

Watch out for scams

Hong Kong brokers and clients alike can be subject to deception and fraud!

Stockbrokers are on the line as well as their clients when it comes to the activities of fraudsters. The two have interests that move in tandem, and good internal controls can help protect both brokers and clients from criminal abuse.

A broker that can demonstrate sound internal control systems can attract and retain clients who have a higher level of comfort and confidence when trading through that company.

Know your client: he may not be one!

2001 was a bad year for some brokerages with regard to a particular scam. Some individuals, initially appearing to be clients of potential value, opened trading accounts with some brokerages using false identity cards. They placed orders to buy unusually large quantities of speculative stocks. In most of these cases, the fraudsters produced pay-in slips that showed that funds had already been deposited into the brokers' bank accounts by cheque.

So far so good, but after these share transactions had been finalised... the cheques bounced and the fraudsters disappeared! Although the SFC issued two circulars to alert brokers to these scams in August and November 2001, similar suspected frauds have occurred to other brokerages recently.

Effective internal control procedures can help protect brokers' operations against frauds and

other dishonest acts. The SFC urges brokers to observe the "Know Your Clients" requirements and exercise caution when dealing with new clients. They have to satisfy themselves about the identities of the parties who are really behind a transaction and keep a record of the relevant information.

Furthermore, cleared funds as opposed to cheques deposited are more useful when it comes to establishing the creditworthiness of new clients. Normally it will take at least one working day for a bank to clear a Hong Kong Dollar cheque that is deposited. This further stringency, together with an immediate report to the Commercial Crime Bureau of the Police by brokers if they suspect any fraudulent acts by new clients, should help protect the investors' and professional broking community's shared interests.

Inside the apple

The potential for fraud can also be increased by a lack of segregation between brokers' internal operations. For example, settlement clerks who also act as account executives may intercept the contract notes and statements of accounts issued by the brokers to clients.

To minimise the chances of conflicts, errors or abuses that may expose brokers and their clients to inappropriate risks, brokers should segregate their operational functions – including sales,

dealing, accounting and settlement, etc.

Consequently, in a general circular issued in July 2002, the SFC urged brokers to examine their operations and ensure that adequate segregation of duties was in place. If not, brokers have to be satisfied that their management supervision can compensate for the lack of segregation of duties.

For details, stockbrokers should refer to the above-mentioned circulars, which are available on the SFC web site (www.hksec.org.hk) under the section "Intermediaries, Licensing and Investment Products - Updates for Intermediaries".



To alert brokers to the risk of frauds that can be committed by fraudsters posing as walk-in clients, the SFC worked with the Police in the making of a recent episode of the "Police Magazine" TV programme. Picture shows Stephen Po, SFC's Director of Intermediaries Supervision, explaining to the programme host Woman Inspector Elaine Ma what brokers should do to avoid falling victim to such frauds.

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Investor advice over multiple channels

After TV, radio, newspaper and websites, the SFC brings you investor education on buses and VCDs

Different people do different things when they are travelling on buses: they read the papers, listen to music, call friends or just take a nap. What do you do?

We hope you saw "Invest with Your Heads Up", an SFC investor video series broadcast on public buses between 15 May and 31 July 2002.

If you have missed it, don't worry. You can now watch the whole series on the SFC-operated

eIRC (the Electronic Investor Resources Centre) at www.hkeirc.org. You can even watch all the 12 episodes in one go, whenever and wherever you like.

The series was well received by the market. Indeed, some brokerages have approached the SFC to borrow the video and show it to their clients as a

(continued on page 2)

Turning in a good report

Regular reporting improves transparency of an organisation's work

The SFC has always advocated transparency, not just in others but also for itself. It has been reporting its financial positions and operations on a quarterly basis since the financial year 2001-2002.

The advantages? More transparent operations that enhance the public's understanding of the Commission's work and generate support from the community, leading to more effective regulation of our markets.

Keeping deficit in check

For example, in the SFC's newly published report for the first quarter of 2002-2003, Chairman Andrew Sheng reported that the SFC had recorded a deficit of about \$7 million during the period April to June 2002, better than the projected deficit of \$29 million in the Commission's approved budget.

