

The Hong Kong Association of Banks - Submission on the Securities and Futures Bill and the Banking (Amendment) Bill 2000

1 Introduction

The HKAB strongly supports the Government's objectives of seeking to modernise the regulatory regime for the securities and futures industry in Hong Kong, to bring Hong Kong into line with international standards and to maintain the competitiveness of Hong Kong as a major international financial centre. Inevitably, with draft legislation of the length and complexity of the Securities and Futures Bill (the "**Bill**") and the Banking (Amendment) Bill (the "**BAB**"), the HKAB has a number of comments, as discussed below, but we are broadly supportive of the overall framework created by the draft legislation as summarised below.

The draft legislation permits authorized institutions to conduct regulated activities as "exempt persons" (referred to in this paper as "**exempt AIs**"). However, subsidiaries of authorized institutions, many of which currently have "exempt dealer" status, will need to become licensed by the SFC to continue engaging in investment-related activities after the Bill is enacted.

Under the Bill (as under the current law) "exempt person" status will not mean that the investment-related activities of an authorized institution will be unregulated. Nor will those activities be less stringently regulated than if they were conducted by a corporation licensed by the SFC.

In fact, exempt AIs, in conducting their securities-related activities, are already required by the HKMA (as per HKMA's letter dated 28 December 1995) to comply with the Code of Conduct and internal control guidelines issued by the SFC for Registered Persons. Exempt AIs are already subject to the supervision of HKMA to ensure that their business conduct is of a comparable standard to the broking industry. Under the Bill, the degree of regulation of exempt AIs will be enhanced, as follows:

- individuals involved in the investment-related business of exempt AIs to be individually registered on a new register to be maintained by the HKMA;
- the new rules, codes and guidelines to be issued by the SFC will, except in clearly defined areas such as financial resources, apply directly to exempt AIs;
- exempt AIs will need to appoint "executive officers", to be approved by the HKMA, to supervise their investment-related activities;
- in the event of misconduct, exempt AI status may be revoked or suspended by the SFC, or the HKMA may issue public or private reprimands, or withdraw "executive officer" status.

The regulatory framework will, in our view, provide for regulation of the investment-related activities of authorized institutions equivalent to that applying to licensed corporations.

We agree with the Government that the HKMA should remain the frontline regulator for authorized institutions, to minimise regulatory overlap and duplication of costs. The HKMA is already responsible for consolidated supervision of the whole of an authorized institution's business and needs to have detailed knowledge of the business conducted as an exempt AI. As the rules and guidelines applying to exempt AIs will be largely the same as those applying to licensed corporations, we do not consider that this approach results in any investor

protection concerns, or any undue competitive advantage to the banking community. It has been suggested that licensed corporations suffer a competitive disadvantage because of the costs they would suffer in establishing a branch network. However, authorized institutions require HKMA approval to establish branches, and have to pay significant fees to the HKMA annually, in respect of each branch maintained by them.

We do not agree with the suggestion that banks should be required to conduct investment-related activities through a subsidiary, thereby enabling those activities to be regulated by the SFC. For a bank to be compelled to structure its operations in this way would be contrary to international practice, and would substantially increase the costs of conducting business in the financial market in Hong Kong, which would be contrary to the interests of the public. With the growth of private banking departments and the increased sophistication of financial products, it is becoming increasingly difficult to distinguish between banking and investment-related services. Consumers will often want to receive a range of banking and other financial services and it may be very artificial and complex, and therefore more expensive, for the services to be provided to them through a number of different entities in the banking group. This is particularly the case as the securities business of a bank is typically incidental to its banking business.

Furthermore, subsidiarisation would lead to duplication of regulatory capital, and would increase systemic risks by reducing the banking group's ability to net banking and investment-related exposures to and from a customer in the event of the customer's default and/or insolvency.

While supporting the overall objectives and framework of the legislation, HKAB has various issues to raise, as discussed in the rest of this paper.

