

## SHORTS

- The SFC hosted a series of international conferences for 73 participants from 28 overseas regulators between 30 January 2002 and 1 February 2002. The meetings held were the IOSCO Emerging Markets Committee Advisory Board and IOSCO Technical Committee and Executive Committee meetings.
- In the first month of 2002, the SFC successfully prosecuted:
  - China Convergent Corporation Limited and Gold Chief Investment Ltd — corporate substantial shareholders of Prosper eVision Limited
  - Man Chin — a director of Wah Fu International Holdings Limited
  - Simon Murray — a non-executive director of Hutchison Whampoa Limited, and
  - New Excellence Holdings Ltd — a corporate substantial shareholder of China Sci-Tech Holdings Ltd
 for contravening the Securities (Disclosure of Interests) Ordinance.
- By the end of the third quarter, the SFC recorded a deficit of \$43.6 million, higher than the budgeted deficit of \$35.6 million. The deficit has reduced SFC's reserves to \$634.6 million. The SFC has already implemented a wage and hiring freeze and additional cost control measures were introduced during the quarter.

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## Who can you trust?

### Certainly not the stranger calling you about an investment opportunity that will triple your money in three weeks

What should you do if you get a phone call from someone you don't know offering an investment scheme which can make 300% on your money in three weeks? The answer is to hang up and report the call to the SFC.

Unfortunately, a surprising number of people are susceptible to the high pressure sales tactics employed by cold calling salespeople pushing investment scams. They may initially be suspicious, but the prospect of the fantastically high returns offered by the smooth-talking salesman often proves too tempting.

The SFC and the Commercial Crime Bureau recently uncovered an investment scam which swindled overseas investors out of about \$2 million in the space of two months. The Hong Kong-based operation went under the name of 'Global Option Trading', though it used other names in overseas jurisdictions. Its victims — mostly clients in Australia — were invited to invest in heating oil or currency options.

One interesting discovery made during the investigation was a manual issued to the salespeople recruited by the masterminds behind the scam suggesting a number of tactics to manipulate the psychology of potential investors.

These include cajoling those who resisted because they did not want to do business internationally with the glib phrase: "Technology has made the whole world our home," and the suggestion that Warren Buffet, after all, made most of his money from international investments. If the investor said he needed to consult his wife, the manual suggested the response: "Hey, I'm married too and I've found it's easier to ask for forgiveness than permission".

In the wake of the investigation, the SFC has published an open letter warning of the dangers of cold calling scams. "Never invest based simply on a telephone call, or unsolicited email, fax or mail-out," said the Commission's Executive Director of Enforcement Alan Linning in the letter published on the SFC website. "Trust your intuition. If an investment sounds too good to be true, then it almost certainly is!"

The letter urges investors to report cold callers and spam e-mails to the SFC which has put on its website a list of 34 unlicensed overseas companies. New names will be added to the list as they come to the SFC's attention.

*Investors can obtain more information about cold calling scams in the "Advice to Investors" section on the SFC website ([www.hksfc.org.hk](http://www.hksfc.org.hk)).*

## Avoiding fraud

### Some tips on how to read the fraud warning signs

Vigilant investors can significantly reduce the likelihood that they become victims of financial fraud if they take some basic preventive measures. Stephen Po, SFC Director of Intermediaries Supervision, recommends that investors take the following steps to protect their own interests.

#### Private dealing

Investors should not enter into private dealing with any individual member of staff of their brokers, nor invest in any financial instruments and investment schemes not officially offered by their brokers. Avoid cash transactions and ensure that cheques are only made out in favour of the broker and not in favour of individuals within the firm.

#### Limit authorisation

Investors should avoid authorising account executives and staff of their brokers to collect contract notes and statements of account on their behalf. They should keep all trading records and supporting documents, and review contract notes and statements of account received from their brokers carefully for discrepancies in transactions and cash and securities balances.

#### Report discrepancies

When the SFC or independent auditors request investors to confirm their holdings and account balances, they should check carefully and report discrepancies to the designated independent party named on the confirmation request promptly.

