

SHORTS

- The SFC has launched a new section on cross-border co-operation on its website. The section contains a list of the formal co-operative arrangements that the SFC has concluded with overseas regulators for exchange of information and investigation assistance. At the moment, there are 34 such formal co-operative arrangements.
- The latest round of SFC Teachers' Workshops got underway in November 2001. The workshops cover three modules: stocks, funds and futures. The SFC hopes the workshops will enable teachers to give their students a basic knowledge about securities and futures markets, and inculcate a proper attitude to investing. All teachers attending the workshops are given relevant materials including case studies to facilitate their discussion with students. The workshops have 15 sessions running up to the end of January next year. The first round of Teachers' Workshops was held last year and was well received by teachers.
- The SFC has won the Gold Award in the "Non-profit Making and Charitable Organisation" category in the Best Annual Reports Award 2001, organised by the Hong Kong Management Association. This is the second year that the SFC has won the prize.

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Yours anon

If you take up your pen to warn the SFC of market malpractice, don't forget the most important detail — your own address

Don't be afraid to gripe. Letters from investors complaining about broker misdemeanours or market malpractice are a valuable source of information for the SFC. Such letters have successfully exposed many abuses and illegal activities in the past.

The seriousness with which the Commission regards such complaints can be seen by the structure it has set up to respond to them. Every complaint is passed to the Complaints Control Committee, which is chaired by an executive director and has members drawn from senior staff from relevant departments. The committee meets every week to review all complaints from the public. Complaints about market intermediaries or listed companies are referred to the appropriate operational divisions for further action.

Not all complaint letters, of course, lead to a successful investigation of malpractice. Some are deemed to be in bad faith, or are simply frivolous. The most common hurdle to the effective investigation of complaints, however, is insufficient information in the complaint letter.

In October, for example, the Commission received 75 complaints, of which 15 were anonymous. One of these anonymous letters alleged that staff at a broker firm had engaged in unregistered dealing. The Commission was unable to pursue the case since the letter did not provide the full names of the persons suspected of wrongdoing and provided no return address. The complainant's wish for anonymity therefore rendered the letter useless.

SFC Chairman Andrew Sheng subsequently issued an open letter to investors appealing for complainants to include their contact details in their communications with the Commission. He reminded them that the SFC is under a legal obligation to keep their identities confidential. The contact address is so that the SFC can contact the writer for further information. All complaints will be treated in strict confidence.

Any comments on this issue can be sent to the SFC's Investor Education & Communications Department.

Keeping investors informed

The SFC proposes to include the disciplinary records of brokers on the public register

In a bid to improve the openness and transparency of Hong Kong's financial markets, the SFC is proposing to include disciplinary records of its licensees on the public register. Any disciplinary action relating to individuals or institutions licensed by the SFC will remain on the register for a period of five years. The proposals will enable the public to verify the clean bill of health of the majority of the intermediaries who are normal and upright.

The proposals, contained in the SFC's newly released draft Securities and Futures (Licensed Persons and Registered Institutions) Rules, also call for licensed corporations to assign a complaints officer — whose name or title and contact details will also be included on the public register — to provide a channel for aggrieved investors to lodge complaints against the company or any of its representatives.

Licensed brokerages would be required to include the following particulars on the public register:

- information on waivers or modifications granted;
- temporary licence status in respect of a corporation;
- list of licensed representatives accredited to a licensed corporation; and
- provisional or temporary licence status in respect of a representative.

The draft rules would bring Hong Kong in line with the regulatory philosophy adopted by overseas counterparts in the US and Australia. They are intended to reduce the chance of misleading

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TRADING FLOOR

Keeping tabs

Unrecorded verbal agreements between clients and brokers are a recipe for trouble

In May last year, the SFC received a complaint from a Mr Lo alleging that his account executive had conducted unauthorised trades in his account. Allegations of unauthorised trades arise when investors dispute transactions on the grounds that they have not placed the orders, or that they have not authorised the account executive or a third party to operate their accounts.

The Commission has been receiving an increasing number of such complaints, and, unfortunately, most of them are impossible to verify. Mr Lo's case was a typical example. He first noticed the alleged unauthorised trading in late 1999, but did not pursue the matter with the broker firm as the account executive promised to repay the losses resulting from the unauthorised trades. However, he received a letter from the broker firm a few months later demanding repayment of \$250,000 for further losses accrued, Mr Lo alleges, as a result of unauthorised trades.