2 Exemption and registration requirements

2.1 Regulated activities

It will be necessary to become licensed by the SFC or (in the case of an authorized institution) to obtain a declaration of exemption, in order to carry on “regulated activities” in Hong Kong. The scope of the “regulated activities” as defined in Schedule 6 to the Bill is extremely wide. There is a concern that some authorized institutions which are not currently “exempt dealers” will, for the future, have to become exempt AIs to allow them to continue with their existing activities. This is a point of considerable significance, because so-called “exempt person” status will carry with it significant compliance burdens and costs.

Advisory activities

In particular, licensed banks are automatically exempted under the Securities Ordinance from the need to become licensed as an investment adviser. There is no equivalent exemption in the Bill, and banks which give investment advice will need to become exempt AIs (although there will be a two-year grace period enabling them to continue advising on securities, advising on corporate finance and conducting asset management activities relating to securities, under para. 32 of Schedule 9 to the Bill).

We note that the definitions of:

- advising on securities
- advising on futures contracts
- advising on corporate finance and
- asset management

are extremely wide (and, unlike the existing legislation, the definitions are not limited to a person who gives advice for remuneration). In the case of registered trust companies, solicitors, counsel and professional accountants, an exemption from the licensing requirement applies to advisory activities which are “wholly incidental” to their main business. We propose that a similar exemption be included for authorized institutions, which give advice to their customers as a wholly incidental part of their trustee services. It seems inappropriate that if an authorized institution provides such trustee services within the authorized institution rather than through a separate registered trust subsidiary, it would not have the benefit of an exemption, and would need to become an exempt AI with the onerous compliance responsibilities that this attracts.

We have some other concerns on this scope of activities requiring a licence or a declaration of exemption, as follows.

Dealing in securities

As compared with the existing definition in the Securities Ordinance, this is extended to include:

“..... providing a facility for bringing together on a regular basis, sellers and purchasers of securities, or for negotiating or concluding sales and purchases of securities”

This is very broad and would appear to catch various types of internet-based and proprietary electronic trading systems, a number of which are being developed with authorized institutions being involved with the system as investors or service providers.

The justification for extending the scope of the definition of “dealing in securities” is unclear. To the extent that the provision of electronic trading facilities should be subject to regulation, this is already addressed under the separate category of regulated activities of “providing automated trading services”.

We propose that this additional limb of the definition of “dealing in securities” be deleted.

Advising on corporate finance

This is broadly defined to include advice concerning corporate restructuring, including the issue, cancellation or variation of rights attaching to securities. Although the definition has been slightly revised as compared with the White Bill, we are still concerned that this may extend to general strategic advice or advice on restructuring loans, and not just to advice involving securities.

We suggest the definition be confined to advice on corporate restructuring involving the issue, cancellation or variation any of rights attaching to any securities. Furthermore, we assume that a bank involved (as lender or as agent bank under a syndication) in a work-out where the borrower is in financial difficulties, even if the work-out involves the issue of new securities by the borrower, would not need to become an exempt AI in respect of Type 6 regulated activities, because its involvement in the work-out would not amount to “advice”.

Providing automated trading services

The definition of “automated trading services” is very wide, and includes services provided by means of electronic facilities whereby offers to sell or purchase securities or futures contracts are regularly made or accepted, or persons are regularly introduced or identified to other persons in order that they may negotiate or conclude sales or purchases of securities or futures contracts.

As noted in HKAB’s previous submission on the White Bill, there is a risk that this will be interpreted as extending to vendors of technology services, where those services enable dealers and banks to effect transactions in securities and futures with their customers. Either the definition should be drafted more narrowly (for example, to exclude services provided to intermediaries), or guidance should be issued on the circumstances in which a licence/declaration of exemption will be required.

2.2 Territorial application of the Bill and the regulatory regime

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.

See also our comments on executive officers in 2.5 below.

2.3 Transitional arrangements

Authorized institutions which are currently “exempt dealers” and/or which currently rely on the exemption from the definition of “investment adviser” in the Securities Ordinance, will need to apply for a declaration of exemption within two years from the commencement of Part V of the Securities and Futures Bill. In the meantime, any individual who was employed to carry out “regulated functions” at the time of such commencement will be deemed to be a person whose name is entered in the HKMA’s register as being employed to conduct regulated functions.

