

STOP PRESS

The Securities and Futures Ordinance was approved in the Legislative Council on 13 March 2002. More details in the next SFC Alert.

SHORTS

- The SFC issued a restriction notice on 21 February 2002 to prohibit Chow Yuk-wah, trading as Teil Stock Investment Company, from carrying on the business of dealing in securities and disposing of or dealing with any assets held by him and Teil. In an inspection of Teil, SFC staff identified a discrepancy between Teil's client stock record and the record of the Central Clearing and Settlement System. SFC staff also found an unusual trading pattern in certain client accounts. Mr Chow failed to give a satisfactory explanation. The SFC has appointed an independent firm of accountants to perform a full circularisation to ascertain the number of affected clients.
- Investors can call the hotlines of Hong Kong Exchanges and Clearing Limited at 2840 3455 or 2840 3457 to enquire about compensation fund applications. The SFC's hotline (2840 9333) will also stay open to answer any queries or concerns that any clients may have.
- The HKSAR Government has accepted the SFC's recommendation to reduce the SFC levy on options on stock futures contracts to \$0.2 per contract per side, from \$1 per contract per side at present. Separately, the Commission has also made rules to reduce the compensation fund levy on trading of the products to \$0.1 per contract per side, from \$0.5 per contract per side.

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An appeal to investors

Investor protection requires investor participation

The SFC is committed to effectively regulating the market and upholding investor confidence. It cannot, however, work alone. Crucial to its investor protection duties is the participation of investors themselves, and in a recent RTHK "Letter from Hong Kong" radio programme, SFC Chairman Mr Andrew Sheng appealed to investors to alert the SFC to any suspicion of malpractice.

Noting that a recent case of suspected broker fraud had led to some loss of confidence in Hong Kong's financial markets, the letter set out the SFC's method for regulating brokers. It monitors brokers' monthly financial returns, and assesses their risk profiles. Brokerages with higher financial risks are then monitored closely. If necessary, the SFC will ask such firms to inject capital to ensure their financial health.

In addition, the SFC conducts onsite inspections of broker firms to identify any possible breaches of legislation, rules and codes. Where there is suspicion, it will ask the broker concerned to appoint an auditor to seek direct confirmation of the securities and cash balances of their respective accounts from the clients. The auditor verifies the internal record of the firm against such client confirmations.

This "circularisation" process is a particular example where the full co-operation of investors is crucial. It is essential that they check their account balances carefully before signing to acknowledge that the information is correct. If there is any discrepancy, they should let the SFC know immediately. Without the help of investors, the SFC

cannot verify the authenticity of the information, not to mention finding out what might have gone wrong.

Another area where investor participation can greatly reduce the threat of malpractice is in the thorough checking of contract notes issued by brokers. These should be in the form of computer printouts and investors receiving typewritten or handwritten notes should notify the senior management of the firm right away.

Mr Sheng concluded his letter with a number of investor do's and don'ts that can help reduce the danger of losses due to malpractice:

- don't authorise your account executive to collect your contract notes and monthly statements for you;
- do check and verify the contract notes and statements upon receipt and keep them safely;
- do stay vigilant at all times; and
- don't deposit the payment for securities purchases into any account executive's personal account, pay the broker directly.

"To maintain investor confidence in the market, all of us - brokers, investors or regulators alike - have our own roles to play. Only through the close monitoring by the regulators and the sound internal controls of brokers, coupled with the vigilance of investors, are we able to keep unscrupulous swindlers out of the scene," Mr Sheng said.

The recorded programme, in Cantonese, is available in the archive of the RTHK website at <http://www.rthk.org.hk>.

Do your homework

Investing on the basis of market rumour is not an investment strategy - it's financial suicide



The share price of Getrichquick company is spiralling upwards and a friend tells you that his neighbour's broker has heard it from a reliable source that the company is about to be acquired by a foreign multinational - what do you do? Unfortunately, many investors are all too ready to buy shares on such flimsy recommendations.

It is risky and not advisable. Know the rules of the game and your rights and responsibilities as an investor. Losing your hard-earned money amid an economic downturn would really hurt.

