

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

**Securities and Futures Bill
Part II and Schedule 2**

INTRODUCTION

This paper outlines the major elements of Part II of, and Schedule 2 to, the Securities and Futures Bill (“the Bill”) which are principally concerned with constitutional matters concerning the Securities and Futures Commission (“SFC”).

2. Much of Part II and Schedule 2 constitutes a repetition of the existing law contained in Part II of, and the Schedule to, the Securities and Futures Commission Ordinance (Cap. 24) (“SFC Ordinance”). A table showing the derivation of the provisions contained in Part II of, and Schedule 2 to, the Bill is at the **Annex**.

BACKGROUND

3. When the SFC was established in 1989, care was taken to ensure that the powers conferred upon it were tempered by suitable safeguards. An important element of this was to ensure that the SFC was accountable for its actions. Under the existing law, such accountability arises out of arrangements such as the following –

- (a) the Chief Executive appoints all directors of the SFC, half of whom must be non-executive;
- (b) the Chief Executive may give the SFC directions regarding the performance of its duties and functions;
- (c) the Chief Executive approves estimates of the SFC’s income and expenditure and the approved estimates are laid before the Legislative Council;

- (d) the SFC must furnish such information to the Financial Secretary as he may specify;
- (e) the Director of Audit may examine the records of the SFC;
- (f) an independent Securities and Futures Appeals Panel (“SFAP”) hears appeals from parties aggrieved by certain decisions made by the SFC;
- (g) any decisions of the SFC concerning the recognition and closure of the exchanges may be appealed to the Chief Executive in Council;
- (h) judicial review by the Court of First Instance of decisions of the SFC is available; and
- (i) complaints against the actions of the SFC or any of its staff may be lodged with the Office of the Ombudsman.

These accountability measures will be preserved by the Bill, subject to changes such as the SFAP being replaced by the Securities and Futures Appeals Tribunal. We shall discuss the new appellate mechanism in detail when examining Part XI of the Bill.

4. In addition, the provisions of Part II of the Bill spell out in greater detail than is the case under the existing law, the **regulatory objectives** of the SFC and its **functions, powers and duties**. In conjunction with this, the Bill incorporates enhanced **checks and balances** designed to ensure that the SFC complies with its revised statutory obligations. This paper will highlight the provisions of Part II of the Bill which are new, with particular emphasis on these changes to the existing law.

PART II AND SCHEDULE 2 – POLICY OBJECTIVES AND MAJOR PROPOSALS

Clause 3 : Securities and Futures Commission

5. This clause secures the continued existence of the SFC notwithstanding the repeal, among others, of section 3 of the SFC Ordinance, under which the SFC was originally created. The constitutional provisions concerning the SFC are currently contained in section 5 of the SFC Ordinance and generally are in similar terms to those contained in Schedule 2 to the Bill.

Clause 4 : Regulatory objectives of the SFC

6. This clause is new and sets out in broad terms the regulatory objectives of the SFC. These objectives, which concern the securities and futures industry, are –

- (a) promotion of fairness, efficiency, competitiveness, transparency and orderliness of the industry;
- (b) promotion of understanding of the operation and functioning of the industry;
- (c) investor protection in relation to financial products;
- (d) minimisation of crime and misconduct;
- (e) reduction of systemic risks; and
- (f) assisting the Financial Secretary in maintaining the financial stability of Hong Kong.

7. The new clause arises out of agreement reached amongst the members (including the SFC) of the International Organization of Securities Commissions¹ (“IOSCO”) in October 1998 that an important principle of securities regulation is that the responsibilities of the regulator should be clearly stated and that the regulator’s exercise of its powers and the discharge of its functions should be readily comprehensible and transparent both to the public and to those whom it regulates.

8. Clause 4, for the first time, states in broad terms the regulatory objectives of the SFC. These are intended to set the benchmarks against which the performance of the SFC may be judged.

9. In the United Kingdom, section 2(2) and sections 3 to 6 of the recently enacted Financial Services and Markets Act 2000 state the regulatory objectives of the Financial Services Authority. These objectives are market confidence, public awareness, the protection of consumers and the reduction of financial crime. Each of these objectives is described in some detail in sections 3

¹ IOSCO is an organization of securities commissioners and administrators from more than 60 countries, the primary mandate of which is to facilitate and co-ordinate international securities regulation and to promote consistency in regulation across international borders.

to 6 of the Act. In broad terms, these are similar to the objectives for which provision is made in clause 4 of the Bill.

Clause 5 : Functions and powers of the SFC

10. This clause should be read in conjunction with clause 4. It defines more specifically the functions of the SFC which permit it to meet its regulatory objectives and stipulates the general powers which the SFC may exercise in the course of exercising its functions and complying with its regulatory objectives.