We note that, as a result of the amendments to Section 20 of the Banking Ordinance (to be enacted pursuant to Section 4 of the BAB), the HKMA can require information on relevant individuals employed by a bank to be included in the register maintained by the HKMA with immediate effect and the register must be in place not later than 12 months after the BAB is enacted.

In our view, the requirement for information on relevant individuals to be provided, and the register of individuals to be maintained, should only take effect at the end of the transitional period i.e. when the authorized institution concerned obtains a declaration of exemption.

Also, the drafting of the proposed Section 20(9)(a) of the Banking Ordinance appears defective, because sections 26(a) and 33 of Schedule 9 to the Bill appear to relate to the individuals, and not to the authorized institution itself. We assume that this should refer to sections 25(a) and 32.

In the case of authorized institutions that are already acting as exempt dealers/investment advisers, we consider that they should effectively be “grandfathered” when applying for exempt AI status, without the HKMA and the SFC conducting an ab initio review of their “fitness and propriety” before issuing a declaration of exemption. We also consider that individuals currently carrying out regulated functions for exempt AIs should be “grandfathered” and automatically eligible for inclusion on the HKMA register, without (for example) any need to obtain recognized industry qualifications.

Under the Bill, although exempt dealers (and licensed banks acting as investment advisers) are deemed to have “exempt person” status during the transitional period, they will still be required, immediately on the commencement of the Securities and Futures Ordinance, to comply with the provisions of the Ordinance, and the rules and guidelines made thereunder by the SFC, relating to “intermediaries”. This could require substantial changes to be made to compliance systems and procedures, and we suggest that there should be a significant lead-time (of at least six months after commencement of the rest of the Ordinance) before any significant new legislative requirements, rules and guidelines applying to intermediaries actually come into force.

2.4 HKMA Register

Under Section 20 of the Banking Ordinance (as to be amended by the BAB) an exempt AI must provide details to the HKMA of individuals employed by the exempt AI to conduct regulated functions in a regulated activity. This information will be included in the register maintained by the HKMA under Section 20.

We have a number of comments on this provision:

- 2.4.1** Clarification is sought that it is not necessary that the persons whose names are to be included on the register actually have a contract of employment with the authorized

institution. For example, staff may be employed by a service company in the group, rather than by the authorized institution itself.

2.4.2 The definition of “regulated function” in Part V of the Securities and Futures Bill is somewhat different from the definition of “regulated function” to be inserted in Section 20(10) of the Banking Ordinance, and it is not clear why there is this difference.

2.4.3 Because of the requirement to maintain a register of the relevant individuals who perform regulated functions for an exempt AI (and the fact that a breach of Section 20 will be a criminal offence by every director and manager of the authorized institution) it is important that there is a sufficient degree of certainty as to the nature of the activities which, if conducted by an individual employee, will trigger an obligation to notify the HKMA for that individual to be included on the register. However, a “regulated function” is rather unhelpfully defined as, in relation to a regulated activity, any function (other than work ordinarily performed by a clerk, cashier or accountant).

Further clarification is needed. For example, we do not believe that the following individuals should be required to be included on the register:

- settlement staff who contact customers in relation to settlement of securities transactions.
- counter staff who arrange for customers to open an account with an authorized institution, even if the account may enable the customer to effect investment-related transactions. It is common for bank customers to open a “bundle” account which include deposit, current and securities accounts etc, and counter staff performing the account opening function should not be required to be individually registered for such activity.
- customer liaison officers, who do not themselves give investment advice or take dealing orders in relation to securities or futures, but who act as an initial contact point with customers.

2.4.4 We do not understand why Section 20(3) of the Banking Ordinance is to be amended to refer expressly to “an authorized institution seeking to be an exempt authorized institution”. Such a person (as an authorized institution) is subject to Section 20(3) in any event. This amendment seems unnecessary.

