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Review of the Securities Market in 2005 and the Way Forward

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Mr. Edward Kwan,
Mr Gary Cheung,
Distinguished Guests,
Ladies and Gentlemen,

1. I am grateful for the opportunity to address members of the HKSI on some of the initiatives the Commission has completed during the past year which may provide you with some insight into our aspiration for the future of the securities brokerage industry in Hong Kong. I believe that the Commission and the brokerage industry are in the same boat. We are sharing the same ups and downs of the industry that we regulate. We are working together for the prosperity of the securities market in Hong Kong.

REVIEW

2. 2005 marked the full recovery of the Hong Kong economy as well as the continual revival of the brokerage industry.
3. The shareholders' fund of the SEHK brokers has increased to \$45 bn, a 43% increase as compared to that of 2003. The reported total net profit was \$5.6 bn, also a 43% increase as compared to that of 2003. The average daily turnover in was 18.5 bn, 76% increase as compared to 2003. The licensed population continued to grow reaching a record high of 25,000, of which brokers employed almost 10,000 licensees as of December 2005.
4. The revival of the industry is mainly attributed to active fund raising activities by Chinese enterprises, the introduction of REIT and the continual active trading in the derivative warrants market.

IPOS OF CHINESE ENTERPRISES

5. As of end Dec, the total amount of funds raised in Hong Kong was US\$38.6 bn in 2005. For the year 2005, Hong Kong to be ranked the 4th largest fund-raising centre, following NYSE, London and Toronto. The amount of funds raised by Mainland enterprises directly and indirectly through HK was US\$23.2 bn in 2005. IPO of Chinese enterprises accounts for 80%+ of HK's total IPOs.

6. Over the coming period we are likely to see a significant number of companies and trusts listing on the stock exchange. We anticipate a growing number of Initial Public Offerings by companies from the Mainland. This provides considerable growth and development for the Hong Kong market. While initial offerings by companies or trusts need to meet the listing criteria of HKEx, there are risks that governance standards in newly listed companies are not as well developed as more established companies. Our Dual Filing team continues to work closely with HKEx in monitoring these issues.
7. The role of Sponsors in bringing new ventures to market is an important one. We are concerned that not all sponsors are meeting the required standards or being as diligent as they should be. Therefore, on 29 June 2005, we released the Consultation Paper on Regulation of Sponsors and Compliance Advisers, proposing a set of additional requirements imposing specific entry criteria and ongoing compliance obligations on sponsors. The proposals focus on four key aspects of the sponsor:
 - Organisational structure, internal controls and resources;
 - Management responsibility;
 - Formation of transaction teams and appointment of Principals; and
 - Ongoing obligations
8. We received various comments in relation to the requirement for mandatory professional indemnity, the qualification of compliance advisers as well as the avoidance of duplication between the Listing Rules requirements and the Commission's new sponsor regime. We believe that the management of a sponsor firm, including its Principals, has the responsibility to ensure that there are sufficient resources, and proper supervision over the sponsor work carried out by the firm. The conclusion of the consultation will be released shortly.
9. We have underway a number of enforcement actions against sponsors. Recently, the SFC has taken action against a sponsor and its responsible officers for their failures to comply with the Code of Conduct for Persons Licensed by or Registered with the SFC by failing to act with due skill, care and diligence when performing due diligence into the two listing applications and to ensure that the prospectuses and the submissions made to HKEx were prepared to the required standard. The sponsor has voluntarily undertaken not to act as a sponsor for any new listing application on both the Main Board and the GEM Board for a period of 13 months with effect from 7 March 2006.
10. Sponsors must scrutinise information provided by the listing applicants with professional judgement. When issues or concerns are raised by professional advisers, the sponsors also have a duty to follow up with them. When there is any reasonable doubt as to the accuracy of a statement, the sponsor must not include it in the prospectus since it is a public document which will be read and relied upon by the public. We will continue to monitor their performance and take firm action against sponsors who failed to comply with relevant regulations applicable to them.

11. Government has proposed giving statutory backing to the HKEx Listing Rules. Statutory backing would add teeth to the regulation of listed companies in Hong Kong. It enables SFC to prosecute those who provide false or misleading disclosure and those who do not disclose. The proposed amendments to the Securities and Futures (Stock Market Listing) Rules codify the more important Listing Rules covering the following three areas:
 - financial reporting and other periodic disclosure (e.g. annual and interim reports) by listed companies;
 - disclosure of price sensitive information by listed companies; and
 - shareholders' approval for certain notifiable transactions.
12. In our view, legal certainty requires statutory rules, which attract significant sanctions for their breach, to be sufficiently detailed so that those potentially affected by them understand their obligations properly. With statutory backing, we hope to bring our regulatory regime into line with international standards and practices. The SFC released its Consultation Paper in January 2005, which set out in full draft subsidiary legislation to implement statutory backing. The submissions that we received indicated substantial market support for this structure.
13. This will mean that some of the tasks now performed by the Stock Exchange will transfer to the Commission and that a breach of the Rules will become a breach of the law. We believe this initiative will further improve the governance of companies and promote investor confidence. While the final form of the legislation and its commencement is not yet certain, it will involve a changed and increased role for the Commission both for regulating and enforcing.

