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

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

| Clause no. | Respondent | Respondent's comments | Administration's response |
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| ***Part VII – Business Conduct, etc. of Intermediaries*** | | | |
| 163 | HKSbA | Under this section, the Commission may make rules regarding conduct in carrying on the regulated activities. Failure to comply with these rules will be a criminal offence. Until the rules are available in draft, no constructive comments can be made. | 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 practitioners, 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 the comment on the draft rules.<br><br>As regards the specific concern here regarding business conduct related requirements, the SFC will upon commencement of the SF Bill continue the current practice to prescribe them through codes (to be made under clause 164), instead of through rules (to be made under clause 163) (see also the response immediately below). The enabling power under clause 163 to make rules, which is subsidiary legislation that requires negative vetting by the Legislative Council, is included to cater for future market development. As a standard practice, the SFC does conduct consultation with the market on any emerging draft subsidiary legislation.<br><br>Finally, we wish to clarify that breaches of specified requirements in the business conduct rules constitute an offence only if the relevant omission or act is done **without reasonable excuse**. |
| 163 & etc.* | HKSbA<br><br>Hon Henry Wu | Breach of rules made by the SFC without intent to defraud should not be a criminal offence as the rules concern business practices and standards. Under sections 150 & 151 of the U.K.'s Financial Services and Markets Act ("FSMA"), breach of rules is not a | The prescription of detailed and technical requirements as well as requirements that require updating over time through subsidiary legislation, is fundamental to the scheme of the SF Bill. As in existing law, breaches of certain specified requirements which are essential for investor protection (for example, section 81(8)&(9) of the Securities Ordinance on the handling of clients' assets), without reasonable excuse, should constitute criminal offence. These requirements would be adapted into rules to be made |

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

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| | | criminal offence. | under the SF Bill when enacted, with clear reference as to which sections of the rules will give rise to criminal liability. In effect, the status quo will be preserved in this way, though the rules evolve in rhythm with developments in market practices and new developments. Such rules, being subsidiary legislation, are subject to negative vetting by the Legislative Council.<br><br>Whilst contravention of rules made by the Financial Services Authority ("FSA") under the FSMA does not attract criminal liability, the FSA is able to impose unlimited fines ("a penalty of such amount as it considers appropriate"); and many of the provisions of the FSMA which attract criminal penalties can be amended by subsidiary legislation (i.e. treasury order). The FSA rules are extra-parliamentary, i.e. they are part of the statute but exempt from parliamentary vetting. In the local context, we remain satisfied that our legislative model is appropriate. |
| 163(2) (e)&(f)* | HKSbA<br><br>Hon Henry Wu | The suitability of information and advice depends on a myriad of circumstances. The disclosure of financial risks involved in the financial product offered by the intermediary to the client is the real test of suitability. The question of suitability under paragraph (2)(e) should be superseded by paragraph (2)(f). | Suitability and risk disclosure are discrete issues. We have noted the concerns of the industry about use of the word "ensure" in (e) and shall propose a Committee Stage Amendment accordingly. The effect would be that once an intermediary or its representative has taken the steps specified in the Business Conduct Rules made under clause 163, it has discharged its obligation regardless of the eventual suitability of the advice. |
| 163(2)(j)* | HKSbA<br><br>Hon Henry Wu | The avoidance of all conflicts of interest between an intermediary and a client is not entirely possible, for example, when an exchange participant takes an order to buy or sell shares of the stock exchange, or when broking associates of HSBC trade in shares of HSBC Holdings. We suggest that it would suffice if the interest is obvious or is declared. | Clause 163 provides that rules may be made on "steps to avoid" conflicts of interest. The SFC would not, in the absence of more particular facts, regard the examples given as indicative of a conflict of interest. Under the Code of Conduct for Persons Registered with the Securities and Futures Commission, General Principle 6 provides that a registered person should try to avoid conflicts of interest and, when they cannot be avoided, should ensure that its clients are fairly treated. In addition, under code paragraph 10.1, a registered person who has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to a transaction, may advise or deal in relation to the transaction if it has disclosed that material interest or conflict of interest to the client and has taken all reasonable steps to ensure fair treatment of the client. Accordingly, all conflicts of interest should be declared to the client regardless of whether they are considered obvious or not. The existing requirements under the Code of Conduct have worked well and should therefore continue. |
| 163(2)(m)* | Hon Henry Wu | This provision is not necessary as money laundering is specifically covered by other legislation. The SFC has already issued guidelines on steps which intermediaries | We do not agree. The money laundering provisions in other legislation mandate reporting of suspicious transactions. Rules made under this provision could help reduce the risk of money laundering by requiring that licensees adopt certain practices – for example as to account opening, cash handling and internal systems and controls. The Guidelines |

