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

Summary of Public Comments and Administration's Response on Part III of the Securities and Futures Bill

Clause no.	Respondent	Respondent's comments	Administration's response
Part III – Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and automated Trading Services			
Div.2 general	Charles Schwab	The SF Bill clearly places the promotion of 'competitiveness' among the SFC's regulatory objectives and references to the SFC's regard to competition as one of its general duties. The Bill should make explicit reference to the value of competition in the clauses introducing the regulation of exchange companies.	The SF Bill prescribes in clause 4(a) the maintenance and promotion of competitiveness of the securities and futures industry as one of the regulatory objectives of the SFC. The SFC is further required to have regard to, among others, the desirability of maintaining Hong Kong as a competitive international financial centre (clause 6(2)(a)); and the principle that competition among persons carrying on activities regulated by the SFC under any of the relevant provisions should not be impeded unnecessarily (clause 6(2)(c)). The above provisions underline the importance of and the value towards promoting competition in the overall regulatory framework under the SF Bill. We believe further explicit reference to it is not necessary.
Div.5 general	Charles Schwab	A sound investor compensation scheme is critical both to the protection of investors and addressing systemic risk to the Hong Kong markets. While being generally supportive of the Bill's effort at providing flexibility, two important issues should be dealt with in the Bill itself and not left to the SFC's discretion. First, the Bill should set out the per investor compensation ceiling as an objective for an investor compensation company. Furthermore, the end-customer should have the full protection of the fund on the default either of the securities firm of which he or she is a customer or on the default of another securities firm in Hong Kong used by the customer's firm for execution, clearing or settlement purposes. As a result, an investor with a securities firm that in turn places trades through an Exchange member should be given clearly stated protection levels for his or her account.	Agreed. The compensation ceiling is intended to be prescribed by way of subsidiary legislation under clause 236 of the SF Bill for more flexibly maintaining the real value of the compensation maximum and meeting with market development. The subsidiary legislation is to be prescribed by the Chief Executive in Council and is subject to negative vetting by the LegCo. The SFC released the detailed compensation proposals for consultation with the LegCo and the market in March 2001. Under the consultation proposal which is well supported by the market, the compensation arrangements would be extended to clients of all securities dealers, irrespective of their being an exchange participant or not.

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		Second, systemic risks are not sufficiently addressed in the Bill. The question of whether there is a requirement of securities firms to 'top up' the fund should be explicitly addressed in the Bill. Flexibility, with regard to emergencies should not be left to the future but incorporated in the Bill.	The mechanism to deal with systemic risks is intended to be dealt with through subsidiary legislation to be made under clause 236. As part of the consultation proposals, the SFC has put forward a number of funding options for the new compensation arrangements, covering also the situation where there is a shortfall in the compensation funds to deal with the compensation claims, for example, imposition of a levy, insurance coverage, credit facility provided by authorized institutions and guarantee by the Government. The proposal finalized in this regard will be reflected in the aforesaid subsidiary legislation.
19	Charles Schwab	Concern was expressed that clause 19 did not go far enough in providing for more than one "potential recognized exchange company" operating a stock market in Hong Kong since in practice it preserved SEHK's monopoly, despite the flexibility provided for 'automated trading services' ("ATS").	The Stock Exchange of Hong Kong (SEHK) enjoys statutory monopoly to operate a stock market as prescribed in clause 19 of the SF Bill. This statutory monopoly is the same as that under existing legislation and is consistent with the commitment of the Government made in 1999 for promoting the merger of the exchanges and clearing houses. We take the view this statutory monopoly will allow the Hong Kong Exchanges and Clearing Limited (HKEx) as the merged entity to benefit from economies of scale, concentration of resources, as well as consistency and coherence in business and risk management strategies in meeting the competitive challenge of globalization. The subject of statutory monopoly however will be kept in view in the light of market developments.
19	Group of nine investment bankers	It was assumed that (on general principles of statutory interpretation) the prohibition in clause 19 only applies to a stock market or futures market operated from a place in Hong Kong. However, there is a concern that a person based in Hong Kong who (for example) accepts orders from its customers and inputs them for execution on an overseas exchange could contravene Clause 19(1)(c) or (d), because it would be "assisting" in the operation of the overseas exchange.	The provision is not intended to have extra-territorial effect. We see the ambiguity as pointed out in the market submission and would propose a Committee Stage Amendment to amend clause 19(1)(c) and (d) along the lines of assisting in the operation of a stock market / futures market "which is operating in contravention of clause 19(1)(a) and (b)" to address the concern of the respondents.
19(2)	HKISD	In the exercise to merge the exchanges, assurances were given that the monopoly of the Stock Exchange Company would be preserved. This undertaking should be maintained.	Clause 19(1) prescribes the types of persons that may operate a stock market, which are the SEHK, the HKEx and a company of which the HKEx is the exchange controller. This restriction upholds the statutory monopoly but within the context of the HKEx group. The SFC in granting an application for recognition is already subject to the restriction under the clause.
21(1)(a)	HKISD	The recognized exchange company should promote an efficient and competitive environment which would best enhance market turnover and fair and anti-dominant environment among participants.	Under clause 21(1)(a) and 21(2)(a) of the SF Bill, a recognized exchange company has the duty to ensure as far as reasonably practicable, an orderly, informed and fair market, and to act in the interests of the public especially the investing public. They should have embraced the market views. Moreover,