When the account executive was questioned, she claimed that the client had agreed at the outset to allow her to trade on his behalf without seeking his prior consent. There was no written record of these authorisations. All along, Lo received the contract notes and the monthly statements of accounts. Since it was one person's word against another's, the SFC was unable to form a view on the complaint. Had Mr Lo allowed his accounts to be used by the account executive and alleged unauthorised trading to avoid the losses incurred? Or had the account executive conducted personal trades through Mr Lo's accounts without his knowledge for personal profit?

The following are some internal control measures the SFC recommends broker firms take to reduce the risk of unauthorised trading.

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investors about a person's licensing status, and to ensure the SFC is kept informed of significant changes to licensed persons and registered institutions. Brokerages would be required to notify the SFC of any relevant changes, particularly the name and contact details of persons assigned to be its main point of contact with the Commission in the event of market emergency.

The draft rules also require a licensed corporation or registered institution to return its licence or certificate of registration after it has ceased to engage in any regulated activity.

Written authorisation

Ensure that all account executives are aware of the requirement that clients' written authorisation is needed for a third party, or the account executive, to operate an account on a discretionary basis.

Telephone records

Ensure that a telephone recording system is installed. A broker firm should retain the original tapes relating to accounts until any dispute is completely resolved. Discourage the use of mobile phones for accepting orders from clients.

Trading documents

Discourage hold mail arrangements, and ensure that there is a segregation of front and back office functions, including issuance of contract notes or statements of accounts to clients and the placement of orders for clients.

Payments

Do not accept cash or third party cheques from persons other than the account holder for deposit into the accounts of the account holder. If clients are allowed to make payment directly to the bank account of the broker firm, the clients should be required to pass to the settlement department of the broker firm a copy of the deposit slip with the client's name, account number and signature written on it. All payments to clients should be crossed and made to the order of the clients only. Circularise the clients on a routine basis to confirm their account balances.

The SFC believes that failure to adopt these measures without any other compensating control may cast doubts on the effectiveness and adequacy of a firm's internal control procedures and may reflect adversely on its fitness and properness.

The draft rules supplement the Securities and Futures Bill which requires a licensed representative to return his licence to the SFC upon cessation of accreditation.

The SFC issued the draft Securities and Futures (Licensed Persons and Registered Institutions) Rules for public consultation on 16 November 2001. Copies of the consultation document are available at the SFC's office and on the SFC website (www.hksec.org.hk). The public is invited to submit comments before close of business on 17 December 2001.

ENFORCEMENT

Information parity

Hong Kong will not tolerate attempts to profit from privileged price-sensitive information

Insider dealing — dealing in securities using material price-sensitive information which has been obtained through a relationship with a corporation or other privileged position and which is not generally known in the market — is an insidious enemy of open and transparent markets.

"Insider dealing is serious because it damages investor confidence in Hong Kong's financial markets. It's important that investors are confident they have equal access to information that can affect the market price of listed securities. That's why we vigorously pursue insider dealers," said Eugène Goyne, Associate Director of Enforcement.

The seriousness with which the SFC and the judiciary regards insider dealing is apparent from the penalties imposed in the past. Insider dealers have been ordered to pay nearly \$200 million to the government in the past eight years. Since 1993, the Financial Secretary has referred 16 cases to the Insider Dealing Tribunal following SFC investigations. The Tribunal has completed 13 cases in which it has identified 22 people as insider dealers.

What is insider dealing?

Insider dealing is defined by the Securities (Insider Dealing) Ordinance. It mainly concerns dealings in securities listed on the Stock Exchange of Hong Kong (SEHK), but can involve dealings in securities dual listed on the SEHK and overseas exchanges and derivatives of listed securities. Section 9 of the Ordinance defines insider dealing. This includes dealing by a person connected with a corporation (an insider) who has inside information about that corporation. It also covers an insider counselling or procuring another to deal when they know or should know that person will deal. The insider must know the information is inside information.

It also includes where an insider discloses inside information to another who they know or should know will use the information to deal, or counsel or procure a third person to deal. Again, the insider has to know the information is relevant information.