2.4.5 Also, we do not see why the new Section 20(4A) of the Banking Ordinance is needed. The register of relevant individuals will be part of the HKMA’s register maintained under Section 20(1), and therefore available to public inspection under Section 20(5) in any event. Again, this amendment seems unnecessary.

2.5 Executive Officers

The exempt AI needs to appoint not less than two “executive officers”, who require the consent in writing of the HKMA to act as such executive officers.

The definition of “executive officer” seems somewhat circular. It is our understanding that:

- as long as an individual has sufficient authority within the institution to carry out the duties of an executive officer, he or she need not be a director of the institution to be appointed as an executive officer.

- it will not be necessary to appoint as an executive officer every individual who has some supervisory responsibilities for regulated activities e.g. the head of the settlements area.
- on the other hand, if an exempt AI wishes to appoint as an “executive officer” the head and deputy head of each department engaged in a regulated activity it could do so, and there is no limit on the number of executive officers who can be appointed by an exempt AI.

In the case of a licensed corporation, it must appoint at least two responsible officers. There is no guidance as to the role of a “responsible officer”, although at least one such officer must be an “executive director”, meaning a director who actively participates in or is responsible for directly supervising the business of a regulated activity for which the corporation is licensed.

The proposed requirement in Section 71D of the Banking Ordinance, that an exempt AI has at least 2 executive officers responsible for directly supervising the regulated activities, appears to go beyond the requirements in the Bill applying to licensed corporations. The latter could (for example) have one or more responsible officers who actively participate in the regulated activities, rather than supervising the conduct of those activities. Section 71D should be amended to make it consistent with the provisions of the Bill relating to licensed corporations. The wording of the Bill on “responsible officers” should be adopted consistently in the legislation.

Under the proposed Sections 71C and 71E of the Banking Ordinance, the HKMA can give approval to a person being appointed as an executive officer, subject to such conditions as the HKMA thinks proper to attach. Under Clause 125 of the Bill, the SFC may approve individuals as responsible officers of licensed corporations subject to reasonable conditions. Sections 71C and 71E should be amended to refer to “reasonable conditions”.

In the event of a breach of the requirements relating to executive officers, the directors and managers of the exempt AI commit an offence (under Section 71D of the Banking Ordinance as to be inserted by the BAB). Also, if the exempt AI has failed to comply with Section 71D of the Banking Ordinance, the exempt AI commits an offence under Clause 124 of the Bill. This appears to constitute “double jeopardy”. Furthermore, the exempt AI may commit an offence under Clause 124 of the Bill if executive officers had been appointed, but had failed to comply with Section 71C of the Banking Ordinance (for example, by infringing conditions attached to the HKMA’s approval). Again, this would be a breach by the executive officers themselves, under Section 71C of the Banking Ordinance, and it seems unjust to impose criminal liability on the exempt AI as well pursuant to Clause 124 of the Bill. We propose that Clause 124 of the Bill only applies to licensed corporations.

Sections 71C and 71D of the Banking Ordinance impose strict liability on the executive officers and other directors and managers of the authorized institution for non-compliance with those sections. It would be more satisfactory if an offence was only committed if the relevant person acted “without reasonable excuse” (compare Clause 124(3) of the Bill). Also, the penalties for a breach of Sections 71C and 71D are higher than those for a breach of Clause 124, and should be brought into line.

In the case of an institution incorporated in Hong Kong, executive officers must be appointed to supervise the conduct of all “regulated activities” whether or not in Hong Kong. We suggest that this requirement should be confined to regulated activities conducted in Hong Kong. While the board of directors of a Hong Kong-incorporated bank will be responsible

generally for oversight of all its operations, including those outside Hong Kong, the requirements in respect of “executive officers” only make sense in relation to business within the territorial scope of the Securities and Futures Bill, and not for activities of branches outside Hong Kong.

2.6 Applications for exempt AI status/variations and modifications

An application for a declaration of exemption is made to the SFC, but referred to the HKMA (Clause 118(2)). For consistency, the imposition of any reasonable conditions under Clause 118(5) should also be a matter determined by the HKMA, rather than the SFC simply having an obligation to consult the HKMA, as currently provided in Clause 118(9).