INTRODUCTION OF REITs

14. We revised the REITs Code allowing investments in overseas properties and to raise the gearing ratio of a REIT to 45% of its gross asset value. The revised Code took effect on 17 June 2005. 3 REITs were authorised in 2005, namely the Link REIT (the biggest REIT IPO to date worldwide), the Prosperity REIT and the GZI REIT (the first REIT with 100% Mainland properties). All three REITs raised a total of HK\$25.5 billion, and have continued to perform well in terms of both its price and trading volume since their listings.
15. As REITs are Collective Investment Schemes formed as a trust, subject to the oversight of an independent trustee who has a fiduciary duty to act in the best interests of unitholders, they are not subject to the governance of Part XV of the SFO relating to disclosure of interests. To ensure the investors' interest, the Commission announced on 15 December, its policy to require that provisions substantially equivalent to those in Part XV of the SFO be adopted in trust deeds of SFC-authorized REITs. The policy is to enhance transparency and accessibility of information regarding interests in REIT. Holders of REIT units are required to submit to the REIT manager and the HKEx notification of interests upon the attainment of the 5% disclosure threshold, and other changes

in accordance with the trust deed. Such notifications will be posted on the HKEx website.

16. We will continue to monitor the development of REIT in Hong Kong. In view of the heated discussion of various potential REIT Listings, we are concerned that investors might buy shares in the developer because they thought it was about to launch a REIT. Investors should not jump into the recent rally of REITs recklessly, as companies' plans to issue a REIT may not be approved by the Commission. We reiterate that all REIT listings in Hong Kong must be approved by the Commission and applications could be refused if they fail to reach the required standard. We are monitoring the situation to prevent any malpractices or misleading information in the market to protect the interest of the shareholders.

DERIVATIVE WARRANTS

17. Hong Kong's derivative warrants market was the most active in the world in 2005 in terms of its turnover. 22.6 million contracts were traded in 2005. The average daily turnover was HK\$3.5 billion, covering 19.1% of the total market turnover. The trading activities of derivative warrants are getting more active. The turnover of derivative warrants on 23 February was HK\$9.4 bn, 22.3% of the total market turnover. It was a new record high trading day for derivative warrants
18. We believe the strong growth of our derivative warrants market is attributable to a number of factors. These include:
 - Derivative warrants provide a leveraged alternative to directly investing in the underlying stocks.
 - Derivative warrants incorporate attractive features of products traded on the derivatives market but with the ease of trading in the cash market.
 - Issuers put a lot of resources into promoting their derivative warrants and as a result, investor awareness of this product has increased.
19. In view of the significant growth in the trading activities, the Commission released a report entitled "A Healthy Market for Informed Investors – A Report on the Derivative Warrants Market in Hong Kong" on 25 November. The report reviewed market characteristics and practices, assessed the impact of derivative warrant activities on stock market stability and investor education needs. It also identified areas of regulation that needed reform and proposed a Six-Point Plan to improve the market, which includes:
 - Tightening the liquidity provider provisions;
 - A change to the Listing Rules to facilitate both further issues and identical issues;
 - Banning commission rebates and other incentive schemes;
 - Publishing new marketing guidelines;
 - Requiring the use of plain language and summaries in listing documents; and

