Dear Michael,

I had wanted to reply to your letter much earlier but recent events have taken up all my time. Today is the fourth day of the Lunar New Year. This is the first opportunity in three weeks that I can sit quietly in my office to pen this letter to you.

I am sharing the contents of this letter with the many people who have gone through these difficult three weeks with me. They include, the many investors who have invested in Peregrine Investments Holdings and the clients of a large securities and finance group, called CA Pacific Group. They also include my very dedicated staff, government officials, our legislators, the media and the general investing public of Hong Kong. If this letter does come to the attention of our Chief Executive, I would like him to know that his personal concern for the welfare of investors and his personal support for our work has touched each of us deeply. We shall draw strength from this. This letter is therefore a very public letter but I know that you would not mind, as you read on.

First let me thank you for so thoughtfully drawing my attention to the compliment made to Hong Kong in a December issue of *Economist*. In their article about stock markets in the East, the *Economist* states that Hong Kong differs from other markets in the Region because it is serious in enforcing its rules for regulating the securities markets. It is good to see that our efforts have been acknowledged by one of the most respected and popular economic journals in the world. But as we step into a new lunar year, I cannot help but feel that there is still much to be done as events in the past three weeks have shown.

Although the clients of Peregrine’s licensed entities have now received their shares or monies back, I am afraid that the minority shareholders of the listed company must now wonder whether they should have been made aware of the financial difficulties of the Group much earlier. More fundamentally, the general investing public must be entitled to ask whether the disclosure standards for financial groups such as these should be improved. I have asked our Corporate Finance Division to consult the Stock Exchange and develop a program of improvement.

The clients of the CA Pacific Group have been less fortunate. A regulated entity must segregate client assets and so, even if it goes bankrupt, clients are protected. It has now come to light that most of the clients of CA Pacific Securities have signed margin agreements or authorisations allowing other members of the group, particularly, an unregulated finance company, to pledge their shares to others. A large number of these clients have not used any of the margin facilities offered and have signed these margin agreements and authorisations without fully understanding their consequences. As the Group went bankrupt, it became clear that clients who should have been protected, may not be protected. As I spoke to some of the investors either on our Hotline or face to face, I could not help but sympathise with their anger and frustration. They would have a claim against the securities firm but liquidation takes time and realistically, they would only get back a fraction of the value of their investment.

The Stock Exchange has a Compensation Fund which operates on much the same concept of the United Kingdom Compensation Fund. Any client of the CA Pacific Securities who would have a claim against it in relation to property or monies received by the firm would be able to claim from the Compensation Fund. The only problem was that there was an $8 million cap which requires claims to
Preliminary analysis of the claim forms put in so far indicates that the majority of claims were under $200,000. So, if we were able to lift the cap and allow all claims up to $200,000 to be paid in full, then the majority of the small investors would have their investment back. With the potential size of the Fund (which can now go to over $1 billion) and a Government commitment to inject further funds, where necessary, we intend to extend the same treatment to all investors. I will use every fibre in my being to ensure that payment is made before the summer is out and hopefully, sooner than that.

It has been suggested that this scheme opens up a moral hazard. Every compensation scheme opens up a moral hazard because it tends to encourage sloppy management and unjustified risk taking. That is why we have to set up a safety net which favours the small investor and is limited only to circumstances where investors have not taken unjustified risks. Good financial markets require good compliance of the rules by intermediaries and a high degree of vigilance on the part of investors as to their rights and to their understanding of risks. This points to the need for more work in the future.

Although margin lending is covered by the Rules of the Stock Exchange and the Financial Resources Rules of the SFC, the fact that such activities have migrated in a big way to unregulated bodies now requires an immediate response. Policy options have already been discussed and the results will be published as soon as possible by the Task Force headed by the Deputy Secretary for Financial Services.

The margin agreements signed with CA Pacific Finance and other members of the Group favour immensely the Group and in particular, the finance company. As you know, in the United Kingdom and most other jurisdictions - though, unfortunately, Hong Kong is not one of those - consumer contracts as one sided as these, would not only require the more one-sided clauses to be highlighted in the text but also require the consumer to signify that he or she understands the consequences; and an obligation is placed on the vendor to explain the consequences clearly. The Stock Exchange has confirmed that they will remind their members to ensure that the consequences of margin agreements are fully explained to their clients. That is a good thing, but I am sure that after the CA Pacific case, the industry must do more to earn the greater confidence of investors. Although I believe that the long term solution is to enact relevant laws and regulations to give greater protection to consumers of financial services, the Stock Exchange can, I believe, play a crucial interim role by reviewing with their members the margin agreements now in use and applying through their Rules principles for better consumer protection.

To provide even greater confidence to investors, the time has I believe come for us to consider whether an insurance scheme should be fashioned to replace the Compensation Fund which is somewhat rigid. In the United States, the Securities Investors Protection Corporation, formed in 1934, offers insurance cover of US$500,000 per investor and brokers taking out insurance from the Corporation may top up this cover. In fact, brokers in the United States offer typically US$1 million in insurance cover. We have already been developing this concept for some time. I will now ensure that our discussions with the Stock Exchange are speeded up and proposals for a scheme published as soon as possible.

In the five thousand years of recorded history of the Chinese peoples, we have lived on the belief that life always regenerates itself, as every new year brings with it new hope for the future. Hong Kong is my home and China, my country. Although I may not have done well, I am proud to have been a part of the history which we are making. Hong Kong will be a better place because we have not lost confidence in ourselves.

Let me sign off now and wish you and Jane, a healthy and happy Year of the Tiger!

Your Pupil,

Anthony