Clause 126 of the Bill relates to applications by an exempt AI to vary the regulated activities specified in its declaration of exemption. It should be provided that any such application will be referred to the HKMA for consistency with Clause 118 (declarations of exemption). The same comment applies to Clause 131 (modifications and waivers). Clause 131(10) refers to consultation by the SFC with the HKMA, but it would be preferable if the SFC were required to refer the matter to the HKMA.

2.7 Reporting requirements

Clause 132 of the Bill requires an exempt AI to give notice both to the SFC and the HKMA of the various matters required under that Clause to be reported. This is unduly onerous and it should be sufficient to provide the information to the HKMA.

This could easily be achieved by changing “and” to “or” in Clauses 132(1), (2) and (4)(b), and adding a reference to the HKMA in Clause 132(3).

3 Part VI of the Bill - client securities and collateral, records and accounts etc.

As a general comment, we note that the SFC has very extensive rule-making powers in respect of intermediaries and their representatives under Part VI and VII. Those rules may provide that breach of those rules, without reasonable excuse, constitutes a criminal offence punishable with up to two years imprisonment and a fine of HK\$200,000. We have no objection to criminal liability applying where the person concerned acted with intent to defraud, for example, under Clause 144(5). However, it seems that the rules may create offences of strict liability (subject only to the “reasonable excuse” defence). It seems inappropriate for the SFC to have power to create criminal offences punishable with imprisonment and a fine. In our view, any matters which are intended to attract criminal sanctions should be set out in the Bill itself.

3.1 Client Securities and Collateral

The provisions relating to client assets held by intermediaries and their associated entities in Hong Kong are set out in Division 3 of Part VI of the Bill.

The definition of “associated entity” in Schedule 1 seems somewhat unclear. If the entity is an overseas company, it only falls within the definition if it is “complying with the provisions of Part XI of the Companies Ordinance (Cap.32) relating to the registration of documents”. It would be more straightforward simply to refer to an overseas company registered under Part XI, as otherwise a technical breach of Part XI, e.g. failing to file details of all directors with the Registrar of Companies, could mean that the company ceased to fall within the definition of “associated entity”.

Clause 144(1) permits the SFC to make rules specifying how client securities and collateral are to be treated and dealt with. With respect to exempt AIs, the rules only apply in relation to client securities and collateral received or held by them in the course of the businesses which constitute regulated activities for which they are exempt. With respect to associated entities that are authorized financial institutions (“associated entity AIs”), the rules only apply in relation to client securities and collateral received or held by them in the course of their businesses of receiving or holding client securities and collateral of intermediaries of which they are associated entity AIs. 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.

In any case, we question the practicality of Clause 144 as it will apply to exempt AIs and associated entity AIs. Any rules made by the SFC must be such as to ensure that exempt AIs need not create separate custodian accounts, to differentiate between securities received in the course of regulated activities and those not so received, as otherwise this would cause immense practical difficulties, increase costs and greatly inconvenience customers, who would 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, security documents generally create a security interest over all assets held by an authorized institution, to provide security against a default by the client in meeting its obligations to the authorized institution, regardless of which business line those assets (or those obligations) originated from. It would be impracticable, and an added cost which would probably need to be passed on to customers, to have to provide separate security

documents and to have to enforce those security interests separately, in respect of regulated business and other business.

Clause 144(2) provides some limited guidance as to the type of provisions that may be included in rules to be made by the SFC. This includes, by Clause 144(2)(b), the ability to make rules providing that client securities and collateral should not be dealt with except as specified in the rules. 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, in view of the importance of this matter. Similarly, and for the avoidance of doubt, 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.

Section 81(5) of the Securities Ordinance currently imposes certain restrictions on the ability of a dealer to dispose of the client's securities, even where the client is in default of obligations owed to the dealer. In our view, as long as the dealer has an express power of sale in its terms of business with the client, the dealer should be able to exercise those powers, without additional restrictions being imposed under the SFC rules.