- Launching new investor education initiatives.
20. The Commission has invited the public to comment before 31 January. We have received positive responses and a general support to the Six-Point Plan. Responses to the proposals will be considered before formal consultation on any changes to the Listing Rules. We also briefed LegCo's Financial Affairs Panel on the matter on 5 January.
 21. We have also looked into the transaction volume and value traded by different categories of investors. During 2005, there were a total of 22.6 mn transactions in derivative warrants, with a total trading value of HK\$1,706.7 bn. The average transaction size was HK\$75,637, whilst the median transaction size was about HK\$27,500. The transaction size ranged from HK\$5 to HK\$15.4 mn.
 22. According to SEHK's Retail Investor Survey 2004, the median transaction size for retail investors was HK\$30,000. We have used the median transaction size of HK\$30,000 of SEHK's Retail Investor Survey as a guide. According to the analyses, 9.7% of the total trading value and 53.8% of the transactions in derivative warrants during 2005 was below HK\$30,000. The numbers suggest that retail participation of the derivative warrants market in Hong Kong during 2005 was significant in terms of the number of transactions, but not very significant in terms of transaction value.
 23. We have observed that market volatility has been declining in recent years. This is observed in other major markets around the globe as well as in major HSI constituent stocks. In 2005, the average volatility of the Hang Seng Index was maintained at the level of 11%. This was much lower than the average volatility of 16% in 2004 and 17% in 2003. This happened during a period when there was an active derivative warrants market in Hong Kong.
 24. The share of derivative warrants in total market turnover is only one of the indicators which may show the potential impact of the derivative warrants market on the cash market. To assess the potential impact of the derivative warrants market, we should also look at other factors such as the relative size of the derivative warrants market compared to that of the stock market, and the effect of related hedging activities of derivative warrants.
 25. In terms of market capitalisation, at the end of 2005, the market value of all derivative warrants in the hands of the public was HK\$ 4.6 bn, around 0.05% of the total market capitalisation of the stock market. During 2005, a total of 18 issuers participated in the derivative warrants markets. The number of listed derivative warrants in the Hong Kong stock market was 1,304 as at the end of 2005. This was 51% higher than that of 2004.
 26. The derivative warrants are issued on large capitalisation and high turnover stocks such as HSBC, Hutchison, Bank of Communications, China Mobile, PetroChina, China Life, Cheung Kong Holdings, Sun Hung Kai Properties and Sinopec. It is also very common for issuers to issue derivative warrants on indices such as the HSI and HSCEI.

27. The 6 most active issuers issued 68% and 87% of all new issues of derivative warrants in 2005 and 2004 respectively. As more issuers enter the market, the market shares of dominant players are diluted. The issuer participation rate was 75% for 2005. The corresponding figures for 2004 and 2003 were 67% and 61%. The issuer participation rate is the percentage of total value of transactions where an issuer takes part as either the buyer or the seller of the transaction. This follows the practice adopted by HKEx. The high participation rates indicate that issuers are taking an active role in fulfilling their obligation in providing liquidity to warrants that they issued.

DERIVATIVE WARRANTS INVESTORS SURVEY

28. The Commission engaged an independent research centre to carry out a targeted survey on warrant investors. The purpose of the survey is to understand their objective of trading warrants, knowledge level and whether they had made profits or suffered losses out of trading warrants.
29. As per the SFC's Retail Investor Survey 2005 conducted in Sep to Nov 2005, retail participation rate is:
- 4.7% of HK adults or
 - 12.9% of retail investors who had invested in one or more SFC-regulated investment products or overseas stocks during last two years.
30. Purposes of trading warrants:
- 8.4% - risk management/long-term investment purposes.
 - 76% - short-term gains from speculative trading.
 - 10.8% - 'gambling' i.e. they knew nothing about warrants and simply bet on their luck.
31. Perceived risks of warrants:
- Very high or high (92.4%)
 - Medium (4.8%)
 - Low or very low (2.4%)
 - Don't know (0.4%)
32. 76% understood that underlying price is NOT the only factor affecting warrant price. - 64.2% could at least cite one additional factor.
33. 47.6% of warrant investors understood that a higher implied volatility indicates that a derivative warrant is more expensive.
34. What or Who first prompted respondents to trade warrants:
- Own initiative (36.8%)
 - Influence of friends/family members who had traded warrants (31.6%)
 - Market commentators' opinion (20%)
 - Issuers' advertisements/articles/TV or radio programmes (8%)

- Brokers' advice (8%)
35. 73.2% of warrant investors had traded warrants for more than 12 months.
36. 16.8% of the respondents have over 50% of their portfolios invested in warrants.
37. The reason why investors picked warrants as an investment tool:
- Warrants' higher volatility (52%)
 - Better liquidity (23.6%)
 - Narrow bid-ask spread (9.6%)
 - Leverage effect (9.2%)
 - Lower commission, commission rebates or other incentives offered by brokers (5.6%)
38. How investors selected a specific derivative warrant:
- Own analysis (76.8%)
 - Market commentators (19.6%)
 - Friends or family members (14.8%)
 - Issuers' recommendations (8.4%)
 - Brokers' recommendations (8%)
39. Trading Results in the Last 12 months:
- Net gains (30.8%)
 - Net losses (47.2%)
 - Break-even (12%)
 - Don't know (10%)
40. Net gains in dollar terms (HK\$):
- Range: 1,000 to 300,000
 - Median: 20,000
41. Net losses in dollar terms (HK\$):
- Range: 1,000 to 400,000
 - Median: 20,000
42. 47.5% of loss-making investors said that they would continue to trade. Main reasons were:
- Understood the risk of investing and were prepared to take the risk (53.6%)
 - Had learnt more about warrants and hoped to do better in their future trading (41.1%)
 - Hoped to recover their losses from further trading (37.5%)
 - Addicted to trading derivative warrants (10.7%)