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			given the HKEx is a listed company with a profit-making perspective, it is reasonable to expect that the company would strive to enhance efficiency and market turnover. See also the Administration's above response to Charles Schwab's comment in relation to Division 2 generally.
23(3) 40(4)	HKEx & HKISD	It is noted that a wide power has been conferred on the SFC (under clauses 23(3) and 40(4)) to request the recognized exchange company and recognized clearing house to make rules. As the circumstances under which the SFC can make the request are not set out in the Bill, nor is the SFC required to provide any reason for a request, a check and balance provision similar to that provided under Clause 36 should be added. Accordingly, consultation with the Financial Secretary and the recognized exchange company or recognized clearing house, as the case may be, is required before the SFC may make such a request.	We accept the market views and would propose a Committee Stage Amendment to achieve the effect that consultation with the Financial Secretary and the recognized exchange company/clearing house is required before the SFC may request them to make rules.
23(3) 23(4)*	HKSbA	The exchange company may make rules with penalties or sanctions without provision for market consultation. The Commission may direct the exchange company to make or amend such rules. We suggest market consultation and avenue of appeal.	We would like to make clear that the rules made by the exchange company are not subsidiary legislation and criminal sanctions cannot be prescribed for compliance failure. The rules are made by the exchange company to ensure that users of its facilities would follow certain requirements for smooth and proper operation. As a matter of practice, any change in substance to the rules would go through general market consultation or consultation with established specialized consultation committees that include market representation. If a person considers certain parts of the rules made by the exchange company should be, for example, amended, he can either talk to the exchange company or if necessary, to the SFC. In justified cases, the SFC can exercise its power under clause 23(3) to request the exchange company to make the necessary changes.
29*	HKSbA	The Commission may order a 5-day cessation of the exchange company. We suggest this power should rest with the top of the Government.	This is similar to existing law set out in section 27 of the Securities Ordinance (Cap.333), whereby the direction to order cessation is made by the SFC in consultation with the exchange company. The grounds based on which the power can be invoked are clearly prescribed in the legislation, mainly when in

* Response to comments not incorporated in Paper No.3E/01 when last issued.

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			emergency, natural disaster, financial and economic crisis. We do not believe the power would be abused and see no compelling reason for transferring the regulatory authority to the Government. The SFC is generally subject to a comprehensive package of checks and balances to ensure its powers are exercised properly.
35(1) *	HKSbA	The SFC may make rules to prescribe limits on futures contracts. This adds to market unpredictability as to when rules may change. A referee should not be seen to change the rules.	The power of the SFC to prescribe and update position limits on futures contracts is essential for market risk management purpose and the same power exists under existing law (section 59 of the Commodities Trading Ordinance). Similar power exists in overseas jurisdictions. We consider it entirely logical that the SFC, which possess the expertise and is tasked with regulatory oversight of the market, as the authority to make the rules, should be empowered to amend the rules by reference to changing market circumstances. Finally, the rules made under clause 35(1) (including amendment thereto) are subsidiary legislation that requires negative vetting by the Legislative Council.
36	HKEx	The inclusion of consultation with the Financial Secretary as a requirement before the SFC could make statutory rules under Clause 36 is welcomed.	Noted.

