

# CHIEF EXECUTIVE'S REVIEW



CHOW Man Yiu, Paul *Director and Chief Executive*

I am pleased to present a review of HKEx's achievements and operations for the year ended 31 December 2004.

The mission of HKEx is to operate a world-class marketplace for Hong Kong and Mainland securities. In pursuit of this mission, HKEx developed a three-year strategic plan (2004-2006) in the latter part of 2003 which focuses on three main areas: (1) consolidation; (2) becoming a Mainland partner; and (3) building a quality market.

## CONSOLIDATION

Consolidation achieved through organisational restructuring, cost rationalisation, and prioritisation of projects has underpinned our strength and has helped better allocate our available resources to meet the challenges ahead.

The organisational structure was revised in May 2004 to streamline HKEx's regulatory and business operations and improve overall efficiency. The responsibilities of several former units were reorganised so as to further sharpen HKEx's focus on the five key components of its markets: listed issuers, intermediaries, investors, infrastructure, and information dissemination. The revised organisational structure is depicted on page 94.

Cost rationalisation has successfully lowered the Group's total operating expenses for the year by six per cent as compared with those of previous year. In particular, information technology and computer maintenance expenses, a significant component in the Group's expenditure structure dropped by 10 per cent in 2004 against those in 2003.

## BECOMING A MAINLAND PARTNER

We continue to build on the strengths which have established Hong Kong as one of the world's leading equity markets and the premier international capital formation centre for the Mainland. In becoming a Mainland partner, our principal objective is to contribute to, and benefit from, the continued and robust growth of the Mainland economy and capital market.

Further to the establishment of our Beijing Representative Office in November 2003, staff members from the Beijing Representative Office were appointed to station in Guangzhou and Shanghai during 2004 to bolster HKEx's presence on the Mainland, strengthen our relationships with the Mainland government authorities and regulatory bodies, and enhance our liaison work with potential Mainland issuers. Our direct presence on the Mainland also facilitates our provision of listing conferences, seminars, and training sessions on the Mainland. Apart from Mainland state-owned enterprises and privately-owned companies, foreign-controlled joint venture companies on the Mainland have also expressed interest in raising capital in Hong Kong.

On product development, HKEx successfully launched the H-shares Index Options and four stock options on H-shares during 2004 following the launch of the H-shares Index Futures in December 2003. HKEx will continue to develop and gear up its marketing effort to promote new Mainland-related products to complement the existing H-share Index Futures and Options.

HKEx and the SFC have from time-to-time jointly offered training to secondees from the CSRC. During 2004, four secondees were sponsored to attend training in Hong Kong. To further strengthen HKEx's ties with its counterparts on the Mainland, a Memorandum of Understanding was signed in September 2004 with the China Securities Depository and Clearing Corporation Limited on the exchange of information and co-operation on staff training. HKEx has also expanded its Mainland Discount Programme to information vendors for the dissemination of Hong Kong market data in major Mainland cities.

## BUILDING A QUALITY MARKET

As the recognised exchange controller in Hong Kong, HKEx is committed to operating a fair, open and transparent market through the continuing improvement of market infrastructure, issuer regulation, market regulation, and risk management.

### Market Infrastructure

HKEx operates central marketplaces for the trading and the clearing and settlement of cash and derivatives products. In 2004, the infrastructure for these marketplaces operated to the highest standards of integrity, reliability and efficiency. All major market systems, including AMS/3, which is a core part of HKEx's market infrastructure, achieved 100 per cent uptime throughout 2004.

A core value of HKEx is to ensure that its technology is able to meet market demand in an effective and cost-efficient manner. As such, we are particularly delighted that AMS/3 received two awards in 2004, namely the Gold Award (highest honour) for the Application Category of the Hong Kong Computer Society's 6th IT Excellence Award, and a Certificate of Merit for the Financial Application Category of the 2004 Asia Pacific Information and Communications Technology Award.

DCASS, the integrated clearing and settlement system for all futures and options traded on HKEx's markets, was successfully rolled out in April 2004. The system offers improved risk management capabilities, enhances operational efficiency and delivers higher flexibility to traders and intermediaries. HKEx will continue to seek to maintain 100 per cent availability of DCASS and will also gear up its capacity, when appropriate, to match future business growth in the derivatives market.

In late 2004, the Board approved the proposed consolidation of the existing four market system networks, namely AMS/3, HKATS, DCASS, CCASS as well as MDF, into a consolidated network to further enhance capacity, cost effectiveness and reliability. The network consolidation will be implemented in phases, starting from 2005 and is scheduled to be completed by the end of 2007. However, cost savings to HKEx and the Stock EPs have been achieved through reduced network tariffs of about 20 per cent starting from January 2005.

