (852) 2840 9287

SFC website: www.sfc.hk

E-mail: enquiry@sfc.hk

InvestEd website: www.invested.hk