LegCo Panel on Financial Affairs
16 January 2003

SFC to Assist Brokerage Industry

"The Honourable Chairman and Honourable Members of the Panel,

“Let me start by affirming that the SFC welcomes the Government’s establishment of a tripartite forum comprising the Administration, the SFC and Hong Kong Exchanges and Clearing Limited to study possible measures to improve the business environment of broker firms and facilitate the practitioners, in particular the small and medium-sized brokers, to enhance their competitiveness.

The SFC will actively participate in the forum to help industry practitioners to develop their strengths and upgrade their skills, and diversify their services so as to sharpen their competitive edge.

In particular, the SFC will pursue this objective through the following areas:

- Facilitate market development through better corporate governance and products
- Streamline regulatory requirements and facilitate brokers’ compliance
- Ensure a level playing field
- Training and continuous development

<u>Facilitate market development through better corporate governance and products</u>

A top priority of the SFC this year is the implementation of the Securities and Futures Ordinance, which in a number of ways helps strengthen corporate governance:

- The introduction of “dual filing” by listing applicants and listing companies establishes the SFC as the statutory regulator of corporate disclosure. The SFC will not hesitate to exercise its investigatory and prosecution powers against persons filing false or misleading information.

- The law criminalises disclosure of false information inducing investors to enter into securities transactions, with a maximum penalty of 10 years' imprisonment and a fine of $10 million.

- The law provides investors with a new private right of action to seek compensation for pecuniary losses arising from reliance on false or misleading communications, including those issued by listed companies.

- The law provides auditors of listed companies with statutory immunity from civil liability for reporting suspected corporate misconduct to the SFC.

The SFC will work with the Government and HKEx to ensure IPO intermediaries carry out their responsibilities professionally and in accordance with the standards expected of them, hence ensuring the quality of listed companies and increasing investors' confidence in the market.

If investigations reveal a corporate finance adviser to have inadequate standard of work, the SFC would take appropriate licensing and disciplinary action under the Corporate Finance Adviser Code of Conduct.

On product development, we actively review our regulations to remove product entry barriers and create a conducive business environment. Following the introduction of hedge funds authorisation guidelines, the SFC will soon consult the public on the real estate investment trusts (REITs).

- REITs widen the choices of investment products for investors and, as they are often listed on the exchange, may represent opportunities for the broking community. In light of the encouraging response during soft consultation with the market, we will expedite the policy process by issuing a consultation paper on the detailed draft guidelines in February or March, with a view to publishing the final guidelines in the third quarter.

Retail investors would be able to access REITs like stocks via their own brokers, and hence expanding the product range that brokers could transact on behalf of clients.

Streamline regulatory requirements and facilitate brokers’ compliance

The SFC enforces its Financial Resources Rules (FRRs) to help brokers manage their risks, hence protecting investors. The SFC shares the industry’s concern about the difficult operating environment. Where investor protection is not compromised, the SFC will flexibly administer the FRRs.

There are further measures under the SFO which would help facilitate brokers’ compliance:

- A licensed corporation is required to maintain only the highest of the required liquid capital and paid-up share capital that are applicable to the various regulated activities conducted by it, thereby saving capital under the single licence regime.

- As many brokers allow their cash clients to roll their account balance, the new FRRs as amended last year recognise any outstanding net receivables from cash clients as a liquid asset so long as it is adequately covered by the securities which the brokers may dispose of in the event of the client default.

- The illiquid stock adjustment and gearing adjustment under the existing FRRs are kept under review by a working group comprising representatives of broker associations and others. The group is examining the overall financial regulatory framework for brokers.

To prepare the industry for the improvements and requirements of the SFO, the SFC has organised 39 training sessions for nearly 10,500 brokers, fund managers, accountants, lawyers and other practitioners (including one seminar tonight which will be attended by 1,000 people).

There will be 14 more SFO briefings in the months to April with a further 2,500 attendants.

Ensure a level playing field

The SFC has the responsibility to promote competition in the securities and futures industry. To this end, the SFC will ensure that there is a level playing field for those who offer securities services to investors.

Under the SFO, banks engaging in securities activities will be governed by the same rules, codes and guidelines as SFC licensed corporations. Any bank or its relevant individuals found guilty of misconduct will be subject to the full range of SFC sanctions.

