

# Supervision of Markets



Mr Yorkling Chow, despite his 30 years of carpentry experience, does not take the production of a Chinese window frame lightly because the structure calls for sophisticated craftsmanship. Step by step carefully, he carves and polishes the frame to remove any remaining flaws. The SFC works with the market to build an efficient and robust financial infrastructure.



Our mission is to ensure that the regulation and development of Hong Kong's securities and futures markets meet international standards.



## Achievements

- Authorised the first group of five Automated Trading Services (ATS) providers
- Set up the Investor Compensation Company Ltd (ICC) and monitored its operations
- Monitored the development and launch of advanced market infrastructure under SCEFI recommendations, including the clearing systems CCASS/3 and DCASS
- Relaxed further the short selling regulation
- Streamlined regulations on position limits and reporting requirements of futures and options contracts

### This Chapter Is About

#### >> Facilitating market development

- Encouraging product innovation and enhancement
- Relaxation of regulations
- Authorisation of ATS providers
- Review of HKEx's fees

#### >> Strengthening financial infrastructure

- Upgrade of CCASS/3
- Review of HKEx's systems

- Rollout of derivatives trading and clearing systems
- Implementation of SCEFI initiatives

#### >> Investor compensation

- Processing investor compensation claims
- Investor Compensation Company Ltd

#### >> Market research

### WHAT WE DO

- >> **Facilitate the development of and encourage participation in the Hong Kong markets;**
- >> **Strengthen market infrastructure;**
- >> **Supervise and monitor activities of the exchange controller, exchanges and clearing houses;**
- >> **Regulate approved share registrars;**
- >> **Supervise and monitor activities of the independent Investor Compensation Company Ltd; and**
- >> **Manage Hong Kong's investor compensation funds.**

### WHAT WE DID

#### Facilitating Market Development

##### > Encouraging Product Innovation and Enhancement

The SFC encouraged HKEx to widen its product range, enhance its markets and streamline the regulatory requirements for various products:

- On 8 December 2003, Hong Kong Futures Exchange (HKFE) introduced the Hang Seng China Enterprises Index Futures contract. The underlying Hang Seng China Enterprises Index (also known as the H-shares Index) is a popular stock price index to track the performance of the H-shares market. Immediately after the launch the contract received favourable support from market participants and the average daily turnover exceeded 5,000 contracts in a few months' time. A new futures contract is exempt from the SFC levy during the first six months of trading.

- On 1 September 2003, HKEx enhanced its block trade facility for futures and options contracts for a trial period of six months. Block trades comprise privately negotiated large buy and sell orders. The minimum threshold of stock options block trades was increased from 100 contracts to 500 contracts and the block trade restriction imposed on expiring contracts during the last two trading days was removed. At the end of the trial period, the SFC approved the changes on a permanent basis.
- The first ETF authorised under new SFC guidelines was listed on SEHK in November 2003 under the streamlined arrangements in Chapter 20 of the Listing Rules. We had worked closely with HKEx to ensure that the necessary market infrastructure was in place for the trading of this ETF, including the HKSCC rule amendments to facilitate scripless creation and redemption of ETFs and short selling with tick rule exemption.

##### > Relaxation of Regulations

To maintain the competitiveness of our markets and to reduce the compliance burden of market participants, the SFC has been working closely with the industry, HKEx and the Government on measures to streamline the short selling regime. Following the legislative changes in 2002 to relax short selling regulation, on 26 May 2003, the SFC approved HKSCC rule changes to facilitate the introduction of buy-in exemption for settlement failures resulting from a delay in the recall of loaned securities.

With the exemption, a stock lender unable to settle its short positions on T+2 due to a failure to recall loaned securities will be exempted from the compulsory buy-in. But as in the case of other buy-in exemptions, these outstanding positions must be settled in full by T+3.

The exemption allows a lender to maintain fewer buffers in the lending pool. As more securities are available for lending, the liquidity of the stock market is enhanced. The exemption came into operation on 6 June 2003 for a six-month trial period. Subsequently the SFC approved the exemption on a permanent basis.

On 17 September 2003, the SFC issued a consultation document on the draft Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2003.

The Amendment Rules allow any person, including a non-Exchange Participant, who holds or controls futures or stock options to apply the reporting requirements and the prescribed limits separately to his own account and to each of the other persons except where the person has discretion in respect of the futures or stock options contracts which he holds for the other persons. This helps provide a level playing field for Exchange Participants and non-Exchange Participants.