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45	HKSA	The SF Bill seeks to enforce the completion of a pending market contract, settlement of which could be due to occur after insolvency proceedings have commenced. This measure would contrast sharply with the law of insolvency. Risk of allowing such trades to be completed is that the exchange participant entering into the trade is dealing in stocks to which it may not have clear title. Clauses 45(1) & 45 (2) serve to protect the interests of the clearing house rather than individual investors by allowing the clearing house to complete all outstanding uncompleted contracts at the date of the insolvency proceedings. These provisions should be brought to the attention of investors either in the account opening documentation or contract notes.	This provision is practically identical to section 5 of the Securities and Futures (Clearing Houses) Ordinance (Cap.420). That Ordinance was enacted in 1992 and was based broadly on UK legislation. The UK legislation was introduced in order to minimise the chances of systemic risks arising from failure to complete pending market contracts. For the same reason, Cap.420 deliberately created a regime in which clearing houses were accorded priority in the event of an insolvency. There was thorough consideration of the legislation both by the market and the LegCo at the time. Were this not the case a chain reaction of defaults might occur which would damage confidence in the Hong Kong market. In this respect, early clearance can be of benefit to investors too. This provision and the others in Part III of Cap.420 were drafted narrowly to extend the protection to the minimum extent necessary to meet the agreed policy objective of minimising systemic risk. Clause 45 and the other related clauses in Division 3 of Part III of the SF Bill largely reproduce the current law. This regime has operated well on those few occasions on which it has been called into play.
46	HKSA	The clearing house should be obliged to notify a relevant office-holder of default proceedings in the event that they are still continuing irrespective of the date of commencement.	The relevant office-holder as the trustee of the defaulter during insolvency proceedings would be provided with daily statements from the Hong Kong Securities Clearing Company (HKSCC) and reports of activity in HKSCC affecting the defaulter. In addition, the clearing house is already obliged under clause 47(2) to supply the office-holder acting in relation to the defaulter to whom the report relates or the defaulter's estate a report on default proceedings, upon completion of the proceedings. This provision is practically identical to section 6 Cap.420.
46(1)	HKSA	This clause appears to compel a relevant office-holder to make an application for a release from specific duties where such duties would be compromised by the provisions of the Bill. The costs of such an application could be prohibitive and would ultimately be borne by the creditors or investors.	Clause 46(1) does not compel a relevant officer-holder to make an application. It only seeks to empower a court to make an order altering or releasing him from compliance with the functions of his office affected by default proceedings if such an application is made. Regardless of whether an application is made, the functions of a relevant officer-holder would be altered to the extent provided in clause 45(2), i.e. the powers of a relevant office-holder shall not be exercised in a way as to prevent or interfere with any default proceedings.
46(3)	HKSA	This clause states that sections 12, 40 & 20 of the Bankruptcy Ordinance (BO) and sections 166, 181, 183, 186 & 254 of the Companies Ordinance (CO) do not prevent or interfere with any default proceedings. The court should be	See the Administration's policy intention as set out in the response in relation to HKSA's comment on clause 45. This provision is practically identical to section 6 Cap.420.