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| | | should take in suspicious circumstances. | referred to in the comment are a good example of subject matters that might be dealt with under statutory rules, particularly if it became apparent that the Guidelines were not sufficient to ensure appropriate conduct. |
| 163 & 164 | HKAB | There should be a requirement for public consultation before the conduct of business rules or codes of conduct are issued.<br><br>There should also be guidance on when the SFC will exercise its rule-making power or instead choose to issue a code of conduct. | As a standard practice, the SFC does conduct consultation with the market on emerging draft subsidiary legislation, just as it does with codes and guidelines (see also the response immediately above).<br><br>Upon commencement of the SF Bill, the SFC will continue the current practice to prescribe business conduct requirements through codes. This is because codes are more flexible and may be expressed in simple market language to promote good practice, particularly in areas where detailed prescription is neither necessary nor desirable. This is also the approach adopted by other international market regulators. The enabling power to make business conduct rules is included to cater for future market development. |
| 163, 164, 384 & 385 | HKAB | The SFC has further rule making powers in Clause 384 and further power to issue codes or guidelines in Clause 385. It is confusing that its various powers are to be found in different Parts of the Bill.<br><br>Clause 384(7) and 385(9) require consultation with the HKMA in respect of rules and codes applying to exempt AIs and associated entity AIs. It would be clearer if equivalent provisions were included in Clauses 163 and 164 as well. | The SF Bill confers the SFC with the power to make rules / codes on key and distinct subjects in its relevant parts. The general power to make rules in clause 384 and codes in clause 385 complements the specific power to deal with other miscellaneous issues and serves also as a general enabling power to cater for future market development. This will be further considered in a paper to be prepared on Part XVI of the SF Bill.<br><br>The consultation requirement is an arrangement between the SFC and the HKMA. Clause 384(7) and 385(9) state clearly that the SFC shall consult the HKMA in respect of rules / codes made under any provision of the SF [Ordinance], in so far as such rules / codes apply to AIs by reason of their being exempt persons or associated entities of intermediaries. We do not consider it necessary to add further to the length of the SF Bill by repeating the requirements throughout the SF Bill. |
| 163, 164, 384 & 385 | HKAB | In order to avoid the risk of overlapping and potentially inconsistent requirements being imposed on exempt AIs by the SFC and the HKMA (eg, in relation to money laundering), there should be a general provision in the Bill which states that where the HKMA has published guidelines, in relation to exempt AIs, these will take precedence over rules and codes made by the SFC. | The concern over significant risk of overlap or inconsistency should not arise as the SFC is obliged to consult with the HKMA regarding rules (clause 384(7)) and codes (clause 385(9)) it proposes to make, in so far as they may affect AIs that are exempt persons or associated entities of intermediaries. Moreover, we do not see the argument that the guidelines published by the HKMA should as a general application take precedence over the rules / codes made by the SFC, which in most instances concern the regulation of the securities and futures industry. |

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| 163 & 164<br><br>(See also comment at 102 & 109, above) | WOCOM | Certain classes of persons who give investment advice to the public or investors are not subject to the rules and codes made by the SFC under these sections, e.g. journalists or authors of financial articles in newspapers, DJs or emcees in radio or television shows, etc. The commentaries of some of these persons are very popular and sometimes create a gambling ambience. If this loophole is exploited, the regulatory objective of maintaining financial stability might not be achievable. | The exclusion referred to in the market comment is available to a person who gives the advice through publication which is made generally available to the public, or broadcast for reception by the public or a section of the public. While the person does not require a licence from the SFC, there are however general provisions governing the dissemination of information under Parts IV (clauses 106 and 107), X (clause 208) and XIII/XIV (clauses 268, 290 and 293), and such person would not be in a position different from members of the public contravening such provisions. Moreover, the SFC will continue the current practice to provide investor education, and advise the public to exercise "discretion" with respect to the advice under concern. |
| 164* | HKSbA | Codes made by the SFC must be compatible with existing trade custom and prove to be workable and practical. Market practitioners must, therefore, be consulted before codes are compiled or modified. Clauses 163 & 164 could be merged without the different functions overlapping. For the reasons stated above, there is no need to specify a criminal penalty in clause 163. | We do not agree. Codes of conduct made under clause 164 will set out the SFC's expectations of the practice that intermediaries and their representatives should follow. They will normally reflect the market best practice, but may in certain cases not accord with "existing trade custom".<br><br>In practice, the SFC always consults the industry before issuing Codes, and this practice will continue.<br><br>We have explained above why we have not taken on board the comment to do away with criminal sanctions for non-compliance with rules made under clause 163. We intend to continue the current practice to prescribe business conduct requirements through codes. This is because codes are more flexible and may be expressed in simple market language to promote good practice, particularly in areas where detailed prescription is neither necessary nor desirable. This is also the approach adopted by other international market regulators. But we would like to retain reserve power to confer the requirements with legislative effect where future market development requires. We take the view that keeping separate clauses 163 and 164 on business conduct rules and business conduct codes respectively avoids confusion and enhances clarity. |

