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

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

Clause no.	Respondent	Respondent's comments	Administration's response
Part VI – Capital Requirements, Client Assets, Records and audit relating to Intermediaries			
141 FRR*	HKSbA	Contraventions of the financial resources rules (FFRs) should be taken as a "wake-up call" and they should not be viewed as an absolute breach and a subject of criminality.	We fully accept that inability to meet with the specified amount requirements imposed under the Financial Resources Rules should not per se attract sanction. For this reason, the enabling power for the SFC to prescribe sanctions against breaches of the FRRs reads "The financial resources rules may provide that a licensed corporation which, without reasonable excuse, contravenes any specified provision of the financial resources rules that applies to it, other than that imposing any of the specified amount requirements, commits an offence …". It is only if a licensed corporation becomes aware of its failure to meet the specified amount requirements but does not notify the SFC; or does not cease to trade or with the permission of the SFC continues trading but does not act in accordance with the conditions set by the SFC, that the licensed corporation will be committing an offence. In sum, a licensed corporation will not be subject to any criminal sanctions by reason only that it does not comply with the specified amount requirements. We take the view the requirement to notify the SFC of the failure to comply with the specified amount requirements, indeed serves the wake-up call purpose.
		The financial resources rules to which exempt persons are subject under the BO (even if more stringent) are entirely incompatible with the FRRs and securities in particular.	Broadly put, the objectives of imposing financial resources requirements are to ensure that the relevant entity would be able to meet with its financial obligations when they arise. As such, we do not agree to the view set out in the market submission that even if the financial resources requirements to which AIs are subject under the Banking Ordinance are more stringent, they are entirely incompatible with the Financial Resources Rules to be made under the SF Bill.
		There is no corresponding rule in the BO to provide for specified amount requirements, the breach of which results in criminal liability. This section illustrates the lack of a level playing field.	As regards the specified amount requirements applicable to the banking business, they are included in section 98 of (as elaborated in Schedule 3 to) the Banking Ordinance with respect to capital adequacy ratio; and section 102 of (as elaborated in Schedule 4 to) the Banking Ordinance with respect to liquidity ratio. There are also minimum paid up capital requirements as set out in Schedule 7 to the Ordinance.

* Response to comments not incorporated in paper No. 6A/01 when last issued.

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			Moreover, similar to the SF Bill, while the failure to meet with the capital adequacy ratio and the liquidity ratio per se does not attract criminal sanction, sections 99 and 103 of the Banking Ordinance respectively require the AI to forthwith notify the HKMA of failure to keep to its capital adequacy ratio and liquidity ratio. Every director and every manager of an AI who fails to notify commits an offence and is liable on conviction upon indictment to a fine at tier 8 and to imprisonment for 5 years; and in the case of a continuing offence, to a further fine at tier 3 for every day during which the offence continues. Moreover, section 67 of the Banking Ordinance imposes a general duty on an AI to forthwith report to the HKMA if it is likely to become unable to meet its obligations or is about to suspend payment. Again, failure to do so constitutes an offence.
142	HKISD	Under the existing Financial Resources Rules (FRR), a regulated company might have breached the FRR under circumstances beyond its control. For instance, the violation may be due to the substantial decline of the prices of shares held by its clients, or mergers resulting in the securities held by clients relating to connected companies, or financial difficulties of clients leading to bloated bad debts on the part of the company. In such cases, it may take the securities company some time to rectify the situation. It is very undesirable to require cessation of business at this stage, which is prejudicial to the interests of both the company and the investing public.	We take failure by a licensed corporation to maintain financial resources in accordance with the prescribed amount, which may cause financial damages to its clients, counter-parties and the clearing house, for example, most seriously. For this reason, there is an early warning system under the FRRs (a licensed corporation is required to notify the SFC when their liquid capital becomes less than 120% of the required minimum) to alert the licensed corporations and the SFC of potential financial compliance problems. The licensed corporations should keep a reasonable "buffer" against market movements and where possible prepare for the risk of actual breach by arranging capital injection. That said, as explained in paragraph 6 of Paper No.6/01, we are conscious that "unnecessary" cessation of business of a licensed corporation is indeed not in the clients' best interest. Clause 142(2) therefore provides the SFC with the flexibility to allow the relevant licensed corporation to continue business subject to conditions as the SFC may impose. Currently, the SFC has indeed given the concerned companies a chance to find the necessary funding to rectify the deficiency and may also allow trading to continue subject to conditions. The SF Bill seeks to codify the practice.