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TRADING FLOOR

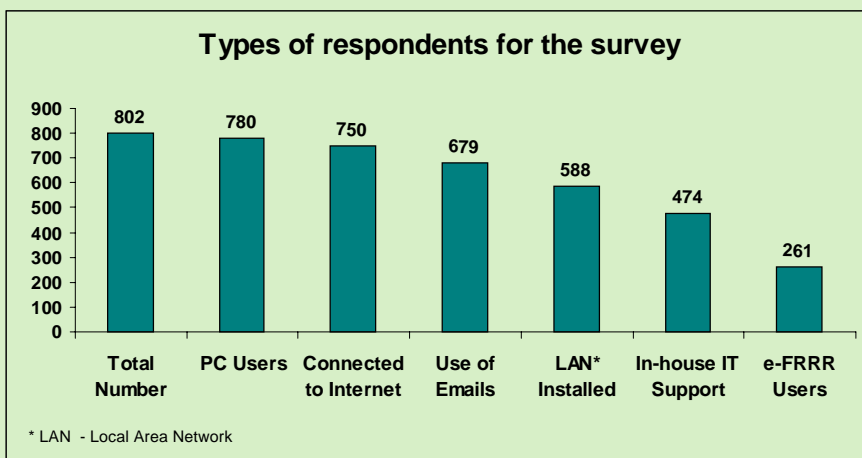
## e-Survey

**Most securities dealers in Hong Kong are hooked up to the Net - but how secure are their connections? The SFC now has a secured solution - FinNet.**

A new survey conducted by the SFC, the first ever conducted over the Internet, sought to find out how cybersavvy Hong Kong's securities dealers are. The IT Deployment Survey contacted all 874 registered dealers in July last year.

The response rate was exceptionally high with nearly 94% of the responses returned online. The survey found that the dealer community is well

versed in the use of the Internet. Perhaps not surprisingly, nearly all respondents (97.3%) have personal computers in their offices. A healthy 93.5% are connected to the Internet, and 84.7% use electronic mail. More than 70% of the respondents have installed a local network in their offices. About two-thirds have in-house IT support, while 10% of the remaining firms plan to hire IT staff within 12 months.



The survey also found, however, that only 31.4% of the dealers have adopted security measures in their electronic transmissions. Half of these use 128-bit SSL encryption technology, while the other half use the Hongkong Post e-Cert.

The SFC believes, however, that the fact that such a high proportion of dealers are equipped to conduct business electronically is good news for the efficiency and speed of Hong Kong financial markets. It hopes to boost the number of dealers using its secured electronic services, such as the Financial Resources Rules Return (eFRRR) system for the electronic submission

of documents, online survey, online consultation and its free email circular service on the FinNet network.

### e-Circular

The SFC hopes to migrate all circular subscribers to the e-mail service and discontinue fax transmission by 1 May 2002. Those market participants who still wish to receive circulars by fax should notify the SFC in writing before 15 April 2002. Further information on FinNet services is available by email: [e-circularshelp@hksfc.org.hk](mailto:e-circularshelp@hksfc.org.hk), or by fax: 2293-5824.

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### Beware of unusual contract notes

A contract note that is hand-written or typed on a typewriter — as opposed to the usual computer generated note — is an early indication that a transaction is not above board. If investors receive such contract notes, they should seek direct independent clarification with management of their brokers and should report to the SFC immediately.

Clients were found to have been given unusual contract notes in a recent case of a default broker. Lam Kwan Kit, the sole proprietor of Ying Kit Stock Company, who disappeared last month. The Police are continuing investigation into the affairs of Ying Kit. The SFC has issued a

restriction notice to preserve the assets of Ying Kit. It has obtained a court order appointing Mr John Lees and Mr Desmond Chiong as administrators of the property of Ying Kit and Lam Kwan Kit. The Stock Exchange of Hong Kong has issued a notice calling for relevant claims against the Unified Exchange Compensation Fund. The time for lodging claims will close at 5:00 pm on Monday, 29 April 2002.

Claim forms for the Unified Exchange Compensation Fund are obtainable from The Stock Exchange of Hong Kong Limited, 1/F, One and Two Exchange Square, 8 Connaught Place, Central, Hong Kong. For any inquiry about the compensation fund application, investors can call the HKEx hotline (Tel: 2840 3455 or 2840 3868).