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| 165 | HKSbA | Human error can cause short selling without any intent (eg, pressing the wrong button on the trading terminal is a frequent occurrence). It is therefore suggested that genuine human error should be a defence. Clause 165(4) should be amended to read as follows: "A person who contravenes subsection (1) without any reasonable excuse commits an offence and is liable on conviction to a fine at level 6 and to imprisonment for 2 years." This approach is in line with section 166(12) on requirements to confirm a short selling order. | It was not our policy intention to extend "lawful excuse" to clause 165 on "naked" short selling. However, in the Guidance Note for Short Selling Reporting and Stock Lending Record Keeping Requirement (published August 2000), the Commission has stated that it is not the Commission's intent to penalize short selling arising from genuine mistakes or errors. It is the Commission's intention to promulgate same guidance note under the new Bill. |
| 165* | HKSbA<br><br>Hon Henry Wu | Short selling exists in all sophisticated markets in the world. It is considered a means for hedging investments and results in correcting the market in an orderly fashion. We do not support it being made a strict criminal offence. Short selling is generally an act of not being unable to deliver physically the securities at the appointed time and can be dealt with as a breach of settlement. Article 7 of the HK Bill of Rights Ordinance states that no one shall be imprisoned merely on the ground of inability to fulfil a contractual obligation. The SFC should reconsider the basic elements of short selling, particularly the mens rea and the question of strict liability. | Clause 165 essentially replicates section 80 of the Securities Ordinance. The clause heading reflects the fact that it is not short selling that is prohibited, but engaging in short selling without ensuring that the short seller has securities available to make good the settlement obligations that arise upon such a sale being transacted. The prohibition of "naked" short selling is conducive to an orderly market and does not in any way hinder short selling as a legitimate hedging strategy.<br><br>Article 7 of the Hong Kong Bill of Rights protects against imprisonment as a punishment for inability to fulfil a contractual obligation. The "contractual obligations" envisaged in this article are private law civil obligations rather than statutory obligations. "Naked" short selling is not a mere failure to meet settlement obligations. It has a wider and more serious implication on the securities market as a whole. This clause is not enacted for the purpose of punishing the inability of a person to meet his contractual obligation but for his failure to comply with a statutory obligation which is necessary for maintaining the integrity of the securities market.<br><br>Criminal liability under clause 165 is not strict liability. We believe that clause 165(1)(b) in excluding from the ambit of the offence persons acting reasonably with honest belief, and clause 165(3)(a) and (b) in making the reference to person acting in good faith in the reasonable and honest belief, make clear that only persons who act otherwise are liable to be charged with a contravention of clause 165(1). |
| 166* | HKSbA | The requirements to confirm a short sale are so cumbersome and complicated to follow that short selling, as a method of investment protection, will be stifled. We do not support imposition of criminal sanctions. | Clause 166 reflects section 80B (and part of section 80A) of the Securities Ordinance, which was enacted by the Securities (Amendment) Ordinance (Ord. No. 30 of 2000). The reporting requirements under section 80B were drafted with a view to mirroring the then Stock Exchange Short Selling Regulations requirements, which had been in effect for years. Satisfying the requirements under Clause 166 also provides brokers with a good |