Another problem with Section 81 as currently drafted is that sub-section 81(6) appears to prohibit stock lending of the client's securities (even where authorized by the client) unless this is also permitted by rules made by the SFC, and no such rules have been made. We understand that the rules to be made under the Bill will expressly permit a Hong Kong intermediary to participate in securities lending programs on the client's behalf where the client has authorized this and this is to be welcomed.

Section 81A(6) permits a dealer, with the client's authority, to deposit securities collateral with the Hong Kong clearing houses as security for the dealer's obligations to those clearing houses. However, securities cannot be used as collateral, in respect of transactions of the dealer on overseas exchanges. This should be remedied in the rules to be made by the SFC pursuant to the Bill.

We would argue that it is unnecessary for the client's consent to the use or disposal of securities by the intermediary to be renewed annually. This is unnecessary because the client should always be able to withdraw such consent at any time (save in respect of liabilities already in existence).

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 (claims or liens not affected) is insufficient since a lien would not of itself 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.

3.2 Records and accounts

Rule making powers in respect of records and accounts are set out in Part VI, Division 4 of the Bill.

There may be a concern that an authorized institution will need to keep parallel records to satisfy SFC and HKMA requirements, involving duplication of effort. In particular, the SFC rules will only apply in relation to the "regulated business" of an exempt AI and it would be very artificial to separate out that business from the other services provided to the relevant

customer. We would urge the HKMA and the SFC to ensure that the rules made by the SFC do not result in separate records needing to be maintained.

To facilitate out-sourcing and/or centralisation of back office functions, it would be helpful if the rules made clear that records need not be maintained at the premises of the intermediary in Hong Kong, but 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.

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.

3.3 Contract notes, receipts, statements of account and notifications

The rule-making powers are set out in Clause 148 of the Bill. Again, we are concerned 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, Clause 148(2)(b) provides for statements of account to be sent to clients to whom financial accommodation has been provided. In the case of authorized institutions, an obligation to provide statements (separate from the general banking statements sent to the customer) where financial accommodation has been provided in connection with regulated business, does not make sense.

It would be helpful if the rules could make clear that all such information can be provided electronically where the client has agreed to receiving the information in electronic form.

3.4 Audit

The provisions for the appointment of auditors etc. in Clauses 149 to 152 do not apply to authorized institutions. However, an auditor of an associated entity AI is required to report certain matters to the HKMA and the SFC (Clause 153). If there is to be a reporting obligation, it should be sufficient for the auditor to report to the HKMA.

The SFC may appoint auditors to conduct examinations and audits of an associated entity AI on its own initiative (Clause 155) and on application by any person (Clause 156), after consulting the HKMA. It would be desirable for the power of appointing auditors to be exercisable by the HKMA, instead of the SFC.

4 Part VII of the Bill - Business Conduct

Clause 163 of the Bill empowers the SFC to make conduct of business rules. As discussed above, we regard it as very unsatisfactory that the SFC is given the power to make rules, a breach of which “without reasonable excuse” is a criminal offence. We note that the rules may impose criminal liability not just on intermediaries but also on their representatives. The SFC should not have the power to create criminal offences.

Clause 164 permits the SFC to publish codes of business conduct. There should be a requirement for public consultation before conduct of business rules or codes of conduct are issued. There should also be guidance on when the SFC will exercise its rule-making power or instead choose to issue a code of conduct.

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. 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.

As the rules and codes made by the SFC are to apply to exempt AIs, there is a significant risk of overlapping and potentially inconsistent requirements being imposed on exempt AIs by the SFC and the HKMA. For example, the SFC may make rules under Clause 163 in respect of money laundering, which is already the subject of guidelines issued by the HKMA. 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.

We note that, under Clause 164(4)(c), a failure by a representative of an exempt AI to comply with SFC codes of conduct may be taken into account in considering, for the purposes of any provisions of the Bill, whether his name should remain entered on the HKMA register. The SFC has no power under the Bill to require an individual’s name to be removed from that register, and the nexus between Clause 164(4)(c) and the maintenance of the register by the HKMA under Section 20 of the Banking Ordinance, is obscure. Whether a person is fit and proper to remain entered on the