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Collateral damage

Under current market conditions, it is important for brokers to manage their lending and liquidity risks

Risks faced by financial intermediaries increase as market turnover shrinks and the economy remains sluggish. Intermediaries providing margin financing services will be exposed to even greater risks if they pursue aggressive lending practices. The SFC wants to help.

The SFC has recently reviewed the practices among margin financing intermediaries. It has identified two practices that are particularly risky and imprudent. They are the acceptance as collateral for margin loans of a large quantity of illiquid stocks and the re-pledging of more liquid stocks from margin clients to obtain bank loans to fund the firms' own working capital.

In case a margin client defaults on a loan, a highly-g geared firm might be unable to quickly cash its illiquid securities collateral to cover its loss. It might also be unable, due to cash-flow shortages, to redeem the more liquid stocks re-pledged to banks. In short, one large default of a margin client could cause such a firm to default on its bank loans, with very damaging effects to its clients and market confidence.

The SFC therefore proposes to amend the existing Financial Resources Rules (FRR) to help these margin financing intermediaries better manage their risk exposure, and afford investors better protection. The proposed amendments have been released for public consultation.

Under the proposed amendments, a margin financing intermediary is required to:

- apply a 90% haircut ratio on illiquid stocks and warrants (subject to the two tests

proposed in the consultation paper) which are pledged as margin collateral; and

- effectively self-finance its margin loans to clients by an amount which equals the difference between the bank loan it obtains by re-pledging margin clients' stocks and 50% of the margin loans to clients.

"Intermediaries need to manage their lending and liquidity risks. This is key to the firms' financial health and investor protection," said Mrs Alexa Lam, SFC Executive Director of Intermediaries and Investment Products. "Securities margin financing is similar in nature to the bank loan business, for which an effective risk management system is essential. We believe that a sound risk management system should strengthen a firm's financial health, reputation and competitiveness. It also helps better protect clients' interest and boost investors' confidence in the market, creating a win-win situation for both intermediaries and investors," Mrs Lam said.

"The SFC would like to hear the views of the market on its proposals and will work closely with intermediaries to comply with the new rules. In the meantime, I call upon investors to reconsider whether they need margin financing facilities when investing in the stock market. If not, open a cash account instead," Mrs Lam concluded.

The consultation paper is available at the SFC office and on its website at www.hksfc.org.hk.

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That's why the SFC has been reaching out to the investing public through the media and various other channels to instill in the minds of investors a healthy attitude towards investment. A recently launched initiative is a publicity campaign through TV and radio Announcement of Public Interests (API) that reminds the public to make investment decisions based on facts, and not rumours.

Watch the new TV API on all major Hong Kong television stations, as well as the Chinese and InfoNews channels of Phoenix Satellite TV. The API uses the concept of "human ears" to convey the message "When You Invest, Bank on Facts, not Rumours". Using similar creative themes, the radio API urges investors to "Do Your Homework" before making investment decisions. The radio API is aired on all major Hong Kong radio stations in both Cantonese and Putonghua.

How to get the facts?

Visit the SFC's revamped Electronic Investor Resources Centre (eIRC), at www.hkeirc.org.

With a vast array of educational information and new interactive features, the re-designed eIRC aims to make learning an enjoyable and interesting experience.

Initially launched in June 2000, the eIRC is a one-stop website which provides investors with investment and education information, and helps them carry out research on investments.

The revamped eIRC has five main sections:

Game Zone - Play and learn. Investors can improve their financial literacy through quizzes and participating in games involving matching of market jargons, and scrutiny of company announcements, fund prospectuses and transaction documents. They can also play an "adventure" game and learn to make informed investment decisions.



Studio - Watch the SFC's TV APIs or tune in to the radio segments on subjects of investor interests.

Monthly Focus - Receive news by email about topical issues in the market, investor alert updates as well as the latest regulatory information.

eLibrary - Surf and research through links to over 550 websites of regulators, market institutions and market information, with special focus on the Hong Kong and China markets.

Features - Find key facts on areas of special focus and topical interest.

