

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

**Part II – Securities and Futures Commission  
Written Directions by the Chief Executive**

This paper seeks to address Members' queries raised at the Bills Committee meetings on 5 and 12 January 2001 about clause 11 of the Securities and Futures Bill (the "SF Bill"), which enables the Chief Executive (the "CE") to give written directions to the Securities and Futures Commission (the "SFC").

**Background**

2. In order to have a better understanding of clause 11 of the SF Bill, it is important to examine the provision in the context of SFC's constitution and governance, checks and balances to ensure SFC's accountability, and SFC's relationship with the market operators and Government in the regulatory structure provided under the SF Bill.

**Clause 11**

3. Clause 11 of the SF Bill, as extracted at the **Annex**, enables the CE, after consultation with the Chairman of the SFC and upon being satisfied that it is in the public interest to do so, to give the SFC a written direction as to the furtherance of any of its regulatory objectives or the performance of any of its functions. The provision has its origin in section 11 of the existing Securities and Futures Commission Ordinance (the "SFCO"). It may only be exercised subject to the following restrictions –

- (a) the direction must be in the public interest;
- (b) it must further the SFC's regulatory objectives or the performance of any of its functions, as stipulated in clauses 4 and 5 respectively of the SF Bill; and
- (c) CE must first consult the Chairman of the SFC to formally afford SFC a chance of being heard.

All these three restrictions are in addition to the existing law. They have been included in order to strike a reasonable balance between protecting the public interest and ensuring SFC's independence in performing its day-to-day regulatory functions.

4. This provision can be viewed as a tool of last resort for the Government, through the CE, to implement necessary remedial measures in the most pressing and extreme circumstances. The CE would not give directions to the SFC unless necessary in the public interest and that in doing so he would have sought appropriate advice and take into account all circumstances prevailing at the time. These may include whether there is any major malfunction on the part of the SFC, whether financial stability of Hong Kong is at risk or its reputation as an international financial centre is at stake, the urgency of remedial actions required of the SFC, and whether other checks and balances are performed effectively in the circumstances.

5. Section 11 of the SFCO has never been invoked since its coming into force in 1989. Although no direction has ever been given by the CE in the past, we consider that this provision should be retained in the SF Bill to enable the Government to continue to perform its role in the regulatory structure and account to the legislature and the public for effective regulation of the financial markets. This will be analysed in the ensuing paragraphs.

## **SFC's Constitution and Governance**

6. Under Article 109 of the Basic Law, the Government is responsible for providing an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre. Consequent to the recommendations of the "Report of the Securities Review Committee"<sup>1</sup> (the "SRC Report") published in 1988, the Government has entrusted its responsibilities as regards the regulation of the securities and futures industry to the SFC.

---

<sup>1</sup> On 16 November 1987, following the October stock market crash, the then Governor established the Securities Review Committee (the "SRC") to review, among other things, the constitution, powers, management and operation of the government offices responsible for regulating respectively the securities and futures markets at the time; and to recommend changes that were desirable to ensure the integrity of the markets and to protect investors. The SRC published its Report in May 1988 and recommended, among other things, the establishment of a new market regulator outside the civil service to replace the then Securities Commission, the Commodities Trading Commission and the Office of the Commissioner for Securities and Commodities Trading.

7. Specifically, the SRC recommended the Government to establish a new regulatory body, subsequently christened “the Securities and Futures Commission”, along the following principles –

- (a) the SFC should be a statutory body outside the civil service in order to secure adequate staffing and funding. It should be accountable to the Administration and while it is not part of the civil service, it should be part of the wider Government machinery;
- (b) while the Government should continue to provide an overview, all the statutory regulatory powers should be vested in the SFC in order to ensure its independence;
- (c) to avoid undermining SFC’s independence, the Government should not be represented on its board or advisory committee; and
- (d) the role of Government should be to ensure that SFC does its job properly. If the SFC fails, the Government should be free to reach an independent view as to what is the right course of action.