Following negative vetting by the LegCo, the Amendment Rules came into force on 30 April 2004. A revised Guidance Note on Position Limits and Large Open Position Reporting Requirements has been issued to reflect the changes.

#### ➤ **Authorisation of ATS Providers**

We authorised in October 2003 five ATS providers, including four overseas exchanges and one local subsidiary of an international information provider. Particulars of the authorised entities and the authorisation conditions are listed on the Register of Automated Trading Services, available on the SFC website.

As of March 2004, the SFC was processing three applications (including two from overseas exchanges and one from a local company) to provide ATS in Hong Kong.



An on-line register on the SFC website gives details of ATS providers.

#### ➤ **Review of HKEx's Fees**

Fees charged by HKEx in its capacity as a recognised exchange controller, SEHK and HKFE in their capacities as a recognised exchange company and by the clearing houses in their capacity as a recognised clearing house must be specified in rules and approved in writing by

the Commission. With demutualisation, the Government eliminated the portion of the statutory levy going to SEHK from 1 September 2001 and SEHK sought approval from the SFC to replace the lost revenue with a trading fee of 0.005% of the value of transactions recorded on the SEHK, subject to review after 12 months. The Commission granted approval on condition that HKEx complete a comprehensive review of all its fees within a year of the trading fee taking effect.

The comprehensive fees review has not been completed by HKEx and extensions of time have been approved by the Commission. Now that a number of issues that delayed the review have been resolved, HKEx and the SFC are holding discussions on the way forward to complete the fees review.

### **Strengthening Financial Infrastructure**

#### ➤ **Upgrade of CCASS/3**

The third stage of the new Central Clearing and Settlement System (CCASS/3) was successfully introduced in May 2003 after a series of internal tests and market rehearsals. The new generation of CCASS/3 is equipped with an open architecture, accessibility through the secured network FinNet, common collateral management functions, upgraded security features and direct access to participant supplied systems through open gateway systems. It provides a robust and convenient settlement platform to the clearing participants.

The SFC monitored the project management process, testing procedures, rollout procedures and contingency planning during the implementation and rollout.

#### ➤ **Review of HKEx's Systems**

In view of several HKEx glitches in 2002, the SFC requested HKEx to conduct a series of comprehensive reviews on the technical architecture of its critical systems, the operational procedures and the overall IT quality management framework so as to strengthen the reliability and stability of the systems. In 2003, HKEx invited independent consultants to conduct the various

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reviews and make recommendations. During the year, no critical market-wide system problems were reported. The SFC continues to monitor HKEx's implementation of the recommended measures.

### ➤ Rollout of Derivatives Trading and Clearing Systems

A new derivatives trading system was launched in October 2003 and no critical problems occurred during the two-week stabilisation period. The new system provides a more reliable trading platform and is able to interface with a new derivatives clearing system, known as Derivatives Clearing and Settlement System (DCASS).

In order to minimise the operational risk of the integrated trading and clearing systems, the SFC monitored the independent reviews conducted by HKEx on the project planning and implementation process, testing procedures, rollout procedures, contingency and fallback plans of DCASS. Moreover, we requested HKEx to provide adequate training to clearing participants to ensure market readiness before the rollout. The internal tests and market rehearsals for DCASS were successfully completed in early 2004. DCASS was launched in April.

### ➤ Implementation of SCEFI Initiatives

#### ■ Work Towards a Scripless Model

On 30 September 2003, the SFC published the consultation conclusions on proposals of a scripless securities market. Overall, the market was supportive of the proposals. On 24 October, HKEx published its own independent consultation paper entitled Proposed Operational Model for a Scripless Securities Market, which explained HKEx's proposed operational details of a Split Register Model. In response to market comments, HKEx has revised its proposal to be a Single Register Model, under which the registrars need not issue scrips and instead will keep electronic records of such shares. CCASS will dematerialise most of the jumbo certificates in its vaults but investors or brokers may continue to withdraw physical share certificates from CCASS. Depending on market demand, HKEx may provide further enhancements.

In the meantime, the SFC continues to work with the FSTB and Law Draftsman on redrafting the legislation to reflect the changes in the new model.

#### ■ Strengthening Interoperability

Several initiatives to enhance market interoperability proceeded satisfactorily during the year. They help facilitate straight-through-processing and reduce the need for manual efforts in the settlement process.