Total revenue was 16% down compared with the same period last year. About half of the reduction was due to a decrease in levy income as stock market turnover shrank to \$8.2 billion a day from \$10 billion. Various cost control measures – including staff and wage freezes –



helped keep expenditure in check. Total expenditure was down by 8% against the same quarter last year. Staff costs dropped by 5% because of a freeze on the performance-based variable pay.

At the end of June 2002, our reserves stood at \$617 million, equivalent to 1.37 times the approved annual operating expenditure of \$450 million.

Mr Sheng noted that the financial position for the next quarter was difficult to project under current market conditions. But he expected that the \$29 million budgeted deficit in the second

quarter would not be exceeded based on current information and the tight expenditure control.

Review of operations

On the supervision of intermediaries, Mr Sheng reported that the Financial Resources Rules had been amended to improve risk management of margin financing intermediaries, thereby protecting investors. A new working group would review the financial and capital regulation

for intermediaries in a longer-term project.

On corporate governance, Mr Sheng highlighted a key piece of subsidiary legislation under the Securities and Futures Ordinance. Listed companies and listing applicants would need to file listing documents and disclosure materials with the SFC, making the SFC the statutory regulator of corporate disclosure. The SFC had also prioritised investigations into corporate misgovernance.

Mr Sheng said that the SFC, the Exchange and other relevant bodies were actively examining various proposals and policies targeted at enhancing the corporate governance of listed companies.

In the meantime, the SFC would continue to closely monitor the debates on accounting standards and other corporate governance issues in Hong Kong and overseas with a view to bringing our regulations in line with international standards.

Copies of the latest Quarterly Report are available at the SFC's office and on its website at www.hksec.org.hk.

Investor advice over multiple channels *(continued from page 1)*

part of their own investor education programmes. In response to the positive market feedback, the SFC is planning to produce a video CD (containing all 12 three-minute episodes) and a CD-ROM that includes the video series as well as featured articles and interactive games from the eIRC.

They will be distributed to intermediaries, schools, colleges, or other investor associations so that more investors will be able to watch the video through different channels and learn to become smarter investors.

How can you get a copy? We will announce the details when the VCDs / CD-ROMs are available.

"Invest with Your Heads Up" was the first video drama series the SFC produced for broadcast on public transportation. It explains stock trading and settlement procedures, as well as measures investors should take to protect their own interests when dealing in stocks.

The series had been broadcast on RoadShow Media on 2,400 of Citybus and KMB vehicles as well as 200 public light buses for 12 consecutive weeks.

In the series, practical investor advice was given. In particular, the SFC suggests that you:

- check and keep all your contract notes and monthly statements and look out for unauthorised trades in your statements;
- make cheques payable to the brokerage firm and never deposit cash directly into the bank account of your account executive;
- respond properly to "circularisation" requests, in which the SFC or an auditor of a brokerage seeks your help to reconcile your trading records with the brokerage's;
- understand the "pooling arrangement" in margin accounts, and consider if such an account is suitable for you;
- do not open a discretionary account without seriously considering whether this arrangement is necessary;
- avoid allowing others to trade in your account and never let a third party use your identity to set up an account.

To reach out and empower investors to protect themselves, the SFC has been using various



The "Studio" section of the eIRC where you can watch the whole series of "Invest with Your Heads Up"

methods and channels to promote investor awareness, including TV and radio announcements of public interests, TV dramas, radio quiz shows, newspaper columns, educational leaflets, exhibitions, seminars and workshops, as well as the on-line eIRC.

Should you have further comments or suggestions on the SFC's work on investor education, you are always welcome to call us on the investor hotline: 2840 9333.

ENFORCEMENT

Serious sentencing safeguards market integrity

Hong Kong Court has little sympathy with market crime

Wong Wing-keung, Raymond and Lee Sing-wai, Stephen found crime did not pay when convicted of manipulating the share price of Gay Giano International Group Limited. District Court Judge Bernard Whaley, sentencing on 23 July 2002, said that he was surprised at the leniency of sentences in previous prosecutions, considering "the extent to which the public was put at risk" by these market manipulation activities.

The SFC is encouraged that the Court viewed the offences as serious crimes.

Both Wong and Lee pleaded guilty to the offence of intentionally creating a false or misleading appearance of active trading in the shares of Gay Giano during the period 13 April to 29 September 2000.

The fact that both defendants pleaded guilty had saved the Court a great deal of time and costs, Judge Whaley noted. He also took

into consideration the fact that the defendants had made helpful statements to the Police and promised to give evidence if required in future proceedings. Two more suspects have subsequently been arrested.