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		qualified to consider all the prevailing circumstances of a case and make whatever orders may be necessary.	For completeness, it is worth noting here that we have highlighted in Paper 3A/01 that we shall propose a Committee Stage Amendment to reinstate existing references in section 6(2) of Cap.420 to sections20A-20K (instead of section 20) of the Bankruptcy Ordinance, in clause 46(3) of the SF Bill.
49	HKSA	Disclaiming onerous contracts (which could give rise to an additional liability to an insolvent estate) cannot prohibit the clearing house from submitting a claim/proof of debt to the relevant office-holder. Sections 59(5) of the BO and 268(5) of the CO afford an aggrieved party protection in the event that a disclaimer has prejudiced his rights. The Bill should not seek to take precedence over these sections.	See the Administration's policy intention as set out in the Administration's response in relation to HKSA's comment on clause 45. This provision is practically identical to section 9 Cap.420.
50 & 52	HKSA	Protection afforded to a clearing house as a consequence of this provision (combined with the clauses 45 to 49 and 52 to 53) is similar to that of a secured creditor and if this is the case, investors, creditors and others dealing with the company should be informed of this priority, either through registration in the company's statutory records and/or through client documentation.	See the Administration's policy intention as set out in the response in relation to HKSA's comment on clause 45. This provision is practically identical to section 10 Cap.420 so is settled law which the public is supposed to be aware of in accordance with the common law principle ignorantia juris non excusat (ignorance of the law does not excuse).
51	HKSA	The partial re-instatement of sanctions against transactions at an under- or over-value is limited here to transactions occurring within the preceding 6 month period whereas under the BO (s51(1)(a)) the relevant period could be up to 5 years in some cases.	We accept the market comment that the relevant period should be comparable to the one prescribed in the Banking Ordinance; and shall propose a Committee Stage Amendment accordingly. For completeness, it is worth noting here that we have highlighted in Paper 3A/01 that we shall propose a Committee Stage Amendment to reinstate the words "grounds exist for a creditor to present a bankruptcy petition" as in section 11 Cap.420 in substitution for the words "a bankruptcy order made".
87	HKSA	If the rights of the individual are intended to be restricted only until the payment made to the individual claimant is recovered, the words "to that claimant" or similar, should be added at the end of clause 87(1)(b). The current wording indicates that the individual's rights might be restricted until the ICC has been fully compensated to the extent of all the payments it has made to all claimants. If this is the case, clarification is sought as to the obligation the ICC has to enter into proceedings against the exchange (or participant defaulter) to mitigate the claimants' loss.	This clause is the same as clause 235 on subrogation of the SFC to rights, etc of claimant on payment from compensation fund. As explained at the Bills Committee Meeting on 4 May, we shall propose a Committee Stage Amendment to the effect that the subrogation rights will be consistent with the ruling of the High Court for the failure of the Forluxe Securities Limited in late 2000.
93	HKISD	The suspension of an exchange should come from the Chief Executive, not just	This is similar to existing law as set out in section 51 of the Securities and

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		in consultation with the Financial Secretary.	Futures Commission Ordinance (Cap.24), whereby the suspension is made by the SFC in consultation with the Financial Secretary. This power has never been used. We do not believe it would be abused and see no reason for transferring the regulatory authority to the Chief Executive. The SFC is generally subject to a comprehensive package of checks and balances to ensure its powers are exercised properly.
95 (Sch. 6)	Charles Schwab	In addressing ATS, the April 2000 Consultation Document admirably expressed an understanding that each 'individual ATS can operate very differently'. Flexibility given to ATS in the Bill appropriately addresses the issue of market structure in Hong Kong. However, the definition of ATS should not be so broad as to potentially encompass activities performed by a securities firm in the normal course, and it should not hinge on the electronic nature of the service or system.	Noted. The SFC has released the draft guidelines on ATS for consultation. The draft guidelines seek to address, among others, various concerns of the market. We are conscious that ATS may catch a range of activities which include those provided in the normal course by dealers. In this regard, the SFC has put forward in the draft guidelines that the intention is, in most circumstances, not to impose additional ATS-specific regulations or requirements upon the customary operations of most dealers, though the corporation is required to obtain a single licence under Part V of the SF Bill both for dealing in securities and providing ATS. The regulatory requirements that would apply are the normal ones applicable to a licensed corporation, which we believe are sufficient for regulating the electronic ATS-type services provided by most dealers.
95	HKEx	In considering whether to authorize an overseas stock exchange or futures exchange to provide ATS, it is imperative that such exchanges must meet regulatory standards no less stringent than those imposed on markets operated by HKEx. This will ensure a high level of investor protection and a level playing field for exchanges and ATS. The criteria and regulatory standards should be set out explicitly in the principles and standards in relation to the granting of authorization for providing ATS. Consideration should be given to include provisions similar to those set out in clauses 92 and 93 which empower the SFC to issue restriction notices or suspension orders against a recognized exchange company, recognized clearing house, recognized exchange controller or recognized investor	In the draft guidelines on ATS, the SFC has proposed that authorization of an overseas exchange should be based on an assessment by the SFC that the overseas exchange would be subject to regulations in its home country comparable to the regulation of exchanges in Hong Kong and consistent with international standards. The regulatory approach with respect to the regulation of ATS operated by an overseas exchange is further detailed in the guidelines. Generally, the SFC considers that the power to withdraw an authorization under clause 98 would be more effective than serving restriction notices or issuing suspension notices. This is particularly so where an overseas exchange has no presence in Hong Kong except for the placement of terminals, so according no

