

**Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000**

Part III of the Securities and Futures Bill

**Response to the “Comparison Table of the Common Provisions in the Divisions
of Part III of the Securities and Futures Bill”**

Introduction

The Legal Service Division (“LSD”) of the Legislative Council has prepared a table (sent to the Administration under cover of his letter of 12 February 2001) setting out a clause-by-clause comparison of the different sets of provisions in the Securities and Futures Bill (“SF Bill”) applicable separately to “exchange companies”, “clearing houses”, “exchange controllers”, “minority controllers”, “investor compensation companies” (“ICCs”) and “providers of automated trading services” (“ATS”) (collectively referred to below as “regulatees”). Each group of regulatees is subject to a specific set of provisions. This paper explains the differences among these sets of provisions as identified in the LSD comparison.

General Points

2. Precedents in existing law, particularly the recently enacted Exchanges and Clearing Houses (Merger) Ordinance (Cap.555) have been followed closely. Where possible, they have been drawn on to craft an appropriate regime for the new regulatees, namely the ICCs and the ATSS. Again, where possible, the Law Draftsman has tried to adopt the same or similar wording to deal with analogous situations in the interests of drafting consistency.

3. However, it is worth noting that the different sets of provisions applicable to each type of regulatees, while often similar, are not intended to be 100% mirror images of one another. This is because the regulatees undertake different core activities and the respective regulatory regimes need to be tailored accordingly.

4. One other preliminary point concerns minority controllers, which are not separate market operators and so do not require a stand-alone regulatory regime. Therefore, minority controllers should not be equated with other types of regulatees.

Detailed response

Prohibition of unrecognized companies etc Offence for contravening the prohibition

5. There are obvious regulatory reasons to prohibit the operation of stock/futures markets by persons who are not regulated by the SFC; or those under the control of such persons; or the provision of ATs by unregulated persons.

6. As under existing law, no prohibition is introduced as regards the operation of a clearing house. Such a permissive regime is considered appropriate for three reasons. First, clearing activities are secondary in nature as the transactions in relation to which they occur are conducted on recognized stock/futures markets or through ATs which attract prohibition regimes, and the operators of such markets are required to have such transactions cleared through an approved entity. Secondly, a prohibition regime would be unwieldy as many exemptions would need to be built into the definition of clearing house to exclude clearing activities carried on as an incidental part of other businesses. Thirdly, the existing arrangement has been in place and working well for nearly 10 years. No change is considered necessary.

7. Similarly, an ICC will be a company set up to manage and administer the investor compensation fund established under Part XII. Before an ICC can have access to the investor compensation fund, the Chief Executive in Council needs to have transferred the relevant SFC functions to it. (The transfer may be withdrawn by the Chief Executive in Council.) As such, no general prohibition is considered necessary.

Exonerating circumstances in relation to the offence

8. In addition to clause 19(8) which has been identified by the LSD as exonerating circumstances in respect of recognized exchange companies, exonerating circumstances have also been introduced in respect of ATs. Please see the definition of ATs in Part 2 of Schedule 6 which excludes electronic facilities provided by recognized exchange companies and clearing houses. The exonerating circumstances are provided for in the definition, instead of in the form of an application clause as in the case of recognized exchange companies because ATs have application to both Part III and Part V of the SF Bill.

9. No exonerating circumstances have been introduced in respect of recognized exchange controllers as the scope of Division 4 is defined precisely to embrace those having a controlling relationship with recognized exchange companies and recognized clearing houses. As for recognized clearing houses and ICCs, exonerating circumstances are not necessary as there is no general prohibition applicable to their operation for the reasons given in paragraphs 6 and 7 above.

Statutory defence

10. The statutory defence in clauses 59(6) and 61(5) identified by the LSD concerns the situation when a person has unknowingly become an exchange controller which is by reference to, among other things, his shareholding in a recognized exchange company or clearing house. This scenario is envisaged to be applicable only in respect of recognized exchange controllers, where the catch relies on the shareholding percentage of a 35% (5% for minority controllers).

Definition of expression

11. As a general point, definitions are introduced only where needed. Therefore, comparison of definitions among the different sets of provisions applicable to the various types of regulatees seems not to be meaningful.

12. By way of information, the definition in clause 19(9) identified by the LSD is to ensure that the wider definition of “securities” in Part 1 of Schedule 1 (which unlike the definition of that term in existing legislation includes “interests in any collective investment scheme”) does not apply to the interpretation of the stock market monopoly. This is to ensure that the existing stock market monopoly will not be extended.

The Commission shall prepare and publish guidelines

13. This only applies to ATs which is a novel area that is likely to evolve considerably. Since it is difficult to predict how the market will develop in this area, a broad regulatory framework is proposed to enable the regime for ATs to develop with it. It is thus considered useful and indeed necessary to issue guidelines on this matter.