11. Clause 5 closely resembles sections 4 and 8 of the SFC Ordinance. However, changes have been introduced into clause 5 to better reflect and facilitate the SFC's need to fulfil its regulatory objectives and to bring its functions into line with modern regulatory standards and practices.

12. Notably, clause 5(1)(a) permits the SFC, so far as reasonably practicable, to take steps to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the *securities and futures industry* (as defined in Part 1 of Schedule 1 to the Bill). Closely associated with this function are the SFC's functions to maintain and promote confidence in the securities and futures industry (clause 5(1)(g)), to promote understanding by the public of the securities and futures industry (clause 5(1)(i)), to encourage the public to appreciate the relative benefits of investing in financial products through regulated persons (clause 5(1)(j)) and to promote understanding by the public of the importance of making informed investment decisions concerning financial products and taking responsibility for them (clause 5(1)(k)).

13. Under the Bill, the SFC is also charged with the function of promoting, encouraging and enforcing the adoption of appropriate internal controls and risk management systems amongst regulated persons (clause 5(1)(m)(i)) and taking appropriate steps in relation to the securities and futures industry further to any requirement of the Financial Secretary, for the purpose of providing assistance in maintaining the financial stability of Hong Kong (clause 5(1)(o)).

14. The Bill envisages the existence of close co-operation between the SFC and the Monetary Authority in relation to the regulation of *exempt persons* (i.e. "authorized institutions" within the meaning of the Banking Ordinance, including banks, deposit-taking companies and restricted licence banks which are granted exempt status under the Bill) that carry on activities regulated by the SFC under the Bill. The SFC is required to promote, encourage and enforce the adoption of appropriate internal controls and risk management systems by

exempt persons in relation to such activities (clause 5(1)(m)(ii)). The SFC, in performing its functions in relation to authorized financial institutions (as defined in Part 1 of Schedule 1 to the Bill) as exempt persons or associated entities², or to associated entities of exempt persons may rely, in whole or in part, on the Monetary Authority to supervise them (clause 5(3)). It is envisaged that the Monetary Authority will, in close liaison with the SFC, remain the front-line regulator of these activities on the part of such exempt persons and their associated entities³.

15. Clause 5(4) confers upon the SFC in general terms powers to do such things as it considers necessary in connection with, or reasonably incidental to, the performance of its functions. This provision closely resembles section 8 of the SFC Ordinance.

Clause 6 : General duties of the SFC

16. This clause is new and requires the SFC to act in a way which is compatible with its regulatory objectives (clause 6(1)). Clause 6(2) also requires the SFC, when pursuing its regulatory objectives and performing its functions, to have regard to numerous factors, including the international character of the securities and futures industry, the desirability of innovation, competition which is not unnecessarily impeded, the importance of transparency and the efficient use of the SFC's resources.

17. The objectives, functions, powers and duties, as defined in clauses 4, 5, and 6 of the Bill, exist alongside statutory checks and balances. For practical and operational efficiency reasons, it is necessary for the SFC to have the power to delegate many of its functions to members of the SFC, committees and its employees. This is provided for in clause 10 of the Bill, which closely resembles section 9 of the SFC Ordinance. Clause 10(2) of the Bill prohibits the delegation by the SFC of the key functions that are listed in Part 2 of Schedule 2 to the Bill, which may only be exercised pursuant to decisions taken at meetings of the full SFC. This is seen as creating desirable checks and balances in these important areas.

² The term "associated entity" is defined in Part 1 of Schedule 1 to the Bill. The concept of "associated entity" seeks to regulate those entities which held client assets on behalf of intermediaries. It will be discussed in the context of Part VI of the Bill.

³ Various provisions in the Bill and in the Banking (Amendment) Bill 2000 expressly set out the Monetary Authority's functions in relation to the regulation of the securities business of banks. We shall go into details of these provisions while examining the new licensing regime under Part V to Part VII.

18. Under clauses 1 and 2 of Part 1 of Schedule 2 to the Bill, the SFC will continue to consist of equal numbers of executive and non-executive directors. The non-executive directors are seen as providing essential supervision and checks in the exercise by the SFC of its powers and functions.

19. The members of the SFC will continue to be appointed by the Chief Executive (clause 1 of Part 1 of Schedule 2 to the Bill) and the quorum for meetings of the SFC will continue to be 4, of whom at least 2 must be executive directors and 2 must be non-executive directors (clause 16 of Part 1 of Schedule 2).

Clause 7 : Advisory Committee

20. This clause provides for the creation of an Advisory Committee to advise the SFC in relation to policy matters. The Advisory Committee comprises the chairman of the SFC, not more than 2 executive directors and between 8 and 12 other members appointed by the Chief Executive (clause 27 of Part 1 of Schedule 2 to the Bill). The existing Advisory Committee created under section 10 of the SFC Ordinance operates as a good barometer of educated and experienced market opinion and constitutes a valuable source of advice for the SFC. This will continue under the Bill, with the Advisory Committee acting as an effective level of guidance and checks for the SFC in the exercise of its powers and functions.