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| | | | defence under Clause 165 – acting in good faith. The statutory provision has been in force since 3 July 2000 and the drying-up of short selling activity in Hong Kong that had been predicted as a consequence of enactment of the provision, did not eventuate.<br><br>Clause 166 is necessary to establish a good audit trail for short selling which in turn is important for the investigation of malpractice. Accordingly, the policy that contravention exposes a person to criminal liability must remain to provide sufficient deterrent. |
| 167* | HKSbA | The requirement for an exchange participant to provide notification of short selling orders executed by him may mislead the market as to the volume of short selling either generally or in relation to a particular stock or as to the likely future direction of the market itself. In the absence of a requirement to notify buy-backs of stocks the picture available to the market is incomplete. | Providing a notification of short selling orders is required under the Stock Exchange Short Selling Regulations. Such notification serves two purposes: 1) to trigger the operation of the tick rule applicable to short selling transactions (or to avoid the circumvention of the tick rule); and 2) to enhance transparency of the market.<br><br>The SFC does not believe the information relating to short selling turnover posted by the Stock Exchange will mislead the market. Rather, it is a piece of information to the market in addition to the normal trading volume.<br><br>Th SFC understands that requiring the report of buy-back transactions may place additional burdens on market participants. Purely netting off the short selling and buy-back turnovers may not provide a complete picture to the market either (or it could be even more misleading) as short covering can be executed by other means, e.g. by exercising a stock option with the same underlying securities. On balance, the SFC has no plan to impose any buy-back reporting requirements. |
| 168 | Group of nine investment bankers | There is no reason to include Clause 168 (option trading) as a separate section - any rule-making power should be included in Clause 163. | This is a response to market concern. In current law, (s.76, SO) options trading is prohibited except where specified in rules. Clause 168 reverses this position by enabling options trading unless prohibited by rules. This is a discrete matter that is better dealt with in a separate clause in our view. |

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| 169 | HKAB and<br><br>Group of nine investment bankers | The rationale for the prohibition on cold calling is to prevent high-pressure sales techniques. The definition of "call" in Clause 169(7) is too wide and the prohibition in Clause 169 should only apply in respect of personal visits or telephone calls. | The cold calling prohibition is designed to protect the interests of the investing public and to curtail improper selling techniques by intermediaries. The reason for not agreeing to limit the provision to calls in person and by telephone is that the other means of communication specified in the definition of "call" in sub-clause (7) may be used also to pressure a person into investing. The submission is too much focused on the current state of technology. The legislation must allow for and anticipate developments that would facilitate new ways of exerting unacceptable pressure.<br><br>The rule-making power in sub-clause (3) will be used to modify the strict application of the prohibition. We are currently drafting the relevant rules that specify the detailed circumstances in which the cold calling provisions do not apply. Such rules will be subject to market consultation in the usual manner. In particular, we are looking at the question of "real time" communications, a concept defined in the draft subsidiary legislation made under the UK Financial Services and Market Act 2000, and where considered appropriate, shall make rules to exempt the relevant calls. |
| 169 | Group of nine investment bankers | The exemption for calls on persons whose business involves the acquisition, disposal or holding of securities has been replaced by an exemption for calls on professional investors. This is in some respects narrower and the previous exemption should be reinstated (in addition to the exemption for calls on professional investors). | The test is possibly narrower but it is a more reliable test for ensuring that person was likely to be able to resist unacceptable pressure. The old test, as using the word "involves" was rather vague and in our view, too wide in scope. |
| 169 | HKAB | It is noted that calls made in compliance with guidelines published by the HKMA relating to unsolicited calls may be declared exempt from Clause 169 in rules made by the SFC. It is suggested that (analogous to Clause 169(2)(b) relating to securities margin financing) the Bill should state that such calls are automatically exempt, without any declaration by the SFC. | The approach is modeled on the Leveraged Foreign Exchange Trading (Calls) Rules made under the Leveraged Foreign Exchange Trading Ordinance. It has been working well and we see no reason for changes. The formulation also serves the purpose to ensure that the guidelines to be published by the HKMA are those which the SFC is satisfied would be capable of achieving results similar to the requirements under the SF Bill (analogous to the requirement on the SFC to consult the HKMA under the SF Bill).<br><br>That in relation to securities margin financing is different as it is an AI's core business to provide financial accommodation, and for this reason, the activities of AIs in the area are indeed specifically excluded from the licensing / exemption requirements, as carried down from the recently enacted Securities (Margin Financing) (Amendment) Ordinance 2000. |