The high level requirements for system enhancements to facilitate central pre-matching of settlement instructions in CCASS were agreed and finalised between HKEx and the industry. Work on system enhancements has commenced and is targeted for implementation in the fourth quarter of 2004.

The Commission is co-ordinating with share registrars and selected market participants to conduct trial runs to provide IPO allotment results in useable data format. If the trial is successful, the initiative will be offered to all market participants in the second quarter of 2004.

The Commission is also working with HKEx and custodians to explore the feasibility of building a centralised Corporate Actions Database with standardised corporate action information. The initiative would save efforts of market participants in manually extracting corporate announcements from newspapers.

Major custodians have agreed on a best practice guide based on the SWIFT message standards, to standardise the use of client reference number in settlement instructions. SWIFT Hong Kong has undertaken to publish the industry recommended best practice.

#### ■ Enhancement of Investor Participant (IP) Accounts Service

The Commission has been working with HKEx to improve the IP Accounts service. HKEx has proposed a number of short-term measures including extending the hours for on-line access to nearly 24 hours a day, allowing the use of user ID and password for Internet access, providing SMS message to alert IPs on activities requiring their actions, allowing IPs to submit electronic request for demand poll voting, allowing Free of Payment IP settlement instructions without affirmation and offering of on-request statement services. The target launch date of these measures is the third quarter of 2004.

The SFC continues to work with HKEx on the implementation of other SCEFI initiatives, taking into account market demands.

## Investor Compensation

### › Processing Investor Compensation Claims

As at 31 March 2004, the net asset values of the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF) were \$323.8 million and \$0.3 million respectively. During the year, compensation payments totalling \$14.5 million were made from the UECF to 258 claimants in respect of the default of C.A. Pacific Securities Ltd (CAPS), Lawsons Securities Company, Ying Kit Company Ltd and Teil Stock Investment Co. Claimants have received, or will receive, the amount allowed by the SEHK up to \$150,000 per claimant under the agreed compensation arrangement. No payments were made from the CECF during the year.

The SFC has made additional payments totalling \$172,700 and \$2.6 million to four clients of Chark Fung Securities Co Ltd and eight clients of Win Successful Securities Ltd respectively under the \$8 million entitlement per Exchange Participant of UECF.

During the year, the SFC worked with the liquidators of CAPS and HKEx on the asset distribution to the claimants of CAPS. In May 2003, a Court order was made to the last group of appellants on the classification of the cash and margin clients. As there was no further appeal during the 28-day appeal period, the liquidators started the share distribution from 30 June until 28 October 2003. The claimants who had received compensation payment could opt to receive all the allocated shares from the liquidators if they paid back the entire compensation amount to UECF. About 300 claimants returned \$31.8 million to the UECF. The SFC has also collected allocated shares from liquidators under its subrogation rights.

### › Investor Compensation Company Ltd

Under the SFO, the independent ICC has been set up to administer and manage the Investor Compensation

Fund (ICF), which replaces the UECF and the CECF. The compensation arrangement has been streamlined and there is greater protection to investors. Coverage has been extended to all investors transacting through licensed intermediaries dealing in HKEx's products, including securities and futures dealers, registered institutions under the Banking Ordinance and margin financiers.

ICC came into operation on 1 April 2003 with its own Board of Directors. The Commission has established an Investor Compensation Fund Committee to monitor and regulate the ICF and ICC. We have assisted the ICC in setting up its operational procedures, claim handling process, corporate policy and technical infrastructure.

During the year, ICC received three claims. One of them was rejected and the other two were being processed as of 31 March 2004.

UECF and CECF have transferred assets of \$700 million and \$108 million respectively to ICF. Including the ongoing transaction levy and investment income, the net asset size of ICF was \$962 million as of 31 March 2004.

## Market Research

The Division extensively researches developments in the securities and futures markets of Hong Kong and other major markets. We also work with other divisions and regulators to monitor market and industry performance. Apart from providing support to the Commission to achieve our regulatory objectives by analysing information and identifying the latest trends, we give information to the Government and IOSCO.

To better communicate with market participants and investors and to provide them with timely information, we enhanced the research paper series and the Statistics section on our website. During the year, we issued 10 research papers covering various aspects of the securities and futures markets and widened our coverage of market and industry statistics. The SFC worked with other regulators and academia on the publication of the research-based *SFC Quarterly Bulletin*.