8. To implement these principles, the SRC further recommended that –

- (a) the Governor [now the CE] should appoint the Chairman and other directors of the SFC board and should have the power to dismiss them;
- (b) the Governor [now the CE] should be able to give the SFC directions;
- (c) the SFC should be obliged to present an annual report and statement account to the Governor [now the CE] who would lay them before the Legislative Council;
- (d) the SFC Advisory Committee should be appointed by the SFC with the approval of the Governor [now the CE]; and
- (e) the SFC should develop and submit its annual budget to the Legislative Council.

9. The SRC Report laid down a blueprint for the constitution and governance of the SFC, details of which was subsequently reflected in the SFCO, enacted in 1989 to establish the SFC.

10. In addition to the checks and balances recommended by the SRC in paragraph 8 above, the SFC is also subject to the following additional safeguards –

- (a) fees and charges levied by the SFC are required to be set out in subsidiary legislation and subject to negative vetting by the Legislative Council;
- (b) the more important decisions of the SFC have to be made by the full board of the SFC, and are not delegable unless with the approval of the Legislative Council;
- (c) an independent Securities and Futures Appeals Panel (SFAP) is established to hear appeals from parties aggrieved by certain decisions made by the SFC;
- (d) any SFC's decisions concerning the recognition and closure of the exchanges may be appealed to the Chief Executive in Council;
- (e) the Director of Audit may examine records of the SFC;
- (f) judicial review by the Court of First Instance of relevant SFC decisions is available; and
- (g) complaints against the actions of the SFC or any of its staff may be lodged with the Office of the Ombudsman.

11. The SF Bill enhances these checks and balances by, for instance, upgrading the SFAP to a Securities and Futures Appeals Tribunal, which will be chaired by a judge and operated on a full-time basis with an expanded remit. Ahead of the enactment of the SF Bill, the CE appointed a Process Review Panel (PRP) in November 2000 to review internal procedures of the SFC to make sure that they are fair and reasonable. The PRP will submit its reports to the Financial Secretary (the "FS") with a view to publication subject to the SFC's statutory secrecy obligations.

### **A Tiered Regulatory Structure**

12. Under the SFCO a tiered regulatory structure was established. At the first tier, the Government appoints the SFC and entrusts the regulatory work to the SFC. The Government recognizes that while delegating its regulatory

responsibilities to the SFC, it cannot delegate to the SFC all its accountability to the public for a properly regulated securities and futures market. The public expects that the Government has a duty to ensure that the SFC does its job properly, and that the Government will be held ultimately accountable if the SFC falls down on its job. The public also expects that the Government should play an effective role in co-ordinating among the various financial sector regulators as financial institutions become increasingly involved in multi-sector services, and responding to the rapid changes in the financial system. This goes beyond the regulatory remit of the SFC, as its functions and powers cover basically the securities and futures market, and hence may not allow it to address matters which straddle different financial sectors and affect the economy as a whole.

13. At the second and most important tier, the SFC plays the role of the watchdog for market operators, such as the exchanges and clearing houses, as well as market intermediaries, to ensure an efficient, fair, orderly and transparent market for all market participants. For the watchdog to perform its functions effectively, the existing securities and futures legislation vests in the SFC a panoply of necessary regulatory powers. The SFC is principally the regulator of the securities and futures market and has to act independently in performing its regulatory functions. It is not required to be answerable to the Government on its day-to-day exercise of regulatory powers.

14. At the third and front-line tier, the market operators regulated by the SFC play a self-regulatory role and perform certain public functions, such as risk management and market surveillance. Moreover, in 1993 the SFC transferred<sup>2</sup> to the Stock Exchange of Hong Kong (SEHK) its regulatory functions under the Companies Ordinance in respect of any prospectus concerned with the listing of shares in a company approved by the SEHK. This has continued since the merger of the exchanges and clearing houses in the securities and futures market in March 2000.

## **Checks and Balances**

15. Questions were raised by the legislature during the passage of the SFC Bill in 1989 as to how the Government could ensure that the tiered regulatory structure would function effectively without abuse of powers. The answers lay in the need to reinforce the regulatory structure with necessary safeguards to ensure that the watchdog and the market operators properly

---

<sup>2</sup> The transfer was effected by an Order made by the Executive Council under section 47 of the SFCO.

perform their respective functions. These safeguards are enshrined in the SFCO and now preserved in the SF Bill. Some notable examples are set out here.

