Chairman and Honourable Members,

Many of you would still vividly remember the collapse of C.A. Pacific Group in 1998, in which over 5,000 clients filed compensation claims of nearly $1 billion. At that time, C.A. Pacific Finance had capital of only $16 million, but had borrowed more than $500 million by re-pledging a huge amount of client securities to banks. The C.A. Pacific incident triggered a confidence crisis among retail investors, who rushed to withdraw shares from other broker firms. As a result, these firms suffered enormous financial pressure, pushing some of them to the brink of closing down. Many of you may still clearly remember the widespread panic at that time. Indeed, Hong Kong cannot afford a repeat of a brokerage collapse like CA Pacific again.

While we have taken measures to manage down the risks arising from securities margin financing since the C.A. Pacific incident, pooling risk remains a loophole in the existing regulatory regime. This is especially unfair for clients. Once a client has opened a margin account with a broker and authorised the broker to re-pledge his securities, the broker may re-pledge the client's securities without any limits, even when the client has no current borrowing from the broker. Many major financial centres already have laws and regulations in place to protect the interests of consumers in this regard.

Despite our investor education efforts, there are still investors who do not fully understand the risks associated with margin accounts and the implications of entering into a margin account agreement. We should therefore introduce appropriate regulations to protect consumers’ interests accordingly.

As such, we published in 2004 a report of a working group which mainly comprised securities practitioners. The report put forth a re-pledging limit proposal as one of the recommendations. We consulted the public on the proposed measures in the same year. There was general support for a reform of the existing regulatory framework in order to enhance investor protection. However, industry participants were concerned that their interests would be affected by the re-pledging limit as proposed by the working group.
In the past year or so the SFC has 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. However, no consensus has been reached by the industry.

We consider that the matter should not be allowed to drag on further. Let me show you this chart. It shows that there were 431 SEHK broker firms in Hong Kong as of September 2005 and the proposed re-pledging limit would not be applicable to nearly 80% of these firms because they do not re-pledge. As to the remaining 84 which re-pledge client securities, most of them are already able to comply with the proposed re-pledging limit because they do not re-pledge excessively. Hence, only a limited number of broker firms would be affected by the proposal. On the other hand, we firmly believe that increased investor confidence in both the market and the brokerage industry will bring long-term benefits to the future development of the industry.

In addition, we need to bear in mind that the stock market is very crucial to the Hong Kong economy. Currently, the Hong Kong stock market’s capitalisation amounted to $8 trillion, or six times of Hong Kong’s GDP. Last year, Hong Kong became the largest fund-raising hub in Asia, having raised funds of nearly $300 billion in total. It posted over $4.5 trillion in annual turnover. The buoyant stock market has generated handsome revenues for financial industry practitioners as well as other economic sectors. These impressive figures demonstrate the importance of safeguarding the healthy development of our stock market so that it may maintain its contribution to Hong Kong’s economy.

Besides, according to an estimate of the SEHK, there are probably as many as 1.3 million retail investors in Hong Kong, which means that almost one-sixth of the Hong Kong population engage in stock investment. As such, the protection of investors and the maintaining of the reputation of Hong Kong’s securities market and Hong Kong’s international financial centre position must take precedence, as they are overall for the benefit of Hong Kong as a whole.

The SFC therefore intends to adopt the working group's recommendation by setting the re-pledging limit at a range of between 130% and 150%. Nevertheless, we understand that some brokers may need a little time to make adjustments. Hence, we plan to introduce a two-stage approach when implementing the re-pledging limit:

(a) we plan to publish the consultation conclusions and submit the draft legislation to the Legislative Council as soon as practicable, with a view to implementing the re-pledging limit of 180% soonest after completing the legislative process;

(b) after a further period of 12 months, the re-pledging limit will be fixed at a level of between 130% and 150%, i.e. we expect that brokers will have about 18 months to prepare for compliance with the 130% - 150% re-pledging limit.
We believe that our existing proposal has striven to strike an appropriate balance that takes into account the interests of all stakeholders. Unlike complete segregation of securities, re-pledging limit does not eliminate pooling risks but it certainly represents a more practical way to reduce pooling risks in view of the administrative concerns and costs involved in complete segregation. The proposed approach of phasing-in different re-pledging limits would serve to minimise the impact on the industry while enhancing investor protection.

We believe that this is the right time for reform. The high turnover of the Hong Kong stock market (daily turnover averaging $30 billion recently) and good business results of broker firms since 2003 provide a good foundation for implementing enhancement measures. On the other hand, there are many factors that may cause greater volatility in the financial market in 2006. Under such circumstances, we as the market regulator need to put forth responsible proposals accordingly, and the Hong Kong market needs to make a resolute decision.

We wish to reiterate that we should attach great importance to the interests of the 1.3 million retail investors and Hong Kong as a whole, enhance investor protection and safeguard Hong Kong’s reputation as a premier international financial centre. Moreover, as most of those brokers who re-pledge client securities are able to comply with the proposed re-pledging limit, only a handful of broker firms will be affected.

We take this opportunity to appeal to the industry to join hands with us to reduce pooling risks for the sake of the interests of investors and Hong Kong.

We also call upon the Honourable Members to support our proposal in the overall interest of the market and for the benefit of investors.

Finally, I would be happy to answer any questions that you may have on the details of the proposal.

Thank you.
Aims: Investor Protection and Safeguarding IFC Status

HK Stock Market
Market capitalisation as of 2005: $8,100 bn *
About 6 times of HK GDP in 2004#
Jan 2006 average daily SEHK turnover: $30 bn *

Investors
1.3 million retail investors®
Contributing 34% of market turnover^

SEHK Brokers
431 firms

- Safeguard HK’s IFC position
- In line with international best practices
- Provide better investor protection
- Strengthen confidence in brokers
- Facilitate long term growth of the industry
- Do not affect majority of firms

84 firms with repledging

• Most of these firms have complied with the proposed requirements

Source:
* - HKEx
# - HKSAR Government
® - HKEx’s Retail Investor Survey 2004
^ - HKEx’s Cash Market Transaction Survey 2003/04