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142 (1), (2)&(3)*	HKSbA	Timeframe providing for a period, in which contraventions could be adjusted or corrected, should be incorporated into these provisions. For example subsection (1) can be amended to the effect that if a licensed corporation has become aware of its inability to maintain financial resources in accordance with the specified amount requirements and this position is not likely to be remedied within the next few business days and continued trading would be prejudicial to its clients or a section of the investing public, then it is obliged to give notice. Subsection (3) can be similarly dealt with. What sort of a time frame is considered to be workable can be a matter of further research when the detailed rules and requirements are known.	As said in the response to the HKSbA on clause 141 above, a licensed corporation will not be subject to any criminal sanctions by reason only that it does not comply with the specified amount requirements. We take the view the requirement to notify the SFC of the failure to comply with the specified amount requirements indeed serves the wake-up call purpose. As pointed out in the submission, the FRR requires provisions to be made (for example for concentration margin loans and stock collateral) which, unlike liabilities, may not need to be paid off within a specific timeframe. However, as we need to ensure that each licensed corporation has adequate readily realizable assets to meet all liabilities at any one time, it is only prudent to make provisions in anticipation of adverse market conditions. Upon receiving a notification of a FRR breach by a licensed corporation, the SFC will assess the situation on a case-by-case basis and where appropriate allow trading to continue subject to conditions. As a matter of fact, the SFC has always adopted a pragmatic approach in all of its past dealings. We take the view it is not appropriate for a licensed corporation to decide when a notification needs to be made. If there is a judgement call to be made, it must be made by the SFC as the regulator and which is in a neutral position.
142(1), (2) & (3)*	Henry Wu	The time for notification specified in clauses 142(1) and 142(3) is impractical and unreasonably harsh. There are a lot of factors outside the control of the "stockbroker" (such as notification by banks or clients after office hours with regard to dishonoured cheques, overseas fund/asset transfer, etc.) which could marginally affect the financial resources. The Administration should relax the time requirements to a practical and reasonable timeframe. A clause enabling reasonable excuse should be inserted to provide for unintended breaches.	There is a distinction between clauses 142(1) and 142(3). Clause 142(1) pertains to the inability to maintain the specified amount of financial resources. Clause 142(3) pertains to the inability to comply with all or any of the financial resources rules <u>other than</u> the specified amount of financial resources. The inability to maintain the required financial resources is a serious matter and requires urgent attention of the SFC. In both clauses the stipulated reporting timeframe is <u>after</u> the licensed corporation "becomes aware of its inability" to comply, which may be later than the time when the licensed corporation actually becomes unable to comply. The stockbroker will only be in breach of the requirements of clauses 142(1) and 142(3) if it fails to take the required steps when it becomes **aware** of its inability to comply with the FRRs. Once the stockbroker is aware, it is difficult to imagine that it could unintentionally overlook the notification requirements. The examples cited are of factors which might affect the corporation's ability to comply with the FRRs not its ability to comply with the notification requirements once it has become aware of its inability to comply with the FRRs. Clause 142(4) which empowers the SFC to prescribe sanctions against non compliance with the FRRs other than those requirements relating to specified amount requirements already provides for the "without reasonable excuse" defense. Further, clause 142(12) also provides for the "without reasonable excuse" defense in respect of failure to notify non-compliance with financial resources rules except for the specified amount requirements.

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			As for the other sanctions created under clause 142 (clause 142(10) and (11)), they are related to cases where the licensed corporation becomes aware of the non-compliance with the specified amount requirements, but there is either failure to report to the SFC, failure to cease trading (in relation to clause 142(1)(b)), or there is continued trading with permission of the SFC but not in accordance with the conditions imposed by the SFC (in relation to clause 142(2) and (5)). All these are serious breaches that pose major investor protection concerns. In the "critical situations" at issue, we take the view no further excuse for non-compliance with the requirements should be allowed. The imposition of criminal sanctions without the "without reasonable excuse" defense as regards failure to comply with the notification requirements and to cease trading, is the same as that under existing law, for example, in section 65C of the Securities Ordinance. As for the failure to comply with the aforesaid conditions, an express power to impose conditions as an alternative to outright cessation of trading, is newly introduced to allow proportionate response to non-compliance with the specified amount requirements. Comparison with existing law is therefore not available.
142(2), (5)(b) &(6) 143(3) & (4)*	HKSbA Henry Wu	The imposition or amendment of conditions should be written rather than oral as a written notice is more precise, accurate and less likely to be misunderstood or misinterpreted than a verbal communication. The situation is more confusing when conditions in written notices can be countermanded or amended orally subsequently. Moreover, the law does not specify at what level the delegation of such important oral instructions can be given.	Sub-clauses (2) and (5)(b) allowing the SFC to impose conditions orally are meant to codify the existing practice where conditions tend to be agreed in a meeting between the management of the licensed corporations and senior staff of the SFC. It is not unusual that the final decision as to whether to allow trading is made just before trading is due to start on the stock exchange, so that the SFC may evaluate the latest development (such as bank calls and availability of capital). In the interest of time, we wish to make clear that the agreement in the meeting will be binding even before this can be put in writing. The intention is to eliminate any time gaps when the licensed corporation may not be able to trade when waiting for our written confirmation. In the light of the market comments we shall propose a Committee Stage Amendment to allow a licensed corporation an option to request for written notices.
142(4)(a)	HKISD	Very vague requirement. Need supplementary guidelines.	This clause, requiring companies to keep records in sufficient detail to ascertain whether the FRRs are being complied with, is not new (see section 83(4A) of the Securities Ordinance). This has not caused any problem so far. In practice, it is difficult to be more prescriptive about the records kept given that licensed corporations are of varying size and nature. The SFC is prepared to respond to specific enquiries on the records required.