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| 169(2)(a)* | Hon Henry Wu | The definition of "client" is more favorable to banks which engage in more wide-ranging retail services in the course of their business. | We shall propose a Committee Stage Amendment to the definition of "existing clients" such that it means "in relation to an intermediary, a person for whom the intermediary has provided a service, **the provision of which constitutes a regulated activity**, during the period of 3 years immediately preceding the day on which the call is made".<br><br>As such, existing clients of an exempt AI from its other retail services would not fall within the meaning of "existing client" under the SF Bill. |
| 169(2)(a)(i) | Group of nine investment bankers | Under Clause 169(2)(a)(i) there is an exemption for calls on an "existing client". "Existing client" means "a client who has entered into an agreement … in accordance with requirements prescribed by rules made under S384 …". Clarification is sought on the matters which may be prescribed for this purpose. | The general criterion is to assess whether or not the relationship between an intermediary and its client is sufficiently active, and will be expressed in terms of the number of previous transactions entered between the intermediary and the client over a specified period of time, etc. |
| 169(2)(b)* | HKSbA | We see no reason why an AI should be exempted from the prohibition on cold calling in relation to providing securities margin financing and do not see this exemption as a good example of a level playing field. | To provide financial accommodation is AIs' core business and for this reason, the activities of AIs in the area are indeed specifically excluded from the licensing / exemption requirements, as carried down from the recently enacted Securities (Margin Financing) (Amendment) Ordinance 2000. It should nevertheless be noted that the Code of Banking Practice requires AIs to take account of the HKMA Guideline on cold calls relating to leveraged foreign exchange trading (see the point below on Clause 169(4)) when conducting their market activities in general. Comparable standard is therefore already being applied to AIs' cold calling activities. |
| 169(4)* | HKSbA<br><br>Hon Henry Wu | AIs should not be exempted from this provision where the SFC makes rules under clause 169(3) excluding as a class calls that are made in accordance with guidelines issued by the HKMA under section 7(3) of the Banking Ordinance. It is not conducive to a level playing field. | Clause 169(4) replicates the effect of the Leveraged Foreign Exchange Trading (Calls) Rules (Cap. 451 sub. leg.). The SFC may limit the application of rules. The SFC's discretion to limit the application of rules will be conditioned by its consideration of alternative guidelines promulgated by the HKMA. As AIs are not subject to regulation by the Commission in relation to their conduct of leveraged foreign exchange transactions, as is the case under existing law, compliance by AIs with the HKMA's Guidelines in regard to permissible calls for marketing leveraged foreign exchange trading business is considered entirely sufficient. However, if the calls made by AIs are not in compliance with the guidelines, they would automatically fall outside the scope of exemption and be subject to the requirements under clause 169(1) and the sanctions under clause 169(5). This provision avoids subjecting AIs to parallel but different requirements in respect of cold calling. It does not in any way result in the creation of an unlevel playing field. |

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| 169(6)* | HKSbA<br><br>Hon Henry Wu<br><br>Group of nine investment bankers | The 28-day period provided under clause 169(6) under which a person may rescind an agreement made in consequence of a cold call allows a person to take advantage of 4 weeks of market movement and to make a profit if market developments are favourable or to rescind if they are not. Five business days would be ample time for a person to decide whether to rescind the agreement. | We shall propose a Committee Stage Amendment to amend clause 169(6) to provide a right to rescind within the earlier of 28 days of the date of agreement or seven days of becoming aware of the contravention, as opposed to 28 days of becoming aware that the agreement was made in contravention of the clause. |

**Details of Submissions referred to in the Comment / Response Table**

| Date received | Organization /party |
|---|---|
| 29 January 2001, 15 February 2001,<br>2 March 2001, 5 June 2001* | Hong Kong Stockbrokers Association ("HKSbA") |
| 23 January 2001 | Hong Kong Association of Banks ("HKAB") |
| 23 January 2001 | Wocom Holdings Limited ("WOCOM") |
| 23 January 2001, 15 February 2001 | Linklaters & Alliance representing<br>– Bear Stearns Asia Limited<br>– Credit Suisse First Boston (Hong Kong) Limited<br>– Dresdner Kleinwort Wasserstein<br>– Goldman Sachs (Asia) L.L.C.<br>– Merrill Lynch (Asia Pacific) Limited<br>– JP Morgan<br>– Morgan Stanley Dean Witter Asia Limited<br>– Salomon Smith Barney Hong Kong Limited<br>– UBS Warburg<br>("Group of nine investment bankers") |
| 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**
**11 July 2001**