## Trading alternatives

**The SFC has issued guidelines on the regulation of automated trading services (ATS) operating outside Hong Kong's recognised exchanges and clearing houses**

ATS are electronic facilities for trading in securities and futures that are not provided by a recognised exchange company or clearing house (such as HKEx). The SFC guidelines detail seven core standards that a person providing ATS will be generally expected to meet, in relation to financial resources and risk management; operational integrity; fitness; record keeping; transparency; surveillance; and reporting. In drafting the guidelines, the Commission went through an extensive consultation process and was assisted by a working group comprising market practitioners. These guidelines will come into force with the enactment of the Securities and Futures Bill this year.

### Regulatory Approach

The SFC will apply a flexible and pragmatic regulatory approach that will be applied on a case-by-case basis. In general, the level of regulation of an ATS will be commensurate with the functions it performs and the risks it poses. In addition, a fair and level playing field will be sought so that similar regulations are applied to similar functions.

The new guidelines detail two levels of regulation for providers of ATS. ATS providers should either apply for a licence under Part V of the Bill or authorisation under Part III.

As a general principle, the SFC intends that providers of ATS who also perform traditional dealer functions, including online trading, to apply for a licence under Part V. These firms usually provide electronic services to enable clients to trade through the exchanges and may also provide various other services such as agency broking, principal trading, market making, investment advice, etc. The regulations that would apply to them are those that would be normally applied to licensed persons or registered institutions.

Firms who provide mainly ATS services and do not provide traditional dealer services should seek authorisation under Part III. The SFC will consider, among other things, the nature and extent of each ATS activity, the market participants that may be affected by the ATS, whether retail investors may be involved, and whether any systemic risks might arise. Generally, the greater the extent of activity and its potential affect on market participants, the more that will be expected of the ATS. Where the ATS activity is similar in all circumstances to that of an exchange company or clearing house, a level playing field will be sought.

# Scripless trading

## Hong Kong makes the first move to bid farewell to paper share certificates

Slips of paper are a notoriously inefficient way of recording share ownership. They can be lost or stolen, and demand a cumbersome and costly system of registration. They are a glaring anachronism in the electronic trading and clearing systems that have become the norm in financial markets around the world.

That is why many overseas markets (including the UK, France, Australia, Singapore, New Zealand and the Mainland) have moved to a 'scripless market' - where shares are recorded in electronic databases. Now it is Hong Kong's turn. The SFC issued a consultation paper earlier this month (February 2002) proposing measures to enable Hong Kong to make the transition to scripless trading. The consultation paper proposes:

- to enable shares to be issued and transferred electronically
- to integrate Hong Kong's Central Clearing and Settlement System (CCASS) with the share registrars who maintain registers of shareholders for listed companies
- to provide a communications hub (to be provided by FinNet) for effecting scripless registrations of transfers on or between the CCASS and issuer registers, and
- to initially require all listed company Initial Public Offerings to offer subscription options for scripless holdings.

### Who benefits?

The integration of CCASS with the listed companies' registers of shareholders would enable CCASS participants and other investors to be registered shareholders. At the moment their shareholdings are often registered under a CCASS nominee. This means that corporate communications and entitlements, including the ability to vote at company meetings, is sent to the CCASS nominee rather than the actual shareholder.

If CCASS shareholdings were reflected on listed companies' registers, this would mean in effect the substitution of the CCASS nominee name with the names of all CCASS participants with holdings in that security. At the same time, the certificates held by CCASS would be returned to the relevant share registrars for reconciliation and cancellation and the CCASS certificated holdings would be converted to scripless holdings.

An implementation working group will be set up comprising representatives of the SFC, the HKSAR Government, HKEx, CCASS, share registrars, and other market participants to finalise the technical details of the scripless market proposals.