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		compensation company, to apply also to persons authorized to provide ATS.	means for the SFC to exercise jurisdiction over it in proceedings brought here.
95(2)	HKEx	There is an apparent inconsistency between the process that applies to overseas exchanges and a person (other than an overseas exchange) in respect of authorization for providing ATS. For instance, the Bill provides in Clause 95(2) that the SFC may, upon application of a person, authorize that person to provide ATS subject to conditions as it considers appropriate. However, the Bill does not require overseas stock exchanges and futures exchanges to submit an application for authorization to provide ATS and there is no provision in the Bill which would empower the SFC to impose conditions on them. This inconsistency should be addressed through a suitable amendment to the Bill.	The inconsistency may be more apparent than real. In practice, it is anticipated that a process akin to an application will transpire. An overseas exchange will need to give undertakings or agreements as a condition of an authorization and it would be understood that breach of such conditions would result in withdrawal of the authorization. Investor interest would be adequately protected. It is considered preferable to deal with this administratively given the jurisdictional and enforcement problems inherent in a relationship with an overseas exchange. However, the SFC would have no objection to requiring overseas exchanges to make an application too and amending the provision by way of a Committee Stage Amendment accordingly; the end result would be the same. This matter will be further canvassed in the ATS guidelines.
95(5)	HKEx	It is noted that draft guidelines will be subject to market consultation. In this regard, the issues of maintenance of level playing field and protection of investor interest are of the utmost importance.	Noted.
95(5)	HKEx	The guidelines to be promulgated should include specific provisions setting down the criteria for authorizing ATS providers, and in particular subjecting them to conditions and requirements no less stringent than those of the markets operated by HKEx, including but not limited to regulatory standards, service level, system and personnel requirements as well as risk management measures. An equally important point is that the guidelines should set down explicit policy or criteria in relation to the scope of authorization to be granted to ATS providers, including the type of products to be traded under the authorizaiton. The HKEx Group is of the view that such authorization should not allow an ATS provider to trade products which are already traded on markets operated by the HKEx Group. This is because the proliferation of markets which allow the trading of the same products will cause fragmentation of the market and confusion amongst the investing public, and raise cross market and systemic risk management issues.	The issues raised have been covered in the draft ATS guidelines. The general principle in this regard is that a fair and level playing field will be sought so that similar regulation is applied to similar functions. The policy is to preserve only the existing statutory monopoly to the SEHK. The SFC, however, will have regard to the factors referred to from the regulatory perspective in deciding on whether it is appropriate to grant authorization to ATS and if applicable, the authorization conditions.

Details of Submissions Referred to in the Comment / Response Table

Respondent
Charles Schwab
Hong Kong Society of Accountants ("HKSA")
Linklaters & Alliance representing - Bear Stearns Asia Limited - Credit Suisse First Boston (Hong Kong) Limited - Dresdner Kleinwort Wasserstein - Goldman Sachs (Asia) L.L.C. - Merrill Lynch (Asia Pacific) Limited - JP Morgan - Morgan Stanley Dean Witter Asia Limited - Salomon Smith Barney Hong Kong Limited - UBS Warburg ("Group of nine investment bankers")
Hong Kong Institute of Securities Dealers ("HKISD")
Hong Kong Stockbrokers Association ("HKSbA")
Hong Kong Exchanges and Clearing Limited ("HKEx")

Securities and Futures Commission
Financial Services Bureau
8 June 2001