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142(11), (12),(13) & (14)*	HKSbA	Against passing a law with blank subsidiary legislation, which provides for criminal penalties with strict liability. We note the rules are not available for sight at this stage.	As a standard practice, the SFC does conduct consultation with the market and allow a reasonable period for the exercise, when introducing draft subsidiary legislation, just as it does with codes and guidelines. To illustrate, the SFC has already started preparing the key rules and guidelines to be made under the SF Bill. As a first step, the SFC has formed various working groups with market participants, and where appropriate, professional bodies to seek market input at an early stage in drafting those rules which are of more concern to the industry. The plan is to expose the draft rules to the market for consultation by phases. The SFC has released the Client Securities Rules and the Client Money Rules to be made respectively under clauses 144 and 145 for consultation. This should allay market concerns that either unworkable rules will be produced in a vacuum or that there might not be an early chance to consider and comment on the draft rules. As pointed out above, clause 142(14) only empowers the SFC to make FRRs which create the commission of an offence without reasonable excuse. Moreover, we have introduced changes to the effect that an offence will only be committed for breaches of the rules made under Parts VI and VII if the relevant act or omission is done without reasonable excuse or intentionally. Therefore, it is not correct to say that the subsidiary legislation creates strict liabilities.
		Support that in the interests of certainty and justice, any matter which is intended to attract criminal penalties should be set out in the Bill itself or alternatively, any rules proposed to be made by the SFC which would attract criminal liability should be subject to public consultation, vetting by the Legislative Council and/or approval by the Chief Executive in Council.	The prescription of those detailed and technical requirements as well as those requirements that require updating over time through subsidiary legislation is fundamental to the scheme of the SF Bill. The basis for this approach is that, consistent with modern securities legislation such as the UK Financial Services and Markets Act, effective regulation depends upon the regulator having the flexibility to address changing market practices and global conditions by amendments to rules rather than amendments to the primary legislation. Such rule-making power is already a part of the existing law. By way of example, the FRRs introduced by the SFC in April 2000 were laid before the Legislative Council and examined by a Subcommittee before they came into effect. The rules made by the SFC are and shall continue to be subsidiary legislation and require negative vetting by the Legislative Council. We note these safeguards match with the alternative arrangement proposed by the HKSbA.
142(14) or 143	HKISD	Unfair to impose imprisonment when there is no public damage created.	Clauses 142(14) and 143(8) are consistent with other enabling powers in Part VI. Breaches of the FRR are serious offences and custodial sentences need to be available as a deterrent where appropriate. The SFC will specify in the FRR only those essential requirements the breach of which (if without reasonable excuse), as constituting criminal offence. The comment goes to the court's sentencing discretion. We agree a prison term will not often be appropriate. (Please also see the Administration's response to comments on SFC's rule-making power on page 10.)
143(8)	HKISD	The term "imprisoning a licensed corporation" is vague. Guidelines should be made to clarify who would be held liable, eg, employees without knowledge.	By virtue of clause 378, where the commission of an offence by a corporation is proved to have been aided, abetted, counselled, procured or induced by, or committed with the consent or connivance of, or attributable to any recklessness on the part of, any officer of the corporation, or person purporting to be acting in any such capacity, that person will also be guilty of the offence. "Officer" in relation to a corporation means a director, manager or secretary of, or any other person involved in the management of the corporation.

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144	HKAB	In the event that one bank in a group (the associated entity AI) acts as custodian of securities or collateral of clients of another bank in the group (which is an exempt AI) it should be made clear that rules under Part VI may only apply to the former where the latter received the securities or collateral in the course of regulated activities.	"Client securities" and "client collateral" are defined in Schedule 1 to the SF Bill to mean in so far as an exempt AI is concerned those assets in relation to the conduct of the regulated activity. The enabling rule-making power in clause 144 is phrased as "The Commission may make rules requiring intermediaries and their associated entities to treat and deal with client securities and collateral of the intermediaries, and to ensure that client securities and collateral of the intermediaries that are received or held by any other person on their behalf are treated and dealt with, in such manner as is specified in the rules.". It should be apparent that the rules to be made under clause 144 apply only to client securities and client collateral of an exempt AI in relation to the conduct of the regulated activity. Clauses 144(6) and (7) serve as additional safeguards.
144	HKAB	Exempt AIs should not be required to create separate custodian accounts or to differentiate between securities received in the course of regulated activities and those not so received. Such a requirement would cause immense practical difficulties and increase cost. Moreover, customers prefer one account and a single set of account-opening documents. It may also be difficult for associated entity AIs to identify whether securities and collateral received from an intermediary are in fact client securities and collateral of that intermediary. In addition, it would be impracticable and increase cost to have to provide separate security documents and to have to enforce security interests separately, in respect of regulated business and other business.	It is a requirement under existing legislation, for both dealers and exempt dealers, that clients' securities and securities collateral received must be dealt with in accordance with the law (currently sections 121AB, 81 and 81A of the Securities Ordinance). There is actually no differentiation, for the exempt dealers, as to how these securities and securities collateral came about – i.e., whether from regulated activities or not. The SF Bill does not mandate such segregation. The rules to be made under clause 144 will be drafted wide enough to ensure that current banking practice that allows cross collateralisation can continue. Moreover, we have ensured that the rules will not hamper the current practice regarding enforcement of securities.
144	HKAB	The restrictions imposed by section 81(5) of the Securities Ordinance on the ability of a dealer to dispose of the client's securities (even where the client is in default) are not necessary as long as the dealer has an express power of sale in its terms of business with the client. Unlike under section 81(6) of the Securities Ordinance, it is understood and welcomed that the rules to be made under the Bill will expressly permit a Hong Kong intermediary, with a client's authority, to participate in securities lending programs on the client's behalf.	This refers to the restrictions whereby the dealer has to first dispose of other assets that have been pledged as collateral. The SFC will propose in the Client Securities Rules to be made under clause 144 that this restriction as regards the disposal of client's assets does not apply if there is written client agreement authorizing the disposal and the disposal is in accordance with the requirements. This is a correct understanding.