*The SFC invites comments from the public on the scripless market proposals until 8 May 2002. The consultation paper is available on the SFC website at: [www.hksec.org.hk](http://www.hksec.org.hk).*

# Protecting minorities

## New M&A rules seek to increase minority shareholder protection

The Codes on Takeovers and Mergers and Share Repurchases have undergone their most extensive revisions since 1992 when they were first introduced. The latest revisions, which took effect on 1 February 2002, were adopted to keep the Codes in line with market developments and international practice and strengthen investor protection.

The SFC started its review of the Codes at the end of 2000 and invited public comments on proposed amendments by releasing a consultation paper in April 2001. In light of the public comments and the Takeovers Panel's recommendations, the SFC adopted most of the amendments to the Codes as proposed in the consultation paper.

### Voting requirements

One major revision is the rationalising of the voting requirements for company privatisation proposals and for delistings.

Rule 2.10 of the Takeovers Code formerly required a company privatisation by scheme of arrangement to be approved by no less than 90% in value of the disinterested shareholders present and voting. This percentage has been reduced in the amended Rule to 75%. Also, whereas the original Rule stipulated that schemes of arrangement could proceed if they are not disapproved by shareholders holding over 2.5% of the total issued voting shares, the amended Rule says that, despite the 75% approval, there should be at the same time no more than 10% in value of all disinterested shareholders voting against the scheme. Formerly these voting requirements apply only to privatisation of a company by its controlling shareholder. The revised Takeovers Code extends these requirements to cover also acquisition of a company by any other persons.

To address market concerns about delisting being used to pressure minority shareholders into accepting a privatisation by way of general offer, the revised Rule 2.2 of the Takeovers Code imposes voting requirements for voluntary delistings which are the same as those applying to privatisations by scheme of arrangement and subjects the delisting to the offeror being entitled

to exercise, and actually exercising, rights of compulsory acquisition.

A new Rule 2.11 makes it clear that 90% of the disinterested shares (shares other than those held by the offeror and its concert parties) have to be acquired before any legal rights of compulsory acquisition may be exercised.

### Valuations

In the Takeovers Code there is also a new Rule 11 clarifying that the valuations of assets other than land and buildings that are based on profit, earnings and cash flow projections will be regarded as profit forecasts for the purpose of the Takeovers Code, which, if published in relation to an offer or possible offer or during an offer period, will need to be reported on by accountants and financial advisers.

### Conflicts of interests

The new Conflicts of Interests Guidance Note (Schedule VII to the Codes) highlights the SFC's concern over any conflict of interests that may arise when a financial adviser acting in a takeover, merger, or share repurchase, is part of a multi-service financial organisation, including auditing practices or lending institutions.

### Earlier revisions

Earlier amendments to the Takeovers Code, implemented on 19 October 2001, lowered the trigger for takeovers from 35% to 30% and the reduction of the creeper from 5% to 2% in any 12 months.

Shareholders holding between 30% and 34.9% immediately before 19 October 2001 are subject to transitional provisions: their shareholdings may roam within this range freely subject only to the old 35% trigger which will be in place for 10 years. If their shareholding drops below 30%, they will then be subject to the new 30% trigger.

The purpose of the early and immediate implementation of the new trigger and creeper was to keep shareholders previously holding less than 30% from gaining an unfair advantage by increasing their holdings to above 30% before the new trigger was introduced.

## SFC publications

	2001	2000
<b>Consultation Papers</b>	16	8
<b>Consultation Conclusion</b>	5	1
<b>Codes and Guidelines</b>	12	13

## Index funds

The SFC has published provisions for index funds in the Code on Unit Trusts and Mutual Funds setting out the regulatory requirements for the authorisation of index funds. The provisions set out the acceptance criteria, investment restrictions and reporting requirements for index funds.

GET THE FACTS

## Risk-free bonds?

**Don't believe it. All investments carry risks, and bonds are no exception**

When an institution is in need of capital, it may raise funds by issuing bonds. Investors who lend money to the institution will receive bond certificates as a proof of debt. Bondholders can receive interest at regular intervals and an amount equivalent to the par value of the bonds upon maturity. If you are holding convertible bonds, you can exchange your bonds for the shares of the issuer at a specific price within a prescribed period. If you hold the bonds until maturity, you can earn the interest while achieving "capital preservation".

