

Reaching out

The SFC has produced video dramas to be broadcast on public transport. Entitled "Invest with Your Heads Up", the series comprises 12 three-minute episodes, which aim to explain stock trading and settlement procedures, as well as measures investors should take to protect their interests when dealing in stocks. Beginning 15 May 2002 for 12 consecutive Wednesdays, the series will be broadcast on RoadShow Media, on 2,400 buses of the KMB and Citybus lines and on 200 public light buses. After broadcast, each episode will be made available on the Electronic Investor Resources Centre (www.hkeirc.org).

The SFC has also published a Chinese language cartoon leaflet called "Wise Ways when Dealing with Brokers" to educate investors how they could protect their interests in stock trading. The leaflet is available at the SFC Office and the 12 Consumer Advice Centres of the Consumer Council, as well as online on the "Advice to Investors" section of the SFC's website. The SFC will also distribute the leaflet through the 519 district council members' offices.



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Better disclosure discipline

The SFC seeks to ensure that investors are not short changed on vital corporate information

As an investor, you need timely and accurate information to make well-informed investment decisions, but how can you be sure that the information you read in a company prospectus or announcement is reliable?

The existing regulatory framework for corporate information disclosure is largely based on the non-statutory Listing Rules of the Stock Exchange and on the contractual obligation between a listed company and the Exchange under a Listing Agreement, hence the announcements issued by the Exchange to reprimand companies that have "misbehaved".

As the Hong Kong market continues to grow, however, many believe that some kind of statutory support for this disclosure regime has become necessary. So the SFC proposes to require companies and listing applicants to file their disclosure and application materials, not only with the Exchange, but also with the SFC as a statutory filing. (To make things easy, companies and applicants can just pre-authorize the Exchange to forward the documents to the SFC.)

This minimal change to the existing filing arrangement will enable the SFC to investigate and prosecute, under existing statutory powers, those who intentionally or recklessly provide false or misleading information.

Depending on the case, the SFC could prosecute offenders in the courts, or refer them to the Department of Justice for prosecution which may lead to more severe prison penalties or fines. Offences not related to disclosure abuses may also be referred to the Commercial Crime Bureau (e.g. fraud) or the future Market Misconduct Tribunal (e.g. insider dealing or market manipulation). The SFC will also be able to comment on the draft listing documents and related disclosure materials. If the information provided in these documents is insufficient or misleading, the SFC has a reserve power to object to the company's listing application. Again, this is in line with the international practice in all major markets.

"What will be the penalty?" you may ask. Under Section 384 of the newly enacted Securities and Futures Ordinance, if a person provides false or misleading information in a disclosure document knowingly or recklessly, the maximum penalty is a fine of HK\$1 million and imprisonment for two years. So, culprits be warned!

The proposal is now under consultation and the SFC wants to hear from you. Let us know what you think of the proposal which, we believe, would benefit investors and the market as a whole.

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

Hedge funds go retail

New Guidelines pave the way for the introduction of hedge funds for retail investors

Hedge funds have long been suffering from what you might call an image problem. They have somehow acquired for themselves, rightly or wrongly, a rather racy reputation as highly specialised, inherently volatile, or even socially and politically irresponsible financial instruments, and have even been blamed for the 1998 Asian financial crisis. But hedge funds are becoming increasingly popular amongst institutional and high net worth investors who look for absolute returns.

The industry says there is a clear demand for hedge funds in Hong Kong, and the SFC believes in improving the range of investors' choice and facilitating market development. Such funds do involve special risks, but the Commission believes it has mapped out safeguards that will ensure they

can be offered to retail investors in Hong Kong without compromising investor protection.

The safeguards are in the newly released Hedge Funds Guidelines, which incorporate a number of measures discussed in the public consultation that ended last December. A majority of the respondents to the consultation supported the setting up of minimum subscription thresholds for different types of hedge funds. Under this "market segmentation" approach, for example, hedge funds with a 100% capital guarantee will have no restriction on subscription size, while funds of hedge funds and single hedge funds will require a minimum investment of US\$10,000 and US\$50,000 respectively by an investor.

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Partners in regulation

Both regulators and market participants have a role to play in enhancing the quality of Hong Kong's financial markets

Regulators cannot work alone. The most effective strategy for maintaining a transparent, fair and orderly market necessarily involves a close partnership between regulators and market participants. For this reason the SFC has chosen "Regulatory Partnership" as the theme of its latest Annual Report.

"As the theme of our Annual Report suggests, every regulator and market participant has a role to play to enhance the quality of our markets," said SFC Chairman Andrew Sheng. "Regulators must work with the majority of the market participants who play by the rules, and sanction those who flout the rules."