In December 2002, the SFC and the Hong Kong Monetary Authority signed a Memorandum of Understanding setting out the roles of the two organisations in the supervision of securities activities of banks. The HKMA has been taking active steps in informing the authorised institutions of the implications of the SFO. In particular, as part of its preparatory work for the new regulatory regime, it has drafted a module under its Supervisory Policy Manual to cover supervision of registered institutions in great detail and issued it for industry consultation. It has also issued guidelines in respect of the selling of hedge funds similar to the ones issued by the SFC.

This week, the HKMA issued a circular on cold calling by registered institutions to make clear that bank staff cannot call on "pure" banking clients (who are not securities or futures clients) to sell them securities and futures services. Only relevant individuals can handle securities and futures enquiries and related matters.

The SFC and the HKMA will work closely to ensure there is no regulatory gap and that there is essentially uniform regulation of brokers and banks in the conduct of securities activities.

The SFC has formed a task force comprising industry participants, including representatives of the industry associations, to consider the enhancement of the IP (Investor Participant) accounts system. Industry representatives have unanimously agreed that the system should be upgraded so that it can perform full clearing and settlement functions. With a user friendly, efficient and affordable IP accounts system, brokers would be able to have their risks minimised and they would then better compete with banks on the basis of quality of service. HKEX has been asked to design a tentative model for Hong Kong.

Training and continuous development

The poor economic environment last year adversely affected the financial sector including the stockbroking industry. Industry practitioners recognize that it is in their interest to add value to their services. We have figures that demonstrate that there are different opportunities in the industry.

- The SFC notes that last year saw a net increase of 25 securities advisory firms. There were 694 such licensed firms by the end of 2002, of which 74 were approved in the year. These included 16 corporate finance advisers. 1,272 individuals were newly licensed to advise on securities. The SFC is still processing 13 applications from advisory firms and 148 from individuals.

- In the futures sector, 11 dealing and 13 advisory firms entered the industry in 2002 – some of which are spin-offs of stockbroking groups. A total of 596 dealing and 69 advising licences were granted to individuals in the year. Seven firms and 89 individuals are awaiting approval for futures licences.

These figures indicate that there is scope for business in the financial sector even in a challenging operating environment. To help brokers and their representatives upgrade and diversify into other financial services, the SFC has undertaken the following initiatives:

- Published competence exemption guidelines allowing licensed representatives to engage in other regulated activities without having to pass additional regulatory examinations (this is subject to acquiring additional Continuous Professional Training (CPT) hours on the relevant activities). In connection with this, several institutions are introducing new training courses to ensure these representatives are equipped with necessary regulatory knowledge to perform their new functions.

- Support the development of examinations or training programmes on financial planning.

- Work with industry participants, SFC advisory bodies, outside bodies such as the Hong Kong Securities Institute, and other recognised CPT providers to identify training needs of the industry and provide relevant training and retraining courses.

- Secured agreement of the Hong Kong Securities Institute to offer discounted course fees for those who have difficulties.

The SFC is sympathetic to concerns about employment in the industry. The SFC will endeavour to facilitate the practitioners to diversify their skills and services.

- Licensed representatives applying for change of employment will have their applications approved within a week. Under the SFO, provisional licences may be granted within a week to enable practitioners to start work earlier.

- Licensed representatives will have a 180-day period to find new employment before their licences lapse (as opposed to 60 days at present).

- In addition, the SFC is also working with the SEHK to abolish its registration regime for its participants' sales representatives to eliminate regulatory overlaps.

The SFC believes that brokers of different sizes may find their niches and provide services tailored to the needs of their clients. The premise that good service is acknowledged is supported by the findings of HKEx's Retail Investor Survey. In its 2001 survey, the most cited reason by investors for choosing their brokerage firms was "good brokerage services" – 41%. For investors trading through banks, the corresponding figure was 34%. Another reason was "good service/conduct and knowledge of the broker or the account executive" – 26% selected this, against 10% by investors trading through banks.

Conclusion

The SFO requires that the SFC consult the market on changes to its regulations. While the SFO does not come into effect until 1 April 2003, it has been the SFC's practice to actively engage the market. Often working groups are formed or soft consultation conducted to seek market practitioners' views prior to public consultation. Public comments will be carefully considered with an open mind. Only through partnership in the formulation and implementation of the regulations can we make sure Hong Kong has the most suitable regulatory regime which places this city on a par with international standards and at the same time allowing practitioners of all sizes to flourish.

We remain committed to this partnership. We fully support the work of the tripartite forum. We look forward to views of the market and working with the market to overcome the challenges of change. Thank you."

End by

Alexa Lam
Acting Chairman, SFC