The SFC hopes that more investors will take advantage of the eIRC to educate and equip themselves. Its own corporate website at www.hksfc.org.hk also contains useful information about the Hong Kong markets and investor advice.

Visit both the eIRC and the SFC website today and be an informed investor.

ENFORCEMENT

Bad publicity

Advertisements and documents that contain an invitation or offer to the public to take part in an investment arrangement must be approved by the SFC in advance. Property developers and promoters are not exempt from the requirement

Investors must be told clearly what they are invited to invest in. The Protection of Investors Ordinance (PIO) gives the SFC the power to vet advertisements and documents that contain an invitation or offer to the public to take part in an investment arrangement to ensure that no misleading statements are made.

However, the SFC has noted a growing trend for property schemes to be marketed in Hong Kong which risk violating the PIO.

On 25 February, the SFC successfully prosecuted Asia Network Base (Hong Kong) Limited, two of its directors and a staff member under the PIO for the issuance of unauthorised advertisements relating to two investment arrangements. Both investment arrangements were linked to returns from the leasing of a Miami property marketed in Hong Kong. The firm was fined \$40,000. The two directors were fined \$10,200 and \$10,000 respectively and the staff member \$10,000. The firm was also ordered to pay the SFC's investigation costs of \$6,500.

The next day, the SFC prosecuted LM Investment Management Hong Kong and a director under the PIO for the issuance of various unauthorised advertisements relating to an investment arrangement, which allowed an investor to participate as a co-owner of a Hong Kong

commercial property which the firm planned to acquire and to receive a regular monthly income. The firm was fined \$50,000 and the director \$5,000. They were ordered to pay costs totalling \$14,373 to the SFC.

Mr Alan Linning, SFC's Executive Director of Enforcement, reminded property developers and promoters that the promotion of property-related investment schemes was not exempted from the requirement for prior approval by the SFC. "Promoters are advised to take adequate legal advice before launching any scheme. The SFC is willing to assist promoters by discussing in advance the particular terms of any scheme," Mr Linning said.

"As a general principle, we expect all advertisements and promotional documents to disclose material facts about any guarantor and a clear statement to the potential investor of the risks involved in the particular arrangement. The SFC is committed to ensuring that the vetting process provided for under the PIO is observed by promoters and breaches of the law will be prosecuted," he concluded.

Insider Dealing

The Insider Dealing Tribunal has submitted to the Financial Secretary a report on its inquiry in relation to the listed securities of China Apollo Holdings Limited. The Tribunal concluded that Raymond Lau Chan Wing, Zhang Tie Cheng, Lok Fai, Tseung Wai Lok and Arthine Chung Ming Chee had committed insider dealing. Orders and penalties will be made after the Tribunal has heard representations to determine the amount of loss avoided.

Doing more with less

Despite a projected \$118 million deficit in 2002/2003, the SFC will not be seeking government funds. And it is doing its part to make the industry more competitive by proposing a reduction of licensing fees

Against the backdrop of a weak economy, the SFC's levy and investment income declined sharply in the year 2001/2002. The revised figures presented to the Financial Affairs Panel of the Legislative Council (LegCo) on 4 March 2002 estimated that the deficit for the financial year was \$88 million.

Since November 2001, the SFC has introduced a series of cost control measures, including a hiring and salary freeze, and has reduced spending in almost all areas. The SFC is likely to cap the deficit below the revised estimates as it has kept expenses very tight.

The prospects for 2002/2003

In view of the current market situation, the SFC has been conservative in preparing the estimated budget for the financial year 2002/2003. According to figures presented to LegCo by SFC Chairman Mr Andrew Sheng, total revenue is expected to drop to \$333 million, 8% lower than the revised estimate of 2001/2002. Estimated expenditure before depreciation will remain largely the same, at \$422 million.

On this basis, the SFC will incur a deficit of \$118 million after depreciation for the coming financial year. "Despite the estimated deficit, the Commission has, for the 10th consecutive year, decided not to request for an appropriation from the Government and the Legislative Council," Mr Sheng told LegCo. The estimated deficit would be absorbed by the SFC's reserves, which will be

reduced to \$473 million by the end of the financial year 2002/2003.