HKEx will continue to explore the possibility of upgrading the host capacity of the major market systems to accommodate the increasing system demand resulting from increased market turnover. Technology and system software will be replaced as they become obsolete, including all second terminals installed at EPs' offices. A comprehensive review of the AMS/3 satellite applications will also be conducted to identify opportunities for possible enhancement, consolidation and where appropriate, retirement.

On the clearing and settlement front, HKEx continues to support the Government's initiative in developing a scripless market in Hong Kong. In May 2004, HKEx recommended the Issuer Register Model and a progressive approach to implementing the scripless initiative. Pending the completion of the enabling legislation by the Government and the revision of the clearing fee structure to accommodate the scripless market, CCASS dematerialisation of listed shares of locally incorporated companies is scheduled to take place in 2006.

HKEx has also introduced enhanced features for the IP accounts in CCASS to make operation of the accounts more convenient and user-friendly. Promotional programmes were rolled out during the period August to December 2004 to increase public awareness of the IP account services. A steady increase in new IP accounts has been noted. Further enhancements to CCASS services will be implemented progressively in 2005 starting with a total of 19 enhancements set for introduction in March 2005.

HKEx began disseminating real-time odd lot market information, including order prices, and the aggregated order quantity and order size of the five best bid and ask prices, to information vendors in March 2004 to increase market transparency. We will continue to recruit information vendors and review the reporting and compliance regime applicable to our existing information vendors.

### **Issuer Regulation**

As the frontline regulator of listed issuers in Hong Kong, HKEx is committed to playing a leading role in the maintenance and enhancement of market quality. New regulatory arrangements have been adopted to implement the Government's recommendations resulting from the Consultation Conclusions on Proposals to Enhance the Regulation of Listing.

In order to enhance the transparency of the decisions made by the SFC and HKEx in IPO-related listing matters, the Listing Division has been announcing listing decisions and interpretations of the Listing Rules on a regular basis. A total of 16 listing decisions and their interpretations were published in 2004, aiming at providing a more user-friendly reference to market users. Since December 2004, HKEx has also published the Rejection Letters Series on the HKEx website to provide the market and prospective applicants with even higher transparency in listing decisions and interpretations of the Listing Rules. Moreover, in

July 2004, the Listing Committees issued their first annual report to provide an account of the work of the Committees, which is also posted on the HKEx website for public information. As a recommendation in the Consultation Conclusions on Proposals to Enhance the Regulation of Listing, HKEx has proposed a revamp of the role of the Listing Committees to facilitate a simpler and more efficient decision-making process. A consultation paper on the new structure for listing decision-making was published in February 2005 and the consultation period will end on 22 April 2005.

In January 2005, the Government and the SFC respectively published a public consultation paper aiming at giving statutory backing to major listing requirements in the Listing Rules to further enhance the regulation of listed issuers. HKEx is preparing a response to each of the consultation papers.

An annual review is being conducted by the SFC on HKEx's performance of its listing functions, including the procedures and practices of HKEx's Listing Division and the operation of the Listing Committees. It is intended that the SFC's report on their 2005 review will be published around the end of June 2005.

Securities regulation is continually progressing in response to changing local environment, emerging issues, and evolving best practices. In this regard, amendments to the Listing Rules in relation to corporate governance issues, initial listing criteria, and continuing listing obligations took effect on 31 March 2004. Training seminars were held in Hong Kong and Beijing to explain the amendments, and additional guidance materials were published on the HKEx website. The CG Code and the Rules on the CG Report were released in November 2004 and took effect on 1 January 2005, with the exception of the code provisions on internal controls and the proposed disclosure requirements relating to internal controls in the CG Report that will take effect on 1 July 2005.

Sponsors and IFAs bring transactions to the market and investors rely to a great extent on their judgement and integrity. Their role is of particular importance to the Hong Kong securities market due to the large proportion of listed issuers and listing applicants whose domiciles and main operations are located outside Hong Kong. Amendments to the Listing Rules relating to the regulation of sponsors and IFAs were announced in October 2004 and took effect on 1 January 2005, which set out clearly the requirements expected of sponsors, compliance advisers, and IFAs. HKEx will continue to co-operate with the SFC to ensure that any failure to meet the standards is addressed promptly and effectively.

### **Market Regulation**

At the end of 2004, there were 490 Stock EPs and 126 Futures EPs. Under the SFO, securities and derivatives market intermediaries in Hong Kong are subject to a common regulatory framework. Accordingly, a review was conducted in 2004 to align HKEx's existing disciplinary regime for EPs. Internal surveillance systems for the derivatives market, in particular, the monitoring of large open positions, have been strengthened.