Stern sentences

Despite this, Wong - as well as being barred from being a company director for five years - was sentenced to a 240-hour Community Service Order and ordered to pay investigation costs of \$140,000 to the SFC. Lee was also disqualified from being a director for five years and given a nine-month prison sentence, suspended for three years. He was ordered to pay \$93,000 to the SFC.

A 240-hour Community Service Order is the maximum a court can impose and the suspension of a custodial sentence for three years is the longest period of suspension. This was also the first time the court has

disqualified a person from directorship following a conviction of market manipulation.

Don't even think about it!

The case was complicated, involving 20 brokerages and 30 trading accounts. While investigating potential manipulation in Gay Giano's shares, the SFC discovered possible fraud. It referred the matter to the Police, demonstrating that enforcement co-operation between the SFC and other regulators works. The SFC will continue to closely liaise with domestic enforcement agencies and its watchdog counterparts in other places.

The heavy sentences handed down by the Court serve as a strong deterrent to those who might be tempted to break the law. The SFC will also continue to crack down on market manipulation so as to ensure market integrity and to protect the interests of the investing public.

No hiding place

Protecting market integrity and investors is the SFC's job

As seen in the above article, market manipulation is a crime and its perpetrators will be punished. If any SFC registrants are found to have provided assistance to manipulators or become involved in any such impropriety, they will regret it.

Following the successful prosecution of Yeung Yik Cheung for manipulating the shares of Good Fellow Group Ltd, the SFC on 23 July 2002 suspended the registration of Chiang Yuk Oi, a dealer's representative, for six months.

As part of the investigation in Yeung's case, the SFC had interviewed Chiang in January 2000 about the source of orders she had received.

The answers she gave at the interview were materially different from those given by her to the court during Yeung's prosecution. The SFC later found that Chiang had recklessly provided the Commission with misleading information, which might jeopardise the SFC investigation as well as the court hearing.

No right time for crime

On 8 August 2002, the SFC also suspended the registration of Poon Kwok Hoi, another dealer's representative, for one month. The SFC found that between 27 September and 23 October 2000, a client placed one or two board lots orders of a stock with Poon near market

close, at prices that significantly deviated from the prevailing price. Despite his supervisor's warning, Poon continued to accept such potentially improper or illegal orders from the client, resulting in a much higher closing share price than it should have been on 23 October 2000.

The SFC further found that Poon had counselled his clients to circumvent the Rules of the Exchange by putting up a series of small quantity orders for the stock and cancelling them shortly afterwards. That could move the share prices up or down so that his clients could put in their orders at desired price levels.

Responsibility breeds integrity

Mr Alan Linning, SFC Executive Director of Enforcement, stresses that all SFC registrants have a responsibility to the integrity of the market that goes beyond merely satisfying a client's orders.

The SFC expects brokers to know their clients and to understand what they are doing. Where clients' activities appear unusual or suspicious, brokers are under an obligation to inquire and only execute instructions when satisfied with the explanation given.

In addition, the SFC expects brokers to co-operate with and provide assistance to the Commission at all times.



Regulation; education; dissemination

Helping the market and the community as a whole to understand investment-related issues and regulations has always been one of the SFC's priorities.

On 15 July 2002, the Estate Agents Authority and the SFC jointly organised a seminar entitled "Protection of Investors Ordinance and Property Investment Arrangements".

About 80 estate agents were given information relating to the regulation and authorisation of property investment arrangements. The application of the Protection of Investors Ordinance was also discussed.

Picture shows Gary Ho, Manager of Investment Products of the SFC (left), talking to the participants. Sitting next to him were Harold Ko, Senior Manager (centre) and a representative of the Estate Agents Authority.

INVESTOR FOCUS

A lever pulls two ways

When you seek ELIs' potentially higher returns, you must be prepared to take higher risks

In a low interest rate environment, Peter was eager to find alternative investment opportunities. As he pondered his choices, Peter came across news headlines of the listing of equity-linked instruments (ELIs) on the Stock Exchange. Attracted by the apparently high rate of return, he switched his savings to a bull ELI. One month later, Peter was shocked to find that instead of cash, he got a few thousand shares of the company underlying the ELI.

What exactly is an ELI?