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144	HKAB	Unlike under section 81A(6) of the Securities Ordinance, dealers should be able to use securities as collateral in respect of transactions of the dealer on overseas exchanges. This should be set out in the rules to be made under clause 144.	The new client securities rules will only cover securities and collective investment schemes listed on a recognized exchange company and received or held in Hong Kong, and will not generally prohibit, for example, clients' securities to be deposited with overseas exchanges or clearing houses as collateral.
144	HKAB	It is unnecessary for the client's consent to the use or disposal of securities by the intermediary to be renewed annually because the clients are able to withdraw such consent at any time (save in respect of liabilities already in existence).	The new client securities rules provide for the right of disposal to be incorporated in a written agreement. This written agreement does not have to be renewed annually. However, for the repledging of securities collateral with banks, use of securities collateral for securities borrowing and lending, deposit securities collateral with clearing houses as collateral, intermediaries (both licensed and exempt) must obtain client authority. And this client authority has to be renewed annually, although this annual renewal can in writing or through conduct clearly indicating an intention to renew. We do not intend to drop in this regard the annual renewal requirement for client authority as we wish to give investing public an annual opportunity to be reminded that they should consider whether they need to continue with the client authority. We may also further relax this with regards to professional investors in due course.
144(1), (2)(i) & (4), 145, 147, 148*	HKSbA	In these provisions, the breach of any of the rules is an offence under subsection (4) and failing to report a breach within the time specified will be another offence under subsection (2)(i). The arrangement of these provisions is built on self-incrimination and a direct contravention of the principle that in criminal law one should not be forced to incriminate oneself whether by law or by administrative means. We suggest that subsection (2)(i) and provisions of similar effect in the Bill be removed.	For investor protection, the SFC has to know at the earliest opportunity about non-compliance with certain regulatory requirements and decide accordingly the prohibitive and remedial actions that have to be taken to avoid, for example, further misappropriation of clients' assets. For this reason, clause 144(2)(i) enables the SFC to prescribe certain requirements in the rules to be made under clause 144, the breach of which has to be reported to it. The intention is not to cause a person to incriminate himself. The rationale behind clause 144(2)(i) is primarily to encourage voluntary disclosure by intermediaries in the interests of investor protection, not to secure evidence for the prosecution of intermediaries. We are considering the need for a CSA to clarify the matter.
144(2)	HKAB	Rather than being set out in rules, the Bill itself should include provisions that permit disposals of securities held for safe custody or as collateral in certain specified circumstances with the written consent of the client. Similarly it should be clarified in the Bill that any sales proceeds from such disposal may then be used to reduce the liability of the client to the intermediary.	The overall regulatory thrust is to leave the detailed requirements to the Rules to retain the flexibility to respond quickly to market changes. We have worked closely with the working group on the right of disposal to ensure that they do not create practical difficulties for the AIs. Please see the response in page 10 in respect of the rule-making power of the SFC. Again, we are satisfied that the situation can be addressed properly and adequately through the client securities rules to be made under clause 144.

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145*	HKSbA	Under Section 84 of the Securities Ordinance, the licensed person is given the benefit of a "reasonable excuse", whereas in the Bill, any contravention which may be technical or may arise out of clerical error has a strict liability and there is no place for any reasonable excuse no matter how reasonable and compelling it is.	We shall propose a Committee Stage Amendment to add back "without reasonable excuse",
145*	HKSbA	The spirit of the existing law should continue to prevail in that any contravention which does not touch upon fraud should not attract criminal punishment by imprisonment. Any contravention, which does not contain an element of criminal intent, should not be dealt with criminally.	This is not correct – existing legislation already provides for similar sanctions for similar contraventions. Section 81 of the Securities Ordinance (as amended in 2000), (on which the Client Securities Rules to be made under clause 144 are to be based) provides that "A dealer who, without reasonable excuse, contravenes subsection (4) commits an offence and is liable on conviction on indictment, to a fine of $200,000 and to imprisonment for 2 years" (section 81(9)). Similar custodial sentence is created under section 81A of the Securities Ordinance (as amended in 2000) with respect to the handling of securities collateral. As a general response, licensed and exempt persons are in a privileged position with respect to the market, investors and their clients. They have great scope to abuse that position. Custodial sentences would therefore be necessary with respect to contravention that poses major investor protection concerns.
145(2)(k), 147(2)(d), 148(2)(f)*	Henry Wu	These provisions are contrary to the common law principle against self-incrimination. Different sections [i.e. 145, 147, and 148] should be considered separately for their significance, that is, keeping of accounts and records (section 147) and provision of contract notes, receipts (section 148), are issues of more minor consequence than handling clients money (section 145).	See response to HKSbA's comment on clause 144. Certain regulatory requirements in respect of the keeping of accounts and records, and the provision of contract notes and receipts are important also for investor protection. By way of illustration, the accounts and records underline the financial conditions of the intermediary and are heavily relied on by the SFC or the HKMA, as the case may be, in exercising its supervisory functions under clause 175. Please also note it is not the requirement to report non-compliance with each and every requirement under the rules at issue. Instead, the SFC will specify those requirements which early detection of non-compliance is essential, as the target for reporting. By way of illustration, clause 145(2)(k) reads "require a person who becomes aware that he does not comply with any specified provision of the rules that applies to him to notify the Commission of that fact and of any further specified information, within the specified time".

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146	HKAB	Where an intermediary has deposited client securities with an authorized institution as security for a loan, it is essential for the protection of the lender that its security rights remain enforceable notwithstanding that (unknown to the lender) the client had not given the necessary authority or the authority had not been renewed. Clause 146 is insufficient since a lien would not give the lender the right to dispose of the securities. There should be a broader provision to protect lenders who, in good faith, accept client securities from an intermediary as security for a loan.	The HKAB's question cannot be addressed in the Bill (which seeks to maintain the status quo by retaining the same provision on lawful claims and liens as we have now in ss.81B, 86 and 121AO of the SO). The concern raised is in fact a general issue, whether it is about client securities pledged by an intermediary or not. Pending further development, we take the view the matter is best left to the Court to decide. It is our understanding that pledges or charges are routinely entered into to secure a loan so bolstering a lien and these accord a right of sale in cases of default.
147	HKAB	There may be a concern that an AI will need to keep parallel records to satisfy both SFC and HKMA requirements, involving duplication of effort and an artificial separation of regulated and other activities. It should be ensured that the rules made by the SFC do not result in separate records needing to be maintained.	We entirely agree that duplication should be avoided. The SFC is engaging the banking sector (and the broking community as well) in preparing the draft rules to make sure they are appropriate. Moreover, the SFC shall consult the HKMA on the making of any rules affecting exempt AI, and endeavor to minimize regulatory overlap.
147	HKAB	It would be helpful if the rules made clear that records could be maintained by an affiliate or by a service provider, whether in or outside Hong Kong, as long as there are appropriate arrangements in place to ensure that the records are accessible to the Hong Kong intermediary and the SFC.	Agreed. The SFC will prepare the rules to the effect that they will not reject generally premises of an affiliate of an intermediary or an overseas premises, provided the premises are suitable and there are appropriate arrangements in place to ensure that the records are accessible to the intermediary in Hong Kong and the SFC.
147	HKAB	Under the current laws and regulations, there are various record-keeping and accounting requirements. These include Section 67 of the Securities Ordinance, which requires a dealer or investment adviser to maintain a register of the securities in which it has an interest, in a manner and form approved by the SFC. The reason for this requirement is unclear, and it is to be hoped that it will not be repeated in the rules to be made under the Bill.	The rules to be made under the SF Bill will not seek to re-enact the present requirement (section 67 of the Securities Ordinance) for the maintenance of a register in a form and manner approved by the SFC. Instead, the SFC will prescribe by rules the requirements that a licensed corporation or an exempt AI shall cause records to be kept to show all securities that are the dealer's property, showing by whom the securities are held and where they are held by some other person, whether or not they are held as security against loans or advances.