Duties of the various types of regulatees

14. Paragraphs 15 to 24 below concern the duties of the various types of regulatees, which have been tailored according to their core operations. No statutory duties have been placed upon ICCs and ATs. As regards an ICC, it will be a single-purpose company set up to manage and administer the investor compensation fund in accordance with detailed requirements to be prescribed in statutory rules to be made by the Chief Executive in Council and the SFC under Part XII of the SF Bill. Therefore, we do not consider it particularly meaningful to impose any statutory duties on the ICC. As for ATs, given that different ones may have different modes and types of business operations and the commercial nature of such operations, it is inappropriate to impose a uniform set of statutory duties for application to each of them. Instead, the intended arrangement is, where appropriate, to impose tailored duties on each AT as a condition of its authorization. On this basis, the explanation below only deals with the different duties of recognized exchange companies, recognized clearing houses and recognized exchange controllers.

Duty to ensure an orderly, informed and fair market

15. This is a duty applicable only to a recognized exchange company and its recognized exchange controller as the overseeing authority in respect of this broad issue.

Duty to ensure that there are orderly, fair and expeditious clearing and settlement arrangements

16. This is a duty applicable only to a recognized clearing house and its recognized exchange controller as the overseeing entity in respect of this broad issue.

Duty to ensure that risks associated with its business and operations are managed prudently

17. This duty applies to a recognized exchange company, a recognized clearing house and a recognized exchange controller of either of them as the overseeing entity in respect of this broad issue.

Duty to ensure compliance with lawful requirement under any enactment placed on the recognized exchange company or recognized clearing house

18. This duty applies only to a recognized exchange controller, as any recognized exchange company or recognized clearing house under its control already has the primary obligation to comply with applicable requirements imposed under other provisions.

To act in the interest of the public, having particular regard to the interest of the investing public

19. This duty has application to a recognized exchange company, recognized clearing house and a recognized exchange controller of either of them as the overseeing entity in respect of this broad issue.

To ensure that the interests of the public prevail where there is a conflict of interest

20. This duty has application to a recognized exchange company, recognized clearing house and a recognized exchange controller of either of them as the overseeing authority in respect of this broad issue. It seeks to put beyond doubt that these regulatees should put public interests before their own interests.

To operate facilities in accordance with rules approved by the Commission

21. This duty is applicable to a recognized exchange company and a recognized clearing house, but not to a recognized exchange controller of either of

them as only an exchange company or a clearing house directly operates the facilities at issue.

To formulate and implement appropriate procedures for ensuring participants' compliance with the rules of the company

22. This duty is applicable to a recognized exchange company and a recognized clearing house, but not to a recognized exchange controller of either of them as only an exchange company or a clearing house has participants as defined in the SF Bill (please see "exchange participants" and "clearing participants" in Part 1 of Schedule 1).

To notify the Commission upon becoming aware of any non-compliance of any rules or any financial irregularity or other matter concerning financial integrity or standing

23. Clause 21(5) identified by the LSD concerns the financial health of an exchange participant. As is under existing law, the duty is applicable only to a recognized exchange company. The SFC does not seek to expand the application of this duty as the existing mechanism in this regard has been working well.

At all times to maintain adequate and properly equipped premises etc

24. This duty is applicable to a recognized exchange company and a recognized clearing house, but not to a recognized exchange controller of either of them as only an exchange company or a clearing house directly operates the premises at issue.

No civil liability

25. This is set out in similar terms, save the relevant section references, for a recognized exchange company, a recognized clearing house, a recognized exchange controller and an ICC with respect to the statutory functions placed upon each of them. Regarding an ATS, it is essentially a commercial operation in respect of which we do not envisage that the provision of statutory immunity would be appropriate.

Duties not applicable in respect of anything done or omitted to be done in good faith by the company in consequence of the discharge or purported discharge by the recognized exchange controller of its duties

26. This relates to the situation where a recognized exchange controller, in compliance with its statutory duties, gives an instruction to the recognized exchange company or recognized clearing house it controls. Therefore, it is peculiar to recognized exchange companies and recognized clearing houses.

Certain matters relating to the making of rules

27. All rules made by the regulatees under Part III of the SF Bill are not subsidiary legislation. The provisions identified by the LSD under the heading of “to make rules” are in similar terms for recognized exchange companies, recognized clearing houses, recognized exchange controllers and ICCs. They refer to the making of rules by these regulatees governing their functions and operations. Regarding an ATS, it is essentially a commercial operation and can introduce its own “commercial” rules governing the detailed operations of users of its trading facilities. We do not envisage the need to empower an ATS in statute to make such “commercial rules”.

28. The detailed scope of each rule making power identified by the LSD under the heading of “rule making” with respect to a recognized exchange company and a recognised clearing house respectively, concerns the listing function and the default rules, which are peculiar to these two types of regulatees. The imperative in clause 40(2) is adopted as default rules are essential for system integrity.