The Annual Report summarises the SFC's work in the financial year 2001-2002 and discusses its plans for the coming year. On financial performance, Mr Sheng reported that, due to the sharp decline in daily turnover and market activity, the total revenue of the Commission was down 27% from the previous financial year to \$363 million. With the implementation of a salary and hiring freeze since November 2001, as well as severe expenditure cuts, the SFC had been able to achieve a 4.4% reduction in staff costs and had successfully capped the actual deficit to \$54.2 million, only 2.5% higher than the projected deficit of \$52.9 million approved by LegCo in March 2001. At the end of March 2002, the reserves of the SFC stood at a healthy level of \$624 million.

Quoting Harvard Professor Malcolm Sparrow's maxim: "pick important problems, fix them and tell everyone", Mr Sheng stressed that the SFC had to adopt a risk-based approach to regulation and select the right regulatory tools.

The Annual Report devotes a section to the SFC's own corporate governance and includes another new section giving three-year comparisons of key statistics. It also gives a detailed account of the achievements of each SFC Division in 2001-2002.

In the meantime, the SFC has also launched a book entitled *Securities Regulation in Hong Kong*, and an electronic Regulatory Handbook. The *Securities Regulation in Hong Kong* is a collection of selected speeches and articles by Chairmen of the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange, and members of the SFC as well as key excerpts from the *Davison Report*. This compilation of speeches over the past 10 years offers a useful perspective for the understanding of the development of market regulation in Hong Kong.

The electronic Regulatory Handbook provides a one-stop web-based guide to the regulatory requirements for various regulated activities. It comprises two volumes: the first describes the SFC's regulatory philosophy and the second carries all the most updated SFC codes, guidelines and important circulars on business standards.

"The publication of the Annual Report 2001-2002, the *Securities Regulation in Hong Kong* and the electronic Regulatory Handbook will help foster partnership by promoting understanding by our stakeholders of the Commission's work, its regulatory philosophy and requirements," Mr Sheng said.

All the publications are available on the SFC's website at www.hksfc.org.hk. Hard copies of the Annual Report and the Book of Speeches are also available for sale.

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The Guidelines also establish high entry standards to ensure the quality of hedge fund managers. For example, the manager of a single hedge fund must have at least US\$100 million worth of assets in hedge fund strategies under management, plus at least two investment personnel each with five year's general experience in managing hedge funds, including at least two years' experience in the same strategy as the applicant scheme. The Guidelines also require the independent safekeeping of assets by a trustee or custodian, adequate internal controls for fund managers, and full and fair disclosure to investors.

Apart from the product guidelines set out above, perhaps the most important safeguard will be the education of investors and intermediaries about the nature and risks of hedge funds. The SFC will launch a series of investor education programmes in the coming months to ensure that investors are well aware of what they are taking on when investing in such funds. Financial intermediaries selling hedge funds will also be reminded of the conduct requirements and the procedures that they should follow.

A final word of caution: hedge funds are not a "sure-win" product. Not all hedge funds employ

Watching the watchdog

The first annual report of the Process Review Panel gives the SFC a clean bill of health

You hear a lot about the SFC's work in making companies and intermediaries accountable for their actions, but who, you may ask, holds the SFC to account? Well, since November 2000, the independent Process Review Panel (PRP) has been playing an active role.

Appointed by the Chief Executive of the HKSAR, the PRP reviews the SFC's internal operations, including its investigative and disciplinary procedures, to ensure that they are fair and consistently followed. PRP members include well-respected professionals selected from the legal, accounting, financial services and academic sectors. Mr Vincent Cheng, Vice-Chairman and Chief Executive of Hang Seng Bank Limited, chairs the Panel.

We believe it is the first such independent review panel for a securities regulator around the world. Far from resenting scrutiny by an independent body, the SFC supported PRP's establishment from the outset.

During the period November 2000 to December 2001, the PRP reviewed 43 SFC completed cases in areas such as corporate finance, enforcement, intermediaries supervision and licensing. The SFC co-operated fully with the PRP in its review exercise.

The PRP's first annual report has just been published following submission to the Financial Secretary. It concludes that there were no serious deficiencies in the SFC's procedures, but makes some proposals on the improvement of procedures.

The SFC welcomes the report and the recommendations, including those that would help streamline and standardise its licensing and inspection procedures. We believe that the removal

hedging strategies and some can be highly leveraged. The risks inherent in hedge funds may be different from those in traditional funds. Investors must consider their own financial circumstances and suitability of hedge funds as part of their overall investment portfolios.

The Hedge Funds Guidelines will be incorporated into the Code on Unit Trusts and Mutual Funds as Chapter 8.7 and will take effect from 17 May 2002. The public can find the guidelines on the SFC website at www.hksfc.org.hk.

The SFC will also issue a Hedge Funds Checklist (to be made available on the SFC website) to assist market participants in their preparation of applications for authorization of hedge funds under the new Guidelines.

of obsolete procedures and rationalisation of processes will encourage compliance and lower the industry's operating costs.