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148	HKAB	There is concern that the application of these rules to exempt AIs may lead to duplication of effort and artificial separation of banking and investment-related services provided to a customer. In particular, it does not make sense to require AIs under Clause 148(2)(b) to send statements of account separate from the general banking statements to clients to whom financial accommodation has been provided.	We entirely agree that duplication should be avoided. The SFC is engaging the banking sector (and the broking community as well) in preparing the draft rules to make sure they are appropriate. Moreover, the SFC shall consult the HKMA and endeavor to minimize regulatory overlap. As regards the specific concerns over the provision of financial accommodation, clause 148(5) reads "Notwithstanding anything in this section, the power of the Commission to make rules under this section in respect of intermediaries shall, where the intermediaries are exempt persons, be regarded as the power to make rules in respect of the intermediaries only in relation to contract notes, receipts, statements of account and notifications relating to the businesses which constitute the regulated activities for which they are exempt as exempt persons." As the provision of financial accommodation by AIs on its own is not a regulated activity the rules made under clause 148 will not have application in respect of financial accommodation provided by AIs.
148	HKAB	It would be helpful if the rules could make clear that with the client's consent all the information required to be provided under this clause can be provided electronically.	The SFC intends to write a paragraph on this in the Rules.
150(1)	HKISD	One business day is very short notice, especially as the fine is set at level 5. Does this section specifically refer only to the "removal of an auditor" before the expiry of its term?	One business day actually relaxes the existing requirement in section 87B of the Securities Ordinance which requires immediate written notice to the SFC. The fine at level 5 is considered reasonable and is consistent with other penalty provisions in Part VI. The clause covers in addition to removal of an auditor before the expiry of his term, also the replacement of an auditor or the decision not to re-appoint an auditor upon the expiration of his term, and also any other circumstances where an auditor ceases to be an auditor of a licensed corporation prior to the expiration of his term.
150(2)	HKISD	It appears that the duty to report the removal of an auditor in respect of an associated entity is the responsibility of the licensed corporation. What is the definition of "associated entity"? What if the associated entity has different major shareholders and management?	A licensed corporation or an associated entity is caught only if it "contravenes subsection (1)", and hence the requirement regarding notification of removal of auditors of an associated entity applies directly to the associated entity, not indirectly via the licensed corporation. "Associated entity" is defined in Schedule 1. "Controlling entity" and "controlling entity relationship" are also defined in Schedule 1 and depict the exact relationship by which, among others, a company will be regarded as an associated entity of an intermediary.
153	HKAB	Under clause 153 an auditor of an associated entity which is also an AI should be required to report certain matters to the HKMA only, but not to SFC..	The concern here is about an AI that is an associated entity of a licensed corporation, which is under direct regulation by the SFC. Given the intertwining nature between the operation of a licensed corporation and its associated entity, we take the view the SFC should at the first instance be informed of the irregularities and take action as appropriate.
153(2)	HKISD	A licensed corporation cannot enforce the rules against an auditor.	The requirement applies directly to the auditor, not indirectly via the licensed corporation.

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154	CK Low	It is not advocated that there should be a duty to detect fraud. However, an auditor should be mandated to report irregularities if these are detected in the ordinary course of the audit.	Clause 153 does impose a duty upon the auditor of a licensed corporation and an associated entity of a licensed corporation an obligation to report certain "reportable matters" to the SFC and the HKMA. Clause 154 indeed deals with the immunity in respect of more general communications that may be made by the auditor to the regulators. The policy intention is for this to cover where an auditor is "reporting" and not to cover "detecting", as clause 154(1)(a) stipulates that it is the information that the auditor "becomes aware of".
155(4)*	HKSbA Henry Wu	The power of the Commission to order, at its entire discretion, the costs and expenses of an auditor appointed by it under subsection (1) to be borne by the licensed corporation even before such appointment would appear to enable the Commission to prejudge the case and order the payment of the expenses even before the appointment of the auditor. It is not clear how the opinion of the Commission is to be formed on the question of payment of costs and expenses and under what circumstances a person is liable for such costs. These circumstances should be expressly spelt out in a policy statement so that the Commission would have to exercise its discretion carefully.	Under clause 155(4), the SFC may, where it is of the opinion that it is appropriate to do so having regard to the conduct (whether before or after appointment) of the licensed corporation or the associated entity, by notice in writing, direct the licensed corporation or the associated entity to pay the costs and expenses of the examination and audit. This means that the Commission can have regard to the conduct of the licensed corporation or the associated entity before or after appointment of an auditor, but does not mean that it can order costs to be borne before the appointment. Clause 155(4) is made appealable is the Securities and Futures Appeals Tribunal under Part 2, Schedule 7. The power under clause 155(4) for the SFC to direct regarding the payment of costs of an auditor is discretionary and will relate to the conduct of the licensed corporation before or after the appointment of the auditor. The SFC has similar discretionary power under existing law, for example, section 90 of the Securities Ordinance to direct the payment of costs. The decision made thereunder is not appealable to the Securities and Futures Appeals Panel, whereas the corresponding decision under the SF Bill is appealable to the Securities and Futures Appeals Tribunal (please see items 44 and 46 of Part 2 of Schedule 7 to the SF Bill).
155 & 156	HKAB	It would be desirable for the power of appointing auditors under clauses 155 and 156 to be exercisable by the HKMA, instead of the SFC.	The concern here is about an AI that is an associated entity of a licensed corporation. Given the intertwining nature between the operation of a licensed corporation and its associated entity, we take the view the SFC should be the authority to appoint an auditor in the circumstances. At any rate, under clause 155(3), the SFC shall consult the HKMA in respect of the appointment and the scope of examination.