16. At the third and front-line tier, the SFC is allowed to require market operators to take remedial action in relation to their constitution, governance, rules, conduct and operation of business. This may take the form of “restriction notices” and “suspension orders” served by the SFC on these operators. The SFC may also direct a recognized exchange to cease to provide or operate specified facilities or services in emergencies. These statutory safeguards are essential to ensure that the front-line regulatory functions are properly performed by market operators in the public interest. They are reserve powers and seen to be nuclear deterrents against any malfunctioning of the market operators. The exercise of these powers is subject to necessary restrictions and an independent appeal mechanism to the Chief Executive in Council.

17. At the second and watchdog level, the Government, through the CE, is allowed to issue written directions to the SFC. Under clause 11 of the SF Bill and as set out in paragraph 3 above, we propose to subject the exercise of this power to additional restrictions, namely application of the public interest test, need for prior consultation with the Chairman of the SFC, and necessary alignment of the written direction with the statutory objectives or functions of the SFC.

18. Giving written directions to the SFC is a reserve power and not to be used lightly. It would only be exercised judiciously for unforeseen and extreme scenarios. The provision can be viewed as a nuclear deterrent against any malfunctioning on the part of the SFC and is the only statutory tool available to the Government for the effective application of remedial measures in a critical situation. The SRC once quoted the remarks of William O Douglas<sup>3</sup>, the Chairman of the US Securities Exchange Commission in the late 1930s who thereafter became a Supreme Court Justice : “[government] would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.” These words best summarize the nature of the reserve power in question.

19. In the course of public consultation on the SF Bill, reserve powers like clause 11 of the SF Bill are generally considered by the market as effective safeguards against possible malfunctioning of the regulator and conducive to

---

<sup>3</sup> William O Douglas, “Democracy and Finance”, 1940

enhancing the regulator's accountability to the Government for proper performance of its functions in the public interest.

### **Similar safeguards under other legislation**

20. The reserve power for the Government to take remedial and other necessary action is not unique to the SFC, and is in fact fairly common in the case of statutory bodies. By way of illustration, section 6E(3) of the Mandatory Provident Fund Schemes Ordinance (Cap. 485) provides that the CE may give directions, either generally or in a particular case, with respect to the exercise by the Mandatory Provident Fund Schemes Authority of its functions; and the Authority must comply with any such directions unless they are inconsistent with the Ordinance. Section 10 of the Banking Ordinance (Cap. 155) provides that the CE may give the FS and the Monetary Authority (the "MA") such directions as he thinks fit with respect to the exercise of their respective functions under the Ordinance, either generally or in any particular case; and the FS and the MA, as the case may be, must comply with the directions.

21. Other jurisdictions have different constitutional frameworks governing the operation of market regulators. The government may influence the regulators through political/administrative means and/or the imposition of statutory controls. It is not possible to assess the former as it will not be transparent by merely surveying overseas statutes. We have decided to adopt a transparent approach to provide in the existing SFCO and in the proposed SF Bill, the tools for the Government to perform its role as the "watchdog to the watchdog" and overseer of financial stability, for protecting the interest of the public. We believe that this is the preferred approach when compared with non-statutory administrative measures.

Financial Services Bureau  
4 May 2001

**Extracted from the Securities and Futures Bill**

**X            X            X            X            X            X**

**11. Directions to Commission**

(1) After consultation with the chairman of the Commission, the Chief Executive may, upon being satisfied that it is in the public interest to do so, give the Commission written directions as to the furtherance of any of its regulatory objectives or the performance of any of its functions.

(2) The Commission shall comply with any written direction given under subsection (1).

(3) Where any written direction is given under subsection (1), any requirement under any other provision of this or any other Ordinance that the Commission shall, for the purpose of performing any of the functions to which the written direction relates —

- (a) form any opinion;
- (b) be satisfied as to any matter (including existence of particular circumstances); or
- (c) consult any person,

shall not apply for all purposes connected with the performance of functions pursuant to, or consequent upon, the written direction.

(4) Written directions given under subsection (1) are not subsidiary legislation.

**X            X            X            X            X            X**