29. Clause 36 is based on current law (section 14 Securities Ordinance Cap.333). From the past regulatory experience, the SFC considers it necessary to be empowered to have analogous powers in relation to exchange companies but not other regulatees, and hence does not seek to expand this specific rule-making power to these regulatees in this reform exercise. The general rule-making power in clause 384 of Part XVI may help bridge any gaps that may arise on light of new market developments.

The Commission may by notice in the Gazette declare a person or a body of persons as subject to the rules made by a recognized exchange controller

30. This is peculiar to exchange controllers and is based closely on law enacted in 2000 (paragraph (c) of the definition of “rules of a recognized exchange controller” in Cap.555). Rules made by a recognized exchange controller generally govern the conduct and procedures of the controller and its Risk Management Committee. However, a controller could make rules applicable to exchange/clearing participants to enable the controller to establish direct relationships with such persons rather than relying on indirect relationships through its subsidiaries.

No rules or any amendment thereto shall have effect without the approval of the Commission

31. Please see paragraphs 27 to 28 for the rule-making power of the various types of regulatees. For those that have been vested with rule-making power, no rule or amendment thereto shall have effect unless it has the approval of the SFC.

To make rules available to the public in a manner approved by the Commission

32. It is not necessary to specify availability to the public in respect of the rules of a recognized exchange company, a recognized clearing house and similarly a recognized exchange controller as they bind a limited and special class of persons who enter into direct contractual relationships with such recognized entities. Anyway, the rules made by a recognized exchange company and a clearing house have been made publicly available as a long standing market practice. In contrast, ICCs will bind the investing public at large. As such, there is a strong policy reason to require wider dissemination of ICC rules.

Not subsidiary legislation

33. Please see paragraphs 27 to 28 for the rule-making power of the various types of regulatees. For all regulatees that have been vested with a rule-making power, rules made by them are not to have legislative effect as expressly set out in clauses 24(8), 41(8), 67(8) and 83(8).

Transfer and resumption of functions of Commission

34. The transfer and resumption of functions of the SFC is applicable only to recognized exchange companies (which occurs under existing law) and recognized exchange controllers as their overseeing entities, as well as the ICCs. In the former case, it may cover for example the listing functions of the SFC, and in the latter case the management and administration of the investor compensation fund established under Part XII. It does not apply to clearing houses, as is the case under current law, because the clearing functions are statutorily created as the purview of a clearing house, and we are not aware of any SFC functions which would be appropriate for transfer to clearing houses. It is not considered appropriate to provide for such a transfer to ATSS which are essentially commercial operations.

*Chairman of the recognized exchange controller approved by CE
Appointment of top officers requires approval of Commission*

35. The requirements for approval of senior personnel in the various types of regulatees follow those under existing law, having regard to the influence of the concerned personnel on the market at large, without unduly interfering in the internal operations of such regulatees.

Production of records, etc. by recognized company

36. These are set out in similar terms for exchange companies, clearing houses, exchange controllers and ICCs, tailored appropriately to the circumstances of each. An equivalent requirement could be imposed upon an ATS operator under clause 97(3)(e), where this is considered appropriate having regard to the scale and mode of application of each ATS.

Withdrawal of recognition

37. The provisions for withdrawal of recognition or authorization are drafted in similar terms for all types of regulatees, save the levels of involvement of the Financial Secretary which have been designed having regard to the market impact of the withdrawal and are considered by the market as appropriate safeguards. To illustrate, withdrawal of recognition granted to an exchange controller requires “consent in writing by the Financial Secretary”, while such withdrawal in respect of an exchange company, a clearing house and an ICC requires “consultation with the Financial Secretary”. The Financial Secretary is not proposed to be involved in the decision to withdraw an authorization to an ATS.

Contravening of notice constitutes offence

38. The offence at issue concerns the direction to provide facilities or services in emergencies. For similar reason set out in paragraph 39, the offence is applicable only to a recognized exchange company.

Direction to cease to provide facilities or services in emergencies Publication of directions

39. The direction to cease providing facilities or services in emergencies is applicable only to a recognized exchange company given its wide market impact as compared with, for example, an ATS. It is not applicable to a recognized exchange controller or an ICC as they provide no such facilities or services under concern. As for a recognized clearing house, the effect of a direction to a recognized exchange company will be felt by it as a consequence as it handles the clearing of the transactions conducted on the market operated by the exchange company.

Appeals

40. An appeal mechanism is provided in respect of exchange companies, clearing houses, exchange controllers and ICCs to the Chief Executive in Council. To align with other SFC licensed intermediaries including ATSS licensed under Part V of the SF Bill, matters relating to ATS authorisation under Part III will have the same access to the Securities and Futures Appeals Tribunal.