Clause no.	Respondent	Respondent's comments	Administration's response
156	HKSA	The reference to an auditor being appointed by the Commission to "examine and audit … the accounts and records of the licensed corporation …" may not be appropriate. The term "audit" in relation to the work of auditors has a specific technical meaning. It is unclear what is intended in the context of this provision as the juxtaposed terms "examination" and "audit" would ordinarily represent two completely different things. It appears that an auditor appointed under clause 156 will not have been appointed to give an opinion on the financial statements of the company as such, in which case the term "audit" would need to be qualified. The engagement under clause 156(2) should be confined to looking into the specific allegations to which the provision refers so that it is not open-ended and uncertain. It is questionable that a decision to appoint an auditor should be an excluded decision under Schedule 7, and therefore not susceptible to appeal to the Securities and Futures Appeals Tribunal.	We have used the word "audit" to mean a series of steps which auditors take in relation to matters of concern, for example, to vouch for the existence of an asset, to reconcile records, to circularize balances of bank accounts, clients and counterparties, and check reasonableness of valuation etc. The word "audit" is now used in similar contexts in section 53 of the Commodities Trading Ordinance, sections 91 and 121AX of the Securities Ordinance and section 34 of the Leveraged Foreign Exchange Trading Ordinance. One would generally expect the terms of reference to outline the scope of auditor's work being different for each assignment and not for these to be laid out in the primary legislation. Generally, the scope of work in such a case will well be something less than a full audit. Note that the terminology is the same under the existing legislation. A full audit may be necessary in exceptional cases and the inquiry may extend beyond specific allegations - these allegations may simply point to more widespread problems. "Excluded decisions" set out in Part 3 of Schedule 7 to the SF Bill refer to those decisions made in respect of AIs and are appealable to the Chief Executive in Council, as governed by clause 225 of the SF Bill. The arrangement is consistent with the appeals lodged by an AI under the Banking Ordinance. Clause 156 is included as item 9 of the list in Part 3. In the case where the decisions are made in respect of non-AIs under the SF Bill, they would be appealable to the Securities and Futures Appeals Tribunal if they are "specified decisions" and included in Part 2 of Schedule 7 to the SF Bill. Clause 156 is included as item 45 of the list in Part 2.

Clause no.	Respondent	Respondent's comments	Administration's response
156(1)(b)	HKSbA	A compliant by the client that his instructions were not followed should not be a statutory cause of complaint leading to an audit on the intermediary as it could be abused by the clients and would be a nuisance to the industry. The Commission should not depart from its power to investigate the dispute and leave it to an appointed auditor.	The SFC is required to give the concerned licensed corporations and the associated entity an opportunity of being heard. The SFC will only appoint an auditor where, having considered the explanations from the licensee or its associated entity, it is satisfied that the person making the application has a good reason to do so, and the appointment would be in the interest of concerned parties or the public. Moreover, the SFC may, having taking into consideration, among others, the conduct of the relevant parties, order the person making the application to bear the cost of the examination and audit. We consider this would deter irresponsible applications. Further, in the light of the market concerns, we have introduced in the SF Bill an additional safeguard that the person making the application must verify all statements in his application by statutory declaration. Moreover, we have confined the previous immunity available to the person making the application against any civil liability (proposed under the White Bill) to liabilities arising from the law of defamation only. This revised scope of immunity is in line with the existing immunity conferred under section 121AX(4) of the Securities Ordinance which is the origin of clause 156. The decision of the SFC to appoint an auditor is appealable to the Securities and Futures Appeals Tribunal.
156(1)(b)*	HKSbA Henry Wu	This new provision deals with client instructions without any qualifications and is to be interpreted to include market instructions. If a licensed corporation fails to follow "market instructions" for reasons of changed circumstances, it could be subjected to complaints from clients who have either earned less profit or suffered more loss, leading to the Commission requiring an audit on the licensed corporation.	As we understand it, the industry's concern about the inclusion of clause 156(1)(b) is that it may give rise to a flood of complaints from clients, where there is an alleged failure to comply with the instructions given. It should be noted that the SFC can only commission an audit when it is satisfied that the person making the application has a good reason for making it. For example, where a client alleges that a licensed corporation has not acted in accordance with his instructions, the SFC will make a preliminary assessment based on what a licensed corporation is reasonably expected to do under the code of conduct etc. Moreover, the client making the application for the appointment of auditors is required under clause 156(3) to provide, among others, the particulars of the circumstances in which the licensed corporation or its associated entity is alleged to have failed to act in accordance with the instructions given, and to verify the statements by statutory declaration. The SFC may also order the client to bear the cost of the audits. Having regard to these safeguards and the few complaints received under the current law (which is essentially reflected in clause 156(1)(a)), we do not think there is any real prospect of clause 156(1)(b) engendering a significant rise in the number of complaints.