An ELI is an instrument with embedded "short" positions in options which allow an investor to take a bull (rising), bear (falling), or range (fluctuating within a specific price range) view on the underlying asset. The return of an ELI is usually determined by the performance of a single stock, a basket of stocks, or an equity index. The "yield" of the ELI is produced mainly by the premium from writing the option.

In the case of a bull ELI, you are buying a structured instrument containing an embedded short position in a put option in favour of the issuer, in the expectation that the price of the underlying asset will be higher than the instrument's strike price on the valuation date. The following demonstrates how a bull ELI works and when profits or losses occur.

Example of a bull ELI on company A's share:

- Face value: \$200,000
- Issue price: 98.77% (\$197,531)
- Term: 1 month
- Annualised yield: 15% p.a.
- Strike price: \$20

If, on the valuation date, company A's share price is at or above \$20, you will receive a predetermined cash amount of \$200,000 (\$197,531 + \$197,531 x 15% / 12).

However, if the price is below \$20 on the valuation date, you will receive a predetermined number of shares of company A, namely \$200,000 / \$20 per share = 10,000 shares. You will have necessarily also assumed the price risk of the shares. If, for example, the price of the shares of company A is now \$15, the market value of the shares received would be \$15 x 10,000 = \$150,000, that is 24% below your original investment of \$197,531.

What are the differences between listed and non-listed ELIs?

Listed ELIs are broadly standardised contracts (although their terms may vary from issuer to issuer) with their terms specified in the listing documents. You have to form your own view on an underlying stock and then choose an appropriate ELI. On the other hand, non-listed ELIs could be tailor-made with specific terms to meet individual needs.

Holder can sell listed ELIs through the Stock Exchange. The Listing Rules require issuers to provide liquidity in their ELIs, so you can usually sell the ELIs back to the issuers. For non-listed ELIs, some issuers may provide a buy-back service, enabling holders to sell the ELIs back to them. However, other issuers may not allow early termination or redemption.

If you buy a listed ELI and need to take physical shares on maturity, you will usually get a predetermined number of board lots of the underlying shares. In some circumstances, such

as where the company has gone through a rights issue or consolidation after the ELI has been issued, the predetermined number of shares to be delivered may involve odd lots of shares or even fractional shares. In these cases, you will receive an amount of cash equivalent to the converted value of the odd lots or fractional shares based on the closing price of the shares on the valuation date. So, you will always receive board lots of shares if you buy listed ELIs. In the case of non-listed ELIs, depending on the terms of issue, it is possible to receive odd lots of shares.

So, what are the risks and considerations?

- You may suffer a capital loss should the underlying stock price goes against your view.
- Unlike traditional time deposits, there is NO guarantee that you will get a return on your investment - or any yield.
- The potential return on your original investment is capped at the predetermined amount specified by the issuer.
- The return of the ELI is determined at a specified time on the valuation date, irrespective of any price fluctuations that may have occurred in the underlying stock price before that time.
- Make the right product choice: read and understand the information memorandum or prospectus before you invest.

For more details, please visit the SFC-operated Electronic Investor Resources Centre (eIRC) at www.hkeirc.org.

SFO updates

LegCo Subcommittee meetings

Chaired by The Hon. Sin Chung-kai, the LegCo Subcommittee on draft subsidiary legislation to be made under the Securities and Futures Ordinance has met six times since 8 March 2002. By 15 July, before LegCo broke for its summer recess, 27 of the 36 pieces of subsidiary legislation had been reviewed by members. The Subcommittee will resume meetings in mid-September.

Consultations and Conclusions

Public consultations on the subsidiary legislation continued over the last month. Four consultation papers and two conclusions were published. They are all available on the SFC's website under the SFO section.

Consultation Papers on the following have been issued since 15 July 2002:	Issue Date	Closing Date
S&F* (Amendment of Schedule 8) Order	5 August	26 August
S&F (Fees) Rules	30 July	24 August
S&F (Offences & Penalties) Regulations	26 July	16 August
S&F (Intermediary Information) Rules	19 July	8 August
Consultation Conclusions on the following have been issued since 15 July 2002:	Issue Date	
Proposed Licensing Fees Under the S&F (Fees) Rules	30 July	
S&F (Stock Market Listing) Rules and S&F (Transfer of Functions - Stock Exchange Company) Order	24 July	

* S&F stands for Securities and Futures