Clause 8 : Commission may establish committees

Clause 9 : Staff of Commission

21. These clauses are similar to sections 6 and 7 respectively of the SFC Ordinance.

Clause 10 : Delegation and sub-delegation of SFC's functions

22. This clause has been discussed in paragraph 17 and is in similar terms to clause 9 of the SFC Ordinance.

Clause 11 : Directions to Commission

23. This clause is in similar terms to section 11 of the SFC Ordinance, under which the Chief Executive may give directions to the SFC regarding the performance of its functions. The SFC is obliged to comply with such directions.

This is a reserve power and the Chief Executive may only give a direction to the SFC if it is in the public interest. The Chief Executive shall also consult the chairman of the SFC prior to giving directions to the SFC.

Clause 12 : Commission to furnish information

Clause 13 : Financial year and estimates

Clause 14 : Appropriation

Clause 15 : Accounts and annual report

Clause 16 : Auditors and audit

Clause 17 : Investment of funds

24. These clauses are similar to existing sections of the SFC Ordinance. Please refer to the derivation table at the Annex.

MARKET COMMENTS

25. We have not received much comment on Part II of the Bill during the public consultation on the White Bill. Of those who commented, their major concerns were that the Bill did not provide for sufficient transparency insofar as the SFC is concerned. We consider that the Bill will indeed enhance transparency and the SFC's accountability by means of the checks and balances referred to earlier in this paper. Full transparency is not always feasible because of issues of commercial sensitivity, the SFC's obligation to preserve secrecy (clause 366) and the necessity in some cases of preserving confidentiality in relation to the affairs of the persons whom the SFC might, for example, be investigating.

26. Concern has been expressed that the SFC's regulatory objectives might lead it to become involved in commercial decision-making, such as that of the Exchanges. The SFC's regulatory objectives are broad in their scope and will exist as factors which the SFC must bear in mind when exercising its functions, powers and duties. Its functions, powers and duties are quite specifically prescribed and generally would not permit it to become actively involved in the commercial decision-making of the Exchanges.

27. There are also concerns that the regulation by the SFC of the activities of recognized exchange companies, recognized clearing houses and recognized exchange controllers should be more precisely defined. The extent of the SFC's functions in this regard is set out in clause 5(1)(b). More detailed provisions are set out in Part III of the Bill.

28. There are also queries as to whether reliance by the SFC on the Monetary Authority in relation to the regulation of exempt persons will lead to

different regulatory standards being imposed on them. We consider that co-ordination between the SFC and the Monetary Authority in accordance with a memorandum of understanding entered into between them will result in the even-handed approach that is needed. We shall consider the new licensing regime in detail while examining Part V to Part VII of the Bill, together with the Banking (Amendment) Bill 2000.

Securities and Futures Commission
Financial Services Bureau
18 December 2000

**Securities and Futures Bill
Part II and Schedule 2**

Derivation Table

Legend:

| | | |
|-------|---|---|
| SFCO | = | Securities and Futures Commission Ordinance (Cap. 24) |
| IOSCO | = | International Organization of Securities Commissions |
| FSMA | = | Financial Services and Markets Act 2000 (UK) |

| Clause | Part | Derivation |
|---|---|--|
| PART II – SECURITIES AND FUTURES COMMISSION | | |
| Division 1 – The Commission | | |
| 3 | Securities and Futures Commission | SFCO ss.3 & 5 |
| 4 | Regulatory objectives of Commission | New: IOSCO principles; FSMA ss.2(2) and 3-6 |
| 5 | Functions and powers of Commission | SFCO s.4 & 8 |
| 6 | General duties of Commission | New |
| 7 | Advisory Committee | SFCO s.10 |
| 8 | Commission may establish committees | SFCO s.6 |
| 9 | Staff of Commission | SFCO s.7 |
| 10 | Delegation and sub-delegation of Commission's functions | SFCO s.9 |
| 11 | Directions to Commission | SFCO s.11 |
| 12 | Commission to furnish information | SFCO s.13 |
| Division 2 – Accounting and financial arrangements | | |
| 13 | Financial year and estimates | SFCO s.14 |
| 14 | Appropriation | SFCO s.53 |
| 15 | Accounts and annual report | SFCO ss.12 & 15 |
| 16 | Auditors and audit | SFCO s.16 |
| 17 | Investment of funds | SFCO s.17 |
| Schedule 2 – Securities and Futures Commission | | |
| Part 1 | Constitution and Proceedings of Commission, etc. | SFCO ss.3, 5 & 10 |
| Part 2 | Non-Delegable Functions of Commission | SFCO Schedule |