Clause no.	Respondent	Respondent's comments	Administration's response
		This could have potential far-reaching consequences for the securities profession. It would be unfair and unreasonable that any allegation(s) made by a client may give rise to such extensive examination of accounts and records by the Commission. If a client fees aggrieved as a result of his broker's action or omission, it should be a matter for civil action or investigation by the Commission and not be resolved by the appointment of an auditor, which process tend to be cumbersome, time-consuming and not cost effective.	Clause 156 refers to "examine and audit" "generally or in respect of any particular matter". In other words, an audit under clause 156 will be a focussed investigation if it is considered appropriate and sufficient in the circumstances. We do not agree the appointment of auditor under clause 156 would tend to be cumbersome, time-consuming and not cost effective, as compared with an investigation by the SFC or a civil action initiated by a client, bearing in mind also that the client may not have the financial resources required in seeking legal remedies.
156(6)*	HKSbA	The Commission must consult the HKMA before appointing an auditor under 156(1) to audit the accounts and records of an associated entity that is an AI. This again serves to illustrate that AIs who are exempt persons are in a more privileged position.	The requirement to consult the HKMA under clause 156(5) is imposed to ensure the input of, as far as possible, all relevant information when a decision is made against an institution which is subject to the regulation of both regulators. The requirement certainly should not be judged as a mechanism for the HKMA to override the SFC in the discharge of regulatory functions by the latter.
156 – 158	HKISD	The cash deposit payable by a licensed corporation for the costs of an auditor may disrupt normal business and constitute a penalty imposed before a verdict is given. The amount payable should be capped (eg, at 200K). There should be provision for recovery of expenses by the licensed corporation if it is exonerated by an audit. Auditors cannot be given the power to examine on oath. There is a strong reservation against a transfer of the SFC's authority of inquiry to auditors.	See above The payment for the costs of auditor is on a reimbursement basis. No cash deposit on the part of the licensed corporation is required. The SFC in exercising its power under clause 156(8) to direct payment of costs of an auditor will have regard to, among others, the conduct of the licensed corporation before or after the appointment of the auditor. In addition, the cost recovery may not necessarily be from the licensed corporation; it may be from the person making the application. See above. This is not new; such a power is contained in current law: see sections.93(a) and 121AZ(1)(a) of the Securities Ordinance, section 55(1)(a) of the Commodities Trading Ordinance and section 36(1)(a) of the Leveraged Foreign Exchange Trading Ordinance. Again, similar arrangement can be found in existing law: see sections 93 and 121AZ of the Securities Ordinance, section 55 of the Commodities Trading Ordinance and section 36 of the Leveraged Foreign Exchange Trading Ordinance. Moreover, this is also similar to the appointment of an external firm under section 143 of the Companies Ordinance to conduct an investigation.

Clause no.	Respondent	Respondent's comments	Administration's response
158(3), 158(4)*	HKSbA	This provision should be deleted as it directly affects one of our basic rights in common law as promulgated by the Basic Law, by using administrative powers to compel a person to answers that may incriminate him. Clause 158(4) is equally objectionable to the extent that one is obliged to comply with the requirement of giving an answer. . We suggest that the parts, which relate to verbal questions and answers, be deleted entirely from subsection 158(4).	Response similar to the comments of the HKSbA made in respect of clauses 144(1), (2)(i) & (4), 145, 147 an 148.
159*	HKSbA HKISD	Under subsection (1) it is noted that the words "deletes" and "alters" can be quite neutral in interpretation whereas words such as "destroys", "mutilates", "conceals" carry a sense of ill motive. If one is guilty of falsifying accounts or records one must have a criminal intent but it is not necessarily so when one "alters" or "deletes" accounts or records. The phrase "with intent to prevent, delay or obstruct" in subsection (1) is completely circumvented by the presumption in subsection (3) in circumstances under paragraph (1)(a). A presumption of this nature is no longer compatible with our existing law, which provides for the presumption of innocence (Article 11 of the BOR). The Australian Securities and Investment Commission Act contains a similar provision in respect of ASIC's investigation and information gathering powers which have a wider application than auditing which does not presume a guilty intent (Section 67). Subsection (3) should be removed and a defence of lack of requisite intent be put in its place.	To "alter" or "delete" requires an action to be taken, rather than just an omission of an action. Hence, the person is presumed to have taken the action deliberately, in the absence of evidence to the contrary. Clause 159(3) is similar to current law, see section 96(2) the Securities Ordinance and section 56(2) of the Commodities Trading Ordinance and section 152D of the Companies Ordinance where the onus is on the person who destroyed, concealed or altered any account or record to prove that this was not done with intent to prevent, delay or obstruct the examination or audit. The Department of Justice advised that Article 11(1) of the Hong Kong Bill of Rights does not prohibit presumptions of fact or law that may operate against the accused. However, it does require that the states confine such presumptions "with reasonable limits which take into account the importance of what is at stake and maintain the rights of the defence." The approach adopted by the Hong Kong courts is that if the fact to be presumed rationally and realistically follows from the proved and also if the presumption is no more than proportionate to what is warranted by the nature of the evil against which society requires protection, the presumption is compatible with Article 11.

Clause no.	Respondent	Respondent's comments	Administration's response
			In the present case, Part VI imposes a duty on a licensed person or an exempt AI to keep accounts and records relating to his business. Further, rules will be made to provide for the period over which the records are to be kept. Thus, if a person deletes or alters the accounts or records, a logical connection exists between the facts relied on (the act of deletion or alteration) and the conclusion which is to be presumed (the deletion or alteration is done with intent to obstruct the examination and audit.) In other words, it appears more likely than not that the deletion or alteration is done with intent to obstruct the audit. As to the requirement of proportionality, the presumption is to go no further than is necessary in infringing the right to presumption of innocence having regard to the evil that is aimed at and the difficulty Government would have in combating it without the aid of the presumption. In the present case, the preservation of the integrity of the securities market and the protection of the interest of the investors may be regarded as of sufficient importance to warrant overriding a constitutional right. Further, it is difficult for the prosecution to prove the intention of the accused person in this kind of offences except by inference drawn from the acts done to the accounts and records whereas it would be a matter of comparative simplicity for a person with a bona fide reason to discharge the burden. The presumption is thus regarded as within acceptable bounds and a measured response to the legitimate aim to be achieved.
159*	Henry Wu	This clause makes no reference to the timeframe and a person may thus commit the offence for merely carrying out routine or normal deletions or alterations of accounts, records or documents before an auditor is appointed.	This comment overlooks the intent requirement set out in cl.159. Routine deletions or alterations of accounts, records or documents before an auditor is appointed, without the requisite intent could never amount to an offence under this clause. The person should be able to prove that the deletions/alterations were routine and not carried out with intent to prevent, delay or obstruct the examination. See above response.