However there are, inevitably, risks involved with trading in bonds. Potential investors should consider the following risk factors before buying bonds.

### Credit risk

This refers to the risk that the issuer may fail to pay you the interest or principal as scheduled. Credit ratings of individual bonds, based on the issuer's financial integrity, source of income, current debt position and business prospects, are assigned by Standard & Poor's or Moody's. If a bond issuer has financial problems, the credit rating of its bonds will be adjusted downward, thus creating pressure on the bond prices.

### Interest rate risk

Since the interest rate is fixed at the time of purchase, if the interest rate subsequently goes up, the attractiveness of your bonds will diminish and the price will go down accordingly.

### Liquidity risk

You may need to sell the bonds before maturity if you have an urgent need for cash, or want to use the capital for other investments. However, you may not be able to sell if the liquidity of the secondary bond market is low.

### Inflation risk

When the inflation rate goes up, the purchasing power of the principal you can receive upon maturity will be lower. This will reduce the attractiveness of the bond and its price.

### Reinvestment risk

If you hold a callable bond, when the interest rate goes down, the issuer may redeem the bond before maturity. In order to reduce its financing cost, the issuer will borrow money from banks or issue bonds with a lower coupon rate. In such circumstances, if you have to re-invest the proceeds received from the bond redemption, the coupon rate of other bonds available in the market will generally be less favourable than before.

REGULATORY UPDATES

## Quality guaranteed

**The SFC proposes tougher eligibility criteria for fund guarantors**

Guaranteed funds have become increasingly popular among Hong Kong retail investors over the past two years. At the end of last year, there were 48 guaranteed funds in operation with a total net asset value of US\$5,582 million. As these products are penetrating rapidly into the retail market, the SFC has recently strengthened the eligibility requirements of fund guarantors to increase investor protection.

The SFC is keen to ensure that fund guarantors have sufficient financial resources to meet their obligations, and that their fitness and properness is assessed on an ongoing basis. It has accordingly revised Chapter 8.5(b) of the Code on Unit Trusts and Mutual Funds.

Previously, the chapter only required a guarantor to be a "substantial financial institution" approved by the Commission. A "substantial financial institution" was defined in the Code as a licensed banking institution authorised under the Banking Ordinance, or a financial institution with a minimum paid-up capital of HK\$150m or its equivalent in foreign currency.

The SFC is satisfied with the financial resources status of the guarantors of the existing authorised guaranteed funds. However, Chapter 8.5(b) of the Code was amended on 25 January 2002 to specify that a fund guarantor must be either:

(a) a licensed banking institution authorised under the Banking Ordinance; or

(b) an authorised insurer authorised under the Insurance Companies Ordinance.

The Commission may consider other substantial financial institutions to act as a guarantor on a case-by-case basis, but it must be satisfied that the institution is of good financial standing and integrity, and that it is subject to prudential regulation and on-going monitoring. The SFC will also consider other investor protection issues such as conflicts of interest and past compliance history.

*The SFC has issued a general circular to SFC-approved Fund Management Companies informing them of the changes in the Code. A copy of the circular is available at the SFC website at: [www.hksfc.org.hk](http://www.hksfc.org.hk), under "Updates for Intermediaries" in the "Intermediaries, Licensing and Investment Products" section.*

### Number of authorised guaranteed funds

Year	Number
2001	36
2000	7
1999	0
1998	2
1997	5
1996	6

### Submission deadlines

- **A Consultation Paper on the Draft Securities and Futures (Professional Investor) Rules**

Closing Date: 28 February 2002

Address for submission via e-mail: [professional\\_investor\\_rules@hksfc.org.hk](mailto:professional_investor_rules@hksfc.org.hk)

- **A Consultation Paper on the Draft Securities and Futures (Price Stabilizing) Rules**

Closing Date: 8 March 2002

Address for submission via e-mail: [cfdconsult@hksfc.org.hk](mailto:cfdconsult@hksfc.org.hk)

- **A Consultation Paper on Proposals for a Scripless Securities Market**

Closing Date: 8 May 2002

Address for submission via e-mail: [scriplessconsult@hksfc.org.hk](mailto:scriplessconsult@hksfc.org.hk)

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