Lowering licensing fees

Although its fees and charges have not been revised since 1993/1994, the SFC is prepared to lower the licensing fees following the passage of the Securities and Futures Ordinance. This is to pass on some of the benefits of procedural reforms under the single licensing regime as provided for in the Ordinance.

It is proposed that the licence application and annual fees for companies and individuals be reduced by 3% from existing levels. An additional discount of 5% for the two-year transitional period would be offered to intermediaries who apply to migrate to the new licensing regime in the first year of the transitional period. (See article "Trimming compliance costs" below)

Ensuring regulatory quality

Concluding his presentation, Mr Sheng said: "It is difficult to control the estimated deficit fully due to the cyclical and volatile nature of market turnover. When the market conditions are unfavourable, we will need to put in more resources to deal with regulatory problems that inevitably surface. Nevertheless, we are always conscious of the importance of continuously enhancing our operational efficiency and cost effectiveness, with tight control of expenditure, without compromising regulatory quality."

Trimming compliance costs

SFC registrants can enjoy up to 8% discount on their licence application and annual fees under a proposed new licensing fee schedule

The SFC has released for public consultation a proposed new fee schedule under the single licensing regime of the Securities and Futures Ordinance. The new licensing system will adopt a "one licence, multiple categories" approach. There will be nine categories of regulated activities. Firms performing different regulated activities will be able to register under the name of one corporate entity to reduce their administrative burden and costs. The nine regulated activities are: (1) dealing in securities; (2) dealing in futures contracts; (3) leveraged foreign exchange trading; (4) advising on securities; (5) advising on futures contracts; (6) advising on corporate finance; (7) providing automated trading services; (8) securities margin financing; and (9) asset management.

The benefits for intermediaries

With the implementation of the new fee schedule, companies or individuals will immediately enjoy a reduction of 3% from the existing levels of application and annual fees. If they choose to apply for migration to the new regime in the first year of the two-year transitional period, an additional one-off 5% discount will be provided, enabling them to enjoy a total of 8% savings in application and annual fees during that transitional period.

To reap the full benefit of the economies arising from the migration to the new licensing regime, intermediaries are advised to review and streamline their operations and if appropriate reduce the number of licensed entities. The "one licence, multiple categories" approach allows more efficient use of capital and deployment of resources, as well as lightening ongoing costs in terms of filing and reporting.

Why a 3% reduction?

The SFC is aware of the importance of assisting intermediaries by reducing compliance costs and

the new single licensing regime offers the Commission an opportunity to re-engineer and streamline licensing procedures. As a result, the SFC will be able to achieve and pass on some savings to intermediaries.

In fact, the existing licensing fee level of the SFC has been in place and unchanged since 1993/1994. In the meantime, the consumer price index has risen 28.3%. In determining the fee schedule, the SFC took into account that it was running a deficit of about \$88 million for the financial year 2001/2002 and a deficit of \$118 million was projected for 2002/2003.

Mrs Alexa Lam, SFC's Executive Director of Intermediaries and Investment Products, said: "The SFC is doing its part to help trim the compliance costs of intermediaries. It will continue to work with the industry to enhance the competitiveness and the quality of our financial markets."

The consultation paper on the proposed licensing fees is available at the SFC office and on its website at www.hksfc.org.hk.

Fight money laundering

Financial intermediaries are in the front line in the battle against money laundering

Money laundering refers to activities and processes intended to give the appearance that illegally obtained money originates from a legitimate source. Since cash is fungible and anonymous, it is the preferred medium of exchange in the criminal world. Trading in the securities, futures and leveraged foreign exchange markets is often the favoured method by which criminals integrate their cash into the general economy.

The ability to liquidate investments quickly, the availability of a wide variety of investment products and the ease with which transfers can be effected between them, make trading in these markets particularly attractive to money launderers. Securities and commodities dealers, investment advisers, leveraged foreign exchange traders and their representatives are therefore in the front line in the battle against money laundering activities, and the SFC is keen to enlist their help in combating the problem.

