

Letterhead of David K.P. Li

CB(1) 1445/00-01(01)

2nd June, 2001

By Fax and By Post

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Following the 1st June meeting of the Bills Committee on the Securities and Futures Bill, I feel it is important to comment on a point raised in the Draft Report on the Overseas Duty Visit conducted jointly by the Financial Affairs Panel and the Bills Committee in April 2001, and tabled at the meeting.

Unfortunately, a long-standing commitment makes it impossible for me to attend the second session of the internal deliberations on the Bill on 5th June, and therefore I am writing this letter for submission to the Committee.

Contained in Part II of the Draft Report is the following statement:

It appears that very compelling argument would be needed to go against the common conclusion of the world's two foremost leaders in financial services and markets and permit AIs to be exempted from the regulatory regime under the SFC.

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This wording betrays an unfortunate bias, for the present Bill does not exempt Authorized Institutions (AIs) from supervision by the Securities and Futures Commission (SFC), nor, as discussed below, do I believe that the practice of the U.S. and the United Kingdom supports having a securities regulator directly regulate the activities of banks. Indeed, there are very compelling arguments why the strategy set forth in the Bill is the correct one.

Before considering these arguments, let us return to basic principles and ask what is the intended function of this Bill.

Through this Bill, we aim to

- Establish a transparent and fair regulatory framework that will protect investors and enable Hong Kong to grow as an International Financial Centre.
- Promote efficient market activity by enhancing competition and avoiding unnecessary regulatory burdens and costs.

At issue is why we should stray from these basic principles.

Are exempt AIs exempt from supervision?

Under the Bill, exempt AIs will most certainly not be exempt from supervision by the SFC. Indeed, exempt AIs will be subject to the same statutory provisions and SFC rules and codes as licensed corporations.

The day-to-day regulator of exempt AIs should be the regulator that these institutions deal with on a day-to-day basis, the Hong Kong Monetary Authority (HKMA). This structure avoids unnecessary regulatory burdens and costs.

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The HKMA is concerned with the overall health of a financial institution. If the SFC were to directly supervise the securities business of banks, this business would still be subject to the HKMA's regulatory oversight, even if it was conducted through a subsidiary. There would be much overlap of reporting and regulatory work, adding cost and complexity for no benefit.

The Draft Report rightly highlights the trend to convergence of financial markets, and the need for a simple, effective and cost-efficient regulatory regime. This is precisely what we recognise and are trying to achieve in Hong Kong.

The trend to convergence is forcing regulators worldwide to re-examine their existing approaches. The U.K. has adopted a system that combines the various existing regulatory regimes under a single regulator. The issues of regulatory overlap and duplication which so concern us will be less evident. Over time, a single regulator may or may not turn out to be an elegant solution. However, as the Draft Report points out, the system has yet to be tested.

The U.S. system of regulation grew out of its own historical experience following the Wall Street crash of 1929, and was aimed at separating commercial banking from investment banking and underwriting activities. Banks have always been able to engage in certain securities-related activities directly, and over the years the range of activities that can be conducted by a bank or a bank holding company subsidiary have been considerably expanded. This has, however, led to immense complexity in the regulatory framework, and to various law suits. The Draft Report noted that, politically, it is very difficult to change the existing system. Yet, as financial markets converge, we may find that the U.S. model becomes increasingly inefficient.

We must not take the retrograde step of implementing the U.S. model piecemeal, and force the compartmentalization of our financial services industry while the rest of the world promotes convergence. Let us build a regulatory structure suited to our circumstances, and to the future.

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In framing the Hong Kong legislation, this background was fully considered. The decision to have the HKMA serve as the front-line regulator of all the activities of banks, including their securities business, while adhering to SFC rules and discipline, is the most effective solution in the Hong Kong context.

Is there unequal treatment of exempt AIs and licensed corporations?

During the course of our examination of this Bill, we have isolated a number of areas where, for historical reasons, the practice in respect of exempt AIs and licensed corporations diverged. Wherever practical, we have brought the procedure followed by exempt AIs into line with those followed by licensed corporations. We expect Committee Stage Amendments to be introduced covering these practices.

All securities staff of exempt AIs will be required to satisfy the fit and proper criteria established by the SFC, including examination requirements and continuous professional training. There is transparency, in that the name of each staff member will be put in a public register to be maintained by the HKMA.

If a member of the securities staff of an exempt AI is not fit and proper, or has committed misconduct, the same range of disciplinary sanctions will apply as would apply to licensed persons. The appeal channel will also be the same.

Therefore, exempt AIs and their securities staff are subject, in relation to their securities business, to the same regulatory regime as persons licensed by the SFC.

The only substantive area of difference will be the Financial Resource Rules, reflecting the fact that banks are already subject to stringent capital adequacy and liquidity ratio requirements.

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What will be the benefits if banks subsidiarise their securities business?

The banking and securities businesses of banks are part of a complete financial management service. Setting artificial barriers between the two will inconvenience the consumer, raise the cost of doing business, and increase the regulatory burden.

More and more people are investing in shares and funds; more channels are opening up to allow them to manage their savings effectively. This is the trend, not just locally, but internationally. We should be working to enhance, rather than reduce, their options.

Banks serve as agents, selling a wide variety of financial products. Many of these are third-party products. Therefore, banks' ability to market these products is a benefit to the financial services industry as a whole. With the active participation of banks, Hong Kong's financial markets will grow in strength and importance.

Banks already have a convenient branch network and large customer base. Hiving off banks' securities business into a subsidiary regulated by the SFC will not eliminate that branch network, nor that customer base. It will simply add to the cost and complexity of doing business. Who will benefit? Certainly not the investing public, nor the community at large.

In considering the way forward, we must not lose sight of the basic principles that I outlined at the beginning of this letter. We stray at great cost to the future prosperity of our community.

Yours sincerely,

Dr. David K.P. Li, JP

cc: Clerk to the Bills Committee