Individuals who get information that they know is inside information from a person they know had access to the information because of their insider status, also engages in insider dealing if he or

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she deals or counsels or procures another to deal. This can happen if a person gets a detailed tip from a person before she knows is an insider and, in some "eavesdropping" situations, for example a secretary who reads a confidential fax, but not in others, such as when a person in a restaurant overhears a conversation between two strangers.

The Insider Dealing Tribunal

If, following an SFC investigation or otherwise, the Financial Secretary thinks that insider dealing may have taken place, he may require the Tribunal to inquire into the matter. In an inquiry, the Tribunal must determine: whether insider dealing has taken place; who has engaged in insider dealing; and the amount of any profit gained or loss avoided as a result of the insider dealing.

The Tribunal can punish those found to be insider dealers by: disqualifying them from being involved in the management of a company for up to five years; ordering them to pay the government the amount of any profit gained or loss avoided by insider dealing; and fining them up to three times that amount.

Securities and Futures Bill

Human rights laws may mean high insider dealing fines are "criminal". This may mean either new sanctions must be found, or the Tribunal must work more like a criminal court. The Tribunal has been so successful mainly because it is not bound by criminal evidence laws. The Securities and Futures Bill will mainly keep the Tribunal's existing procedures, but will replace high fines with new flexible civil sanctions. These will comply with human rights laws but allow Hong Kong to keep a tribunal system to deal more efficiently with insider dealing and other market misconduct. Insider dealing will also become a crime with heavy maximum penalties to deal with more serious cases and help adequately deter insider dealing. Investors hurt by insider dealing will be able to sue for compensation too.

Coming soon

- Codes on index funds
- Stakeholder survey
- Online trading guidelines

Enforcement agenda

Formerly in private practice, the SFC's new enforcement chief looks forward to the challenge of combating malpractice as a market regulator

Before taking up his new role as Executive Director of the SFC's Enforcement Division, Alan Linning worked as International Partner in the Dispute Resolution Practice Group of the law firm Baker and McKenzie. He has extensive legal experience in commercial litigation, corporate disputes and regulatory matters involving corporate and government entities in Hong Kong and around the world.

He joins the SFC at a time when the Enforcement Division is likely to see an increasing workload under the current economic situation. In every economic downturn, there tends to be more complaints since people are more concerned to enforce their rights, he noted.

He looks forward to the work as a development of his previous career, but also for the new perspective it will bring. "A particularly rewarding part of the SFC work is that you are trying to uphold general standards in a market, as opposed to advancing the narrow interest of a particular party. In the SFC, you are looking at it from a much broader perspective and looking at what is in the public interest and the benefit of the market as a whole. That's a new aspect for me that differentiates this job from private practice."

The Enforcement Division under Linning's leadership plans to be proactive in preventing misconduct by issuing reminders to the market and public about practices that will not be tolerated. This will go hand in hand with a readiness to take enforcement action. "We enforce the law in a fair and consistent manner. We expect compliance with the codes of conduct. We will not hesitate to impose serious sanctions on intermediaries or individuals

who fail to comply with the relevant codes of conduct or the law," Linning warned.

"Market manipulation is one focus of our activities. It is one of the worst types of market abuse because it damages the integrity of the market and thus Hong Kong's reputation as an international financial centre," Linning said.

Unregistered dealing is another target for the new enforcement chief. "There is a tendency for certain brokers to employ people as trainees, using them as cheap labour to man the phones and to drum up business. The brokers usually ask the so-called trainees to get their family members and friends in to open accounts, or to make use of margin financing facilities to create some volume of business. The trainees are enticed into it with the promise of commissions. It ends in tears for all concerned: clients lose money, the trainees are prosecuted and the brokers are disciplined and/or prosecuted. Brokers have got to realise that this type of activity is not a solution to more fundamental business problems," said Linning.

Finally, Linning stressed that the success of the Enforcement Division is in large measure due to the professionalism of his staff. "Our staff are professional, they have been extremely well trained and know how to go about interviewing people in a firm but polite manner. Often they have to ask awkward questions which some people don't like, but they have to do so for us to do our job properly. We don't expect to be well liked, but we aim to be respected as being firm and fair."

Alan Linning was appointed by the Financial Secretary as an Executive Director of the SFC for three years from 1 November to 31 October 2004.