Examples of specific recommendations adopted by the SFC include:

- standardising the practice of giving at least a seven-day advance notice to intermediaries selected for inspection, except for surprise checks;
- standardising documentation of reasons for inspections;
- formalising the rotation of inspection staff to improve objectivity in the inspection of intermediaries;
- requiring all inspection fieldwork be performed by at least two authorised staff to reduce subjectivity;
- formulating objective guidelines for assessing independence of auditors for circularisation exercises; and
- standardising the complaint handling procedures.

Apart from the PRP, the SFC is subject to other checks and balances. They include:

- an independent Securities and Futures Appeals Panel which hears appeals against the SFC's decisions;
- the Independent Commission Against Corruption that audits the Commission's operations every year; and
- the Ombudsman, who investigate complaints of maladministration.

As a public body the SFC is always mindful of its duty to act in a fair, equitable and transparent manner. We aim to be a regulator you can count on to be accountable.

Copies of the PRP report are available for collection from the Government Publications Centre at G/F, Queensway Government Office (Low Block), or can be downloaded from the Financial Services Bureau's website (www.info.gov.hk/lsb/info/preport_e.htm).

Humble opinions

In an interview with *SFC Alert*, Alexa Lam, SFC's Executive Director of Intermediaries and Investment Products, reminds stockbrokers that survival in today's highly competitive financial markets is a matter of continually upgrading skills

We live in interesting times. During this period of rapid and radical change in the global securities and futures industry, stockbrokers and financial intermediaries cannot afford to stand still. This was the main message given by Alexa Lam.

Why is it important for brokers to continuously improve their standards?

"Let's face the truth, we are in a global race. Brokers are not only competing with banks, but also market professionals from around the world. The Internet brokers are already here and we expect more Automatic Trading Services providers to come. Investors can also invest in overseas markets through international brokerages. Choices abound! Only by continuously raising our service and professional standards to a world-class level can we survive in this increasingly competitive market!"

How can brokers remain competitive?

"Brokers have to strengthen their skill-sets. It is very important for them to act professionally - in fact they should act as professionals. Knowledge about new products, technology and regulation needs to be updated regularly to cope with the fast-changing market. The industry just cannot afford to stand still."

"What's more, we should bear in mind that we are operating in a service economy. Quality counts, both in terms of competence and attitude. The old way of dealing with customers may still be good, but not good

enough. To win the trust and loyalty of clients, brokers not only need to make money for clients. They should act with integrity, be a friendly adviser, cater for clients' every investment need, and project a professional image with the introduction of effective work procedures and internal control systems."

Why should brokers participate in investor education?

"They are providing a value-added service. In fact, they also have a duty, in the larger context, to help educate clients on how to protect themselves in securities dealing. Clients will feel that they are being taken care of. While the clients get smarter, the firm's goodwill is established. It will certainly attract repeat business and is therefore a win-win situation."

"Brokers, as financial professionals, are in fact one of the parties best suited to participate in investor education because they possess invaluable industry knowledge and market experience. Investor education programmes benefit investors, brokers and the market as a whole, so why not get involved?"

Concluding the interview, Mrs Lam reminded brokers that in today's highly competitive securities and futures industry only the strong survive. In this environment, meeting the minimum conduct, competence and financial requirements will not be enough - stockbrokers and financial intermediaries need to always strive to be the best.

"Investors can tell who is better and they will make a wise choice!" Mrs Lam said.

SFO Updates



The online one-stop shop

The SFC has launched a new section on its website dedicated to the recently enacted Securities and Futures Ordinance (SFO). By just clicking on the icon above, you can get hold of the latest news and updates on the Ordinance. The section also contains a link to the full text of the SFO; various consultation and conclusions papers on the subsidiary legislation (together with a table showing the progress of consultations); a derivation table which indicates from where in the current legislation the various sections of the Ordinance have been derived; and related

press releases and circulars. The SFC plans to introduce an automatic update alert service shortly.

What's new?

The SFC has also posted two new articles on the SFO webpage. *The Securities and Futures Ordinance, 2002 - Continuity and Change* gives an overview of the Ordinance and illustrates how the existing law is continued and what new features have been included. *Overview of the New Licensing Regime under the Securities and Futures Ordinance* explains in clear and simple language the types of regulated activities and licences, as well as the effective date and transitional arrangements of the new

regime. Check out the "What's New" section of the SFO webpage and happy reading!

Subsidiary legislation

The SFC issued on 5 May 2002 a consultation paper on the proposed Securities and Futures (Stock Market Listing) Rules and (Transfer of Functions - Stock Exchange Company) Order. Under the draft rules, companies and listing applicants will have to file copies of disclosure materials and application materials with the SFC as a statutory filing. The Commission will then be able to investigate and take prosecutorial actions under its existing powers against those who provide false or misleading information intentionally or recklessly (see the article "Better disclosure discipline" on page 1).