HKEx has completed its review of the narrowing of trading spreads. The consultation conclusions on reducing trading spreads were published on the HKEx website in February 2005, and the first phase is expected to be implemented in mid-2005. The second phase would only be considered subject to a close examination of the results of and market feedback on the phase one changes. HKEx has continued the review of other related trading parameters such as quotation rule and order types, and has tightened the obligations of market makers for ETFs. In order to enhance investor education, we have launched the Simulated Investment Market ("SIMart") and organised training seminars for investors and EPs. During 2004, HKEx organised or co-organised more than 30 training seminars for investors, issuers and market participants in Hong Kong and participated in about 10 educational seminars and conferences held on the Mainland and in Macau.

## Risk Management

Prudent risk management is essential to uphold market confidence. In 2004, HKEx implemented a number of new risk management measures. In respect of the clearing function, risk management measures such as restrictions on accepting bank guarantees, harmonisation of settlement bank eligibility criteria, and revision of the risk management policies of HKCC and SEOCH were implemented to reduce HKEx's risk concentration.

HKEx participated in a market-wide rehearsal for the financial services sector at the end of January 2004 to test market contingency plans and inter-organisation communications in the event of significant market disruption. Other than HKEx, participants included the Financial Services and Treasury Bureau, the Hong Kong Monetary Authority and the SFC. The results of the rehearsal showed that HKEx could handle contingency scenarios well in accordance with the procedures set out in the contingency plans, and communicate with internal and external parties effectively and efficiently during critical situations.

As part of our corporate mission, HKEx will continue to enhance the cash and derivatives market surveillance systems. In addition, HKEx will conduct a comprehensive review of the existing risk management regime to further improve our risk management capability and to ensure that risks across HKEx are always managed in an adequate, timely, and effective manner.

## STAFFING

I strongly believe that a team of dedicated staff members is one of the contributing factors to achieve consistent and sustained performance. We were delighted to welcome Gerald Greiner to join us as our Deputy Chief Operating Officer and Head of Exchange Division in May 2004, Archie Tsim as Special Adviser to the Head of the Listing Division in October 2004, and Vic Tham as Head of the Risk Management Department in November 2004. These appointments add vital expertise and experience to our organisation. The appointments reflect our commitment to further strengthening the operational and regulatory functions of HKEx. We will continue to retain good performers and recruit talent from the financial services industry to add to our existing quality management team.

HKEx considers its staff its greatest asset. As such, we are always a strong advocate of life-long learning and career development. During 2004, on average, each staff member received more than 19 training hours or attended more than three training courses. To enhance the competitiveness of HKEx, we will devote more resources to sponsor and encourage staff members to pursue various self-improvement and corporate-sponsored initiatives. To achieve this, the training budget for 2005 has been increased by 50 per cent against that for 2004. In addition, a Career Development and Training Committee was set up in March 2004 with staff representatives from different Divisions/Departments and levels to recommend ways to enhance the career development and training culture within HKEx. The recommended initiatives are currently being implemented.

### MOVING AHEAD

Shareholders and investors are invited to refer to the Business and Financial Reviews under the Management Discussion and Analysis, where a comprehensive review of the 2004 achievements of HKEx in six key business functions, namely Listing, Trading, Clearing, Business Development and Investor Services, Information Services, and Information Technology, is presented through answers to frequently raised questions of Shareholders, research analysts and fund managers.

Moving ahead, we will strive to achieve our goals through the continued implementation in 2005 of the three-year strategic plan (2004-2006). We will need support from all our stakeholders, including our Shareholders, our market users and participants, our employees, our fellow regulators, the Government, and the investing public at large, in achieving our goals.

We strongly believe that ensuring market quality, strengthening investor confidence, attracting order flow, and increasing liquidity are the key drivers of a successful cash and derivatives market. The senior management team has formulated action and operational plans to achieve the strategic target of operating a world-class marketplace for the Hong Kong and the Mainland securities and derivatives products. We will continue to focus on "Building a Quality Market" to ensure that HKEx and its markets meet international standards of quality in infrastructure, regulation and operations. This includes but is not limited to substantial investment in the capacity and technology upgrade of market systems, and the review of the operation and regulatory policy of the GEM. Moreover, we will continue our efforts in promoting new products and services to the market, including the introduction of Callable Bull/Bear Certificates, and futures and options on the FTSE/Xinhua China 25 Index, the strengthening of HKEx's nominees services in respect of its CCASS Depository, and the expansion of the dissemination of the Hong Kong market information on the Mainland and in other selected regional markets. In addition, HKEx will continue its work on promoting Hong Kong as a major venue within the region for the listing of debts.

Lastly, I would like to take this opportunity to thank all staff members for the outstanding and dedicated efforts that they have made during the past year. I also express my sincere thanks to my fellow Directors for their leadership and guidance, and to our Shareholders for their continued support, interest and confidence in HKEx.

**CHOW Man Yiu, Paul**

*Director and Chief Executive*

Hong Kong, 28 February 2005