Clause no.	Respondent	Respondent's comments	Administration's response
General comments on the Bill			
Rule-making powers of the SFC	Charles Schwab/ HKSbA/ Group of Nine investment bankers/ Law Society/ KGI	Constructive comments can only be made when the rules are available in draft form. The public should be given ample time to study and comment on all the rules to be made by the SFC at a very early stage. This should be an express requirement in the Bill e.g. along the lines of clause 384(3). It could include an express 90 day consultation period as in some other jurisdictions. Even guidelines should be subject to public notice and adequate time for comment. There should be guidance on when the SFC will exercise its rule making power (under clause 163) or instead choose to issue a code of conduct (under clause 164).	The prescription of those detailed and technical requirements as well as those requirements that require updating over time through subsidiary legislation, is fundamental to the scheme of the SF Bill. The basis for this approach is that, consistent with modern securities legislation such as the UK Financial Services and Markets Act, effective regulation depends upon the regulator having the flexibility to address changing market practices and global conditions by amendments to rules rather than amendments to the primary legislation. Such rule-making power is already a part of the existing law. By way of example, the FRRs introduced by the SFC in April 2000 was laid before the Legislative Council and examined by a Subcommittee before they came into effect. The rules made by the SFC are and shall continue to be subsidiary legislation and require negative vetting by the Legislative Council. The rule-making provisions in Parts VI and VII seek to enshrine the scope of these rules and the penalty maxima imposed for breach of such rules. These rules cover the handling of client's securities and money, the financial resources of a licensed corporation and the keeping of accounts and records, etc, which are essential tools for the SFC to protect the investors.
		It is troubling that the SFC should have the power, in effect, to create criminal offences punishable with substantial fines and imprisonment. These offences could be offences of strict liability (subject only to the defence of "reasonable excuse"). This goes well beyond the current rule-making power of the SFC. The propriety, necessity and constitutionality of this is questionable. Any matters that attract criminal liability should be provided for in the Bill itself. If the SFC were to be given such power, its use must be carefully scrutinized e.g. subject to public consultation, vetting by LegCo and/or approval by CE in Council.	As a standard practice, the SFC does conduct consultation with the market and allow reasonable period for the exercise, on emerging draft subsidiary legislation, just as it does with codes and guidelines. To illustrate, the SFC has already started preparing the key rules and guidelines to be made under the SF Bill. As a first step, the SFC has formed various working groups with market participants, and where appropriate, professional bodies to seek market input at an early stage in drafting those rules which are of more concern to the industry. The plan is to expose the draft rules to the market for consultation by phases. This should allay market concerns that either unworkable rules will be produced in a vacuum or that there might not be an early chance to consider and comment on the draft rules. Moreover, we have introduced changes to the effect that an offence will only be committed for breaches of most of the rules made under Parts VI and VII if the relevant act or omission is done without reasonable excuse or with intent to defraud.

Clause no.	Respondent	Respondent's comments	Administration's response
Territorial applica-tion	HKAB	In view of the additional regulation applying to an authorized institution conducting regulated activities as an exempt AI, it is important to have greater certainty as to the territorial scope of the new regime. For example, if a foreign bank with a branch in Hong Kong obtains exempt AI status, we assume that the Hong Kong regulatory regime will not apply if its London branch enters into securities or futures transactions with customers based in Hong Kong. Otherwise, duplicating and potentially inconsistent regulatory requirements would apply. Conversely, if a Hong Kong bank has a branch outside Hong Kong, while the HKMA exercises overall prudential supervision of the bank's operations as a whole, we assume that the detailed Hong Kong regulatory regime for investment-related activities (eg customer agreements, contract notes etc.) is not intended to apply to such activities conducted from that branch, which will be subject to the regulatory regime in the country where the branch is located.	The two assumptions in the HKAB comment are correct. Whether the activities of an overseas entity are subject to the regulatory regime under the SF Bill depends on whether they fall within the meaning and territorial scope of the SF Bill. They will not be required to be brought within the regulatory regime by reason only of having a branch or an affiliate that is subject to the regulatory regime under the SF Bill.

Details of Submissions referred to in the Comment / Response Table

Date received	Organization /party
30 January 2001	Hong Kong Institute of Securities Dealers ("HKISD")
23 January 2001	Hong Kong Association of Banks ("HKAB")
30 January 2001	Professor LOW Chee Keong, CUHK ("CK Low")
31 January 2001	Hong Kong Society of Accountants ("HKSA")
29 January 2001, 15 February 2001, 2 March 2001 and 5 June 2001	Hong Kong Stockbrokers Association ("HKSbA")
29 January 2001	Charles Schwab
23 January 2001, 15 February 2001 and 7 June 2001	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")
23 January 2001	Law Society of Hong Kong ("Law Society")
23 January 2001	KGI Asia Limited ("KGI")
15 February 2001, 1 March 2001, 16 March 2001	The Hon Henry K.C. Wu ("Hon Henry Wu")

Securities and Futures Commission
Financial Services Bureau
5 July 2001