

29 June 2001

The Hon Sin Chung Kai
Chairman
Bills Committee on Securities
and Futures Bill
3/F., Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Mr Sin

Securities and Futures Bill

1. Introduction

We are writing to set out the Association's views on the arguments recently put forward in LegCo concerning the issue of "functional regulation". It has been contended that it would be contrary to the approach taken by various leading financial centres to allow AIs in Hong Kong to remain "exempt persons". The arguments, it appears, are based on the findings of an overseas duty visit conducted by a joint delegation of the Financial Affairs Panel and the Bills Committee on the Securities & Futures Bill ("Bill"). In the course of the delegation's visits to the US and UK, time was spent looking at the very different regulatory models adopted in those countries and comparing them with the regime proposed under the Bill. We strongly disagree with this view, and in this regard welcome the observations made by Dr The Honourable David K P Li in his letter to you of 2 June 2001.

2. Comparisons in context

2.1 As an initial comment, we would question the appropriateness and reliability of such comparisons. The regulatory regime of a particular country is often shaped by market events peculiar to itself

and is also inextricably linked to that country's own economic model and in particular the role of banks within that model. We would caution against comparisons which fail to take these factors into account.

- 2.2 In the **United States** for example (and indeed in economies such as Japan, Korea and Taiwan which emulated the US model in the post war era), banking business has historically been segregated from securities business. This has not been the case in Hong Kong where securities business makes up only a minor part of bank operations. With the growing trend towards customer focus and the rising popularity of "one stop" services, there is also an increasing overlap between banking and securities business.

Furthermore, to adopt the US model under which a bank's securities business was required to be carried on through a separately licensed company would require radical structural change for no obvious benefit. Indeed, it would be contrary to the international trend towards convergence of markets and financial services and would lead to duplication of regulatory capital, increased operating costs and less convenience for the investing public. It could increase risks through reducing the ability of a banking group to net its exposures to and from customers and customers would have to deal with a less well capitalised subsidiary, rather than with the bank itself.

- 2.3 Accordingly, for comparative purposes, the US system is of doubtful relevance to Hong Kong. The position in the **United Kingdom** is also vastly different from that in Hong Kong. In the UK, banking groups have a relationship with a consolidated "super regulator" only, the Financial Services Authority. Having a "super-regulator" means that banks are not subject to overlapping regulatory requirements or duplication of disclosure and reporting obligations that otherwise could be the result of regulation by more than one regulator⁽¹⁾.

⁽¹⁾ It is interesting to note that one of the main catalysts for consolidation of regulatory regimes in the UK was the collapse of Barings through its derivatives dealings in its Singapore subsidiary. Division of regulatory roles

Furthermore, it is not the case that, in the United Kingdom, prudential supervision and conduct of business regulation are treated by the FSA as separate matters, that can be dealt with in isolation from each other. The FSA is moving away from the previous model in the UK, under which banks conducting investment business were (separately) authorised and supervised by the Bank of England and by one or more of the regulatory bodies established under the Financial Services Act 1986. The new approach⁽²⁾ is intended to be more integrated and to be more closely based on an overall assessment of the risks to the market and the public arising from the overall activities of a financial institution or group⁽³⁾.

In any event, given that there is currently no proposal for a single regulator in Hong Kong the relevance of the UK model as a direct point of comparison is therefore also questionable . With the HKMA and the SFC both continuing to act as regulators in Hong Kong, we strongly believe that it would be wrong in principle to force a division of responsibility in particular for the day-to-day monitoring of the business of a bank. As we mentioned in our first submission to Legco dated 22.1.2001, we believe the HKMA should continue to act as the front-line regulator for all banks' businesses. Not only does the HKMA have the most indepth knowledge of banking business, but given that the activities of a banking group, whether securities related or otherwise, could impact the safety and soundness of the group as a whole, we believe that the HKMA should be able to apply its prudential standards consistently across

between the two regulators responsible for the oversight of Barings (the Bank of England and the SFA) was regarded as one of the contributing factors to the bank's collapse.

⁽²⁾ See "Building the new regulator, Progress report 1", December 2000

⁽³⁾ The FSA will operate through 5 divisions (Deposit Takers, Insurance Firms, Investment Firms, Major Financial Groups and Markets/Exchanges). Supervision of a banking group will be allocated either to the Deposit Takers division or Major Financial Group division based on an assessment of where the preponderance of its business lies. While the same prudential and conduct of business requirements will apply to any institution engaged in a particular activity, the approach to monitoring compliance by the institution with both prudential and conduct requirements may vary radically according to the risk categorisation of the institution. The FSA has also established the concept of lead supervision, whereby a single manager in the FSA has responsibility for co-ordinating the regulatory approach to a financial group, even if supervision takes place in a number of different divisions in the FSA.

all areas of the bank's business and, where relevant, adopt the SFC's rules and standards with regard to business conduct.

- 2.4 While the range of activities conducted by banks, the specific regulatory model adopted for regulating those activities, and the operation of the regulatory regime in practice, varies considerably from country to country, there are a number of examples of banks being “exempted” from some or all of the licensing and other requirements applicable to securities dealers.

For example, in **Singapore** there is one regulator (the Monetary Authority of Singapore) which has responsibility for regulation of banks, and for regulation of securities dealers and other financial markets intermediaries. Separate regulatory provisions (pursuant to the Banking Act and the Securities Industry Act, respectively) apply. Banks can conduct securities business, and are exempt dealers for the purposes of the Securities Industry Act, which means that requirements for individual licensing of staff engaged in securities business, and various regulations applying to licensed dealers, do not apply.

We would point out that the MAS has published a draft Securities and Futures Act, expected to be enacted later this year. This will replace the existing laws on regulation of securities and futures business (but not the Banking Act). Under the new Act, banks will be exempt from the capital markets services licensing requirements that will apply to securities dealers and other financial intermediaries. Banks acting as exempt dealers will be subject to various “conduct of business” provisions in the Act e.g. risk disclosures and customer order priority, but will not need to have individual staff licensed as representatives with the MAS. The provisions of the Act on accounts and records, customer assets, contract notes and other prudential requirements only apply to holders of capital markets services licences, and not to banks.

3. Conclusion

We strongly believe that the broad framework as currently proposed in the Bill is the correct approach and re-iterate the arguments set out in our earlier submission. We would also express strong reservations against the drawing of comparisons with the regimes of other countries where little or no account is taken of the economic or historical factors which helped determine the structure of those respective regimes. Such comparisons in our view can be inaccurate and misleading.

Yours sincerely

Peter T S Wong
Chairman

c.c. HKMA (Mr D T R Carse)
Dr The Hon David K P Li
Linklaters (Ms Pauline Ashall)