The Commission urges all financial intermediaries to refer to its Guidance Notes on Money Laundering. Available on the SFC website, the Guidance Notes summarise the main provisions of applicable anti-money laundering legislation in Hong Kong and detail the policies and procedures expected of SFC registrants. In particular, registrants should note that they, like any member of the public, are under a statutory obligation to report suspicious transactions to the Joint Financial Intelligence Unit (JFIU), established and operated by the Police and Customs and Excise Department. Examples of investment activities which might constitute suspicious transactions are also provided in the Guidance Notes.

Registered intermediaries should also observe specific anti-money laundering guidelines set out in circulars issued by the SFC from time to time and posted on its website. For example, intermediaries are required to report transactions with designated entities and persons believed to be related to terrorist groups. (See box story: US President's Executive Order 13224)

For the purpose of identifying suspicious transactions, registered intermediaries should also refer to the suspicious activities indicators which the Police have found to be commonly associated with money laundering. They include:

- large or frequent cash transactions, either deposits or withdrawals;
- suspicious activities based on transaction patterns, such as a period of significantly increased activity amid relatively dormant periods and "U-turn" transactions with which

money passes from one party to another, and then back to the originating party;

- involvement of shelf or shell companies, companies registered in a known tax haven or offshore financial centre, secretarial companies, remittance agencies or moneychangers, and casinos, etc.;
- currencies, countries or nationals of countries commonly associated with international crime or identified as having serious deficiencies in their anti-money laundering regimes. Examples include Thailand, Cambodia, Myanmar, Laos, Colombia (relating to drug trafficking), Nigeria (relating to fraud and drug trafficking), and the 19 NCCTs¹ (Non-cooperative Countries and Territories) identified by that FATF² (International Financial Action Task Force);
- situations in which customers refuse, or are unwilling, to provide explanation of financial activities assessed to be untrue; and
- situations in which financial activities are not commensurate with that expected from the customers considering the information already known to intermediaries about the customers and their previous financial activities, such as customer age, occupation or a company's level of activity.

Registered intermediaries are urged to report to the JFIU if they note any of the above activities indicators and suspect money laundering is involved.

US President's Executive Order 13224

The US President issued an Executive Order on 24 September 2001. It applies to financial assets of, and transactions with entities and individuals believed to be terrorist organisations, terrorist leaders, or to have links with such persons. As of 5 March 2002, nine lists of such entities and persons have been designated.

The SFC urges registered intermediaries to review carefully the lists designated under the Executive Order, available on the website of the Office of Foreign Assets Control under the US Treasury (www.ustreas.gov/ofac), to check whether they have had transactions or dealings with such entities or individuals. To fulfil the obligations under section 25A of the Organised and Serious Crimes Ordinance, registered intermediaries should report to the JFIU should they discover any suspicious accounts, transactions or dealings.

¹ Currently, there are 19 NCCTs identified by FATF. They are the Cook Islands, Dominica, Egypt, Grenada, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshall Islands, Myanmar, Nauru, Nigeria, Niue, the Philippines, Russia, St Kitts and Nevis, St. Vincent and the Grenadines, and Ukraine.

² FATF is an inter-governmental body tasked with the development and promotion of policies, both at national and international levels, to combat money laundering. FATF currently consists of 29 jurisdictions and two international organizations. Hong Kong is one of its members.

Submission deadlines

- **A Consultation Document on the Proposed Amendments to the Current Financial Resources Rules**

Closing Date: 26 March 2002

Written comments may be sent: by mail to SFC FRR, 12/F Edinburgh Tower, The Landmark, 15 Queen's Road Central;

by fax to: 2523 4598; and by e-mail to: FRR@hksfc.org.hk.

- **A Consultation Document on the Proposed Licensing Fees under the Securities and Futures (Fees) Rules**

Closing Date: 8 April 2002

Written comments may be sent: by mail to SFC Application and Annual Fees, 12/F Edinburgh Tower, The Landmark, 15 Queen's Road Central;

by fax to: 2293 5686; and by e-mail to: Application_annual_fees@hksfc.org.hk.

Securities and Futures Commission

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