Market referee

The role of the referee on the pitch is to watch the moves of players, but not to touch the ball when in play

It would come as something of a shock if the referee in a game of football suddenly decided he would take possession of the ball in an attempt to score a goal. Similarly the SFC, as the referee of Hong Kong's financial markets, is responsible for the enforcement of the rules of the game and does not intervene in corporate transactions.

SFC Chairman Andrew Sheng made this point recently in an open letter to investors responding to some investor concerns about the propriety of certain commercial transactions proposed by listed companies. "Hong Kong operates a disclosure-based regulatory system," Mr

Sheng said. "Our primary objective is to ensure that public investors receive reliable information disclosure in order to make the best judgement on transactions or events for themselves."

Together with the Stock Exchange, the SFC enforces process rules to ensure that there is timely, accurate and full disclosure of information on which investors can base their

investment decisions. In suitable cases, transactions are subject to shareholder approval and other requirements. Both the Listing Rules of the Exchange and the Takeovers and Repurchases Codes of the SFC are developed on these principles of transparency and fairness.

"Commercial advantage or disadvantage is for the market to decide. Regulators essentially operate as referees ensuring compliance with the rules of the game"

If company management breaches these rules, it will be held accountable. "The market has the right to expect that we will enforce these rules without fear or favour," Mr Sheng said. In fact, to strengthen its enforcement tools, the SFC has just released for public consultation a new proposal which would enable the SFC to take statutory investigative and prosecutorial actions

against those who provide false or misleading information in disclosure documents (see the article "Better disclosure discipline" on page 1).

"Provided that the rules, codes and all relevant regulations and laws are complied with, regulators will not attempt to intervene in any of the commercial aspects of corporate transactions," Mr Sheng continued. "Commercial

advantage or disadvantage is for the market to decide. Regulators essentially operate as referees ensuring compliance with the rules of the game; we will not make judgments about which side is in the right about proposed transactions, or indeed which side should win."

"Investors may feel aggrieved if they believe that corporate management is failing them. But if this is purely an issue of competence, or a history of bad decision making impacting on value, and the rules have not been violated, the ultimate practical remedy for investors may be to sell," Mr Sheng said.

Mr Sheng encouraged investors to continue communicating with the SFC and to report suspected breaches of securities law, rules and regulations. He reminded investors to get the facts before they invest and to bear in mind the scope of the regulator's role. "The regulator's job is to ensure that investors are able to get all the facts by enforcing our disclosure rules," he concluded.

The full letter is posted on the SFC website under the "Advice to Investors" section.

Continuous training, annual reporting

One year after the continuous professional training requirements came into effect, licensed persons have to declare their compliance

A year ago, on 1 April 2001, the SFC introduced new Continuous Professional Training (CPT) requirements to maintain and enhance the technical knowledge and professional expertise of licensed persons amidst a rapidly changing market environment. Legislative and technological changes, together with the continual emergence of innovative financial products, entail that an SFC licensee has to embrace lifelong learning.

The obligation for CPT will be on both corporate and individual licensees. Corporate licensees must design and implement a continuous education programme best suited to the needs of its licensed directors and representatives. All individual licensees are required to achieve five CPT hours per calendar year. The requisite CPT hours, however, for the calendar year 2001 prorated from 1 April is 3.75 hours.

All licensed persons are required to report to the SFC annually their compliance with the CPT requirements commencing from 1 April 2002. The SFC has amended the Annual Return forms under the Securities Ordinance, Commodities Trading Ordinance and the Leveraged Foreign Exchange Trading Ordinance to enable the CPT reporting by licensees.

Corporate licensees need to declare whether they have implemented a training programme for their licensed staff and evaluated it at least once a year. In addition, they have to report whether all their licensed staff have complied with the CPT requirements, and whether proper records have been kept to evidence their training programme and their staff's CPT activities.

Individual licensees also need to declare if they have completed the required CPT hours and whether they have kept proper records to evidence their CPT compliance.

The SFC has already sent out the Annual Return forms to licensees whose registration anniversary dates fall between 1 April to 15 June and to Common Anniversary Date program licensees whose selected anniversary dates fall between 1 April to 15 July. Licensed persons are reminded that they are required to submit the Annual Return forms to the SFC on or before their anniversary date.

The forms are also available for download on the SFC website (www.hksfc.org.hk) under the section "Licensing, Intermediaries & Investment Products - Licensing Related Matters - Annual Fees and Annual Returns". For enquiries, licensed persons can contact their responsible Licensing manager at the SFC.

The SFC believes that compliance by and the co-operation of licensed persons in relation to the CPT requirements will help affirm the professional standards of financial intermediaries in Hong Kong and further enhance Hong Kong's competitive position as an international financial centre.

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