43. It should also be noted that some Asian markets have just launched / re-opened their derivative warrants markets and they have attracted strong trading interest. In the Mainland, for instance, the trading of warrants was resumed in August 2005 and the market has been growing rapidly. As of the end of 2005, there were seven warrants listed (four on the Shanghai Stock Exchange and three on the Shenzhen Stock Exchange). In the month of December 2005, the Mainland warrants market recorded a total turnover of US\$15.4 bn. It surpassed Hong Kong to become the most active market in the world for that month.
44. It was reported by the media that several other Mainland listed companies planned to issue warrants and some brokerage firms had applied to issue warrants on the SSE50 Index. If the Mainland warrants market continues to grow with new issues and more participants, it is likely that the Mainland market will easily overtake Hong Kong as the world's most active warrants market.
45. The Commission will continue to work with HKEx to monitor and facilitate the activities in the derivative warrants market.

OTHER INITIATIVES

46. Besides, the Commission has also undertaken other initiatives to facilitate the market in general.
47. We all remember the collapse of the C.A. Pacific Group in 1998. To avoid similar incidents from happening again, proper risk management is an important factor. To date, pooling risk remains a loophole in the existing regulatory regime. Appropriate regulations needs to be implemented to protect the interest of consumers in this regard.
48. In the past year or so the Commission devoted a great deal of effort to working with the industry with a view to setting a re-pledging limit at a mutually acceptable level.
49. We proceeded with a proposal to set a securities collateral re-pledging limit. The Commission intends to set the re-pledging limit at a range of between 130% and 150% in a two-phase approach:
 - implementing the re-pledging limit of 180% soonest after completing the legislative process (negative vetting of rules);
 - after a further period of 12 months, the re-pledging limit will be fixed at a level of between 130% and 150%.
50. We reported our proposal to the Legislative Council Panel on Financial Affairs on 6 February and we received a general support by members of the Panel.
51. We believe that our existing proposal has striven an appropriate balance taking into account the interests of all stakeholders and would serve to minimise the impact on the industry while enhancing investor protection.

52. We have also completed the review of disclosure of interest regime. We have received a general support for almost all proposals in Jan 2005 consultation to make the regime more user-friendly. We are now working with the Government to amend the law. We have set up the Working Group on Disclosure Requirements for Security Interests to assist on formulating an appropriate approach.
53. Securities and Futures (Investor Compensation – Levy) Rules were amended to provide for an automatic investor compensation fund levies triggering and suspension mechanism. With the active transactions throughout 2004 & 2005, the ICF reserve has surpassed the target level of HK\$1 bn. The exemption notice was gazetted on 11 Nov 2005 to declare that no person is required to pay investor compensation levies (0.002% on each side of securities transactions executed on SEHK and \$0.5 (\$0.1 for smaller size contracts) per side of a futures contract executed on HKFE) on or after 19 December 2005. The suspension will remain in force until the net asset value of the ICF falls below \$1 bn. The net asset value of ICF on 31 January 2006 was \$1.67 bn.
54. Similarly, the Commission has also submitted an application to the Government to reduce the transaction levy by 20% from 0.005% on each side of the securities transactions executed on SEHK to 0.004%. We expect lower transaction costs would stimulate more securities transactions.
55. Learning from the lessons of 911 and SARS, we understand that the industry should develop a comprehensive contingency plan to face adverse situations. We have started meetings with the market participants to assess the various levels of preparedness and are formulating guidelines for the markets. We are also contributing internationally through international forums our experience in market contingency planning and experience in dealing with SARS and Avian Flu so as to shape international policies and best practices (e.g. We hosted the Joint Forum which was held from 20-22 February 2006 in Hong Kong, during which we had a major discussion on the High Level Principles for Business Continuity Planning. We received favourable comments from various financial institutions and regulators on our comprehensive business contingency planning).

IOSCO ANNUAL CONFERENCE 2006 IN HONG KONG

56. In June 2006, we are bringing the world's focus on Hong Kong again. From 5 to 8 June 2006, the Commission is going to host the IOSCO Annual Conference. Over a thousand delegates of worldwide leaders in the financial industry will gather in Hong Kong to discuss about:
 - the International Financial Reporting Standards,
 - the scope of regulating the hedge funds;
 - the enhancement of the transparency of the bonds market; and
 - the implementation of the IOSCO principles.
57. Your support is crucial and I take this opportunity to appeal for your active participation in this remarkable event.

CONCLUSION

58. This year, we decided to continue to use “Investors First” to be our Annual Theme. The reason for us continuing using this theme is that we firmly believe if the interests of investors are better protected, their confidence improves, together with market turnover and profit opportunities for everyone. As investors prosper, the intermediaries will flourish and the whole market will benefit.
59. Thank you for your cooperation and support.