Public consultation on the offering of hedge funds

The consultation period closed on 7 December 2001. The SFC received a total of 36 submissions. The SFC would like to thank all the respondents for taking the time to comment on the consultation paper.

Category	Number
Commentator has no objection to publication of name and content of submission	23
Commentator requested submission to be published on a "no-name" basis	4
Commentator requested that both name and submission to be withheld from publication	9

GET THE FACTS

Short termers get short changed

Investment-linked assurance schemes are long-term investments — participants who decide to terminate the scheme early maybe subject to heavy penalties

Investment-linked assurance schemes (ILAS) are provided through an insurance policy offered by an insurance company, which in addition to a return on the capital upon maturity, insure the participant in event of his death. Unlike a regular savings plan in unit trusts or mutual funds, these schemes have a time factor to consider. They are usually established for a pre-determined period with a lifetime or a "term" of at least five years, and with fees and charges heavily stacked at the beginning of the term.

As ILAS often have a heavy front fee loading at the early stages of the policy, participants who decide to terminate the scheme early may be subject to heavy penalties, resulting in a final surrender value smaller than the invested amount.

Since January 1997, insurance companies selling such products must produce an illustration document in addition to the principal brochure. Based on two assumed rates of return, the illustration document should demonstrate clearly the projected surrender values over the term of the policy — the sum of what the prospective participant will receive and the net of charges, if he redeems at the end of each of the first five years and then for every fifth year until maturity of the term. Intermediaries selling these schemes should also clearly explain the cost structure to the prospective participant, who will be required to confirm his understanding by signing on the illustration document.

It is important that investors read and understand carefully all the contents in the principal brochure and the illustration document before making a decision to put their money into such schemes.

For more details, please visit Questions Corner in the Advice to Investors section at the SFC website (www.hksfc.org.hk).

REGULATORY UPDATES

Keeping the market open

Suspension of dealings should only be considered in exceptional circumstances

A key factor in the stability of any financial market is the confidence of investors that they can buy or sell on any dealing day. Hong Kong generally received praise for keeping its markets open in the aftermath of the September 11 terrorist attacks in the US, although more than 1,000 funds were suspended after September 11.

A majority of these funds had investments in the US stock markets, and a number of them invested in some Asian markets which had been temporarily closed. Most of the suspended funds resumed trading within two days after the relevant markets re-opened, and all of the funds had resumed trading by 20 September 2001.

In light of this experience, and as a result of discussions with international fund regulators, the SFC has provided guidance to the industry on the appropriate circumstances under which authorised funds can suspend dealings. A circular setting out the new guidelines was issued to fund management companies on 26 November 2001.

The circular reminds the managers of investment funds that suspension should only be considered in exceptional circumstances — as stipulated in Chapter 10.6 of the Code on Unit Trusts and Mutual Funds (the Code). Suspension should generally only be considered where there are difficulties in the valuation of assets of a fund and where such assets are affected to a material extent. Broadly in line with the practice in a number of overseas jurisdictions, an exposure of 10% of

a fund's net asset value to the affected assets may generally be regarded as material.

The SFC has also introduced simplified reporting procedures. Chapter 10.7 of the Code states that a decision to suspend dealings must be reported to the SFC immediately. To ensure timely notification to holders, the SFC no longer requires suspension notices to obtain prior approval but accepts subsequent filing of such notices.

Suspension notices to holders are required to be published in daily newspapers. The SFC will now consider alternative means of notification, such as posting the notice on a website, although the Commission's prior approval should be sought in such cases. Electronic notification may only be allowed where the holders have given prior consent to receiving such notices via the specified electronic media.

Fund managers are also reminded to continue to receive redemption requests during the period of suspension, and that those requests should be processed immediately upon resumption of dealings.

Fund management companies may contact their case manager at the Commission, or call the Investment Products Department at (852) 2840-9259 for enquiries. A copy of the circular containing the guidance note is available on the SFC website: www.hksfc.org.hk.

Submission deadlines

- A Consultation Document on the Draft Securities and Futures

(Recognized Counterparty) Rules

Closing Date: 29 December 2001

Address for submission via e-mail: recognized_counterparty_rules@hksfc.org.hk

- A Consultation Document on the Draft Securities and Futures (Licensed Persons And Registered Institutions) Rules

Closing Date: 17 December 2001

Address for submission via e-mail: licensed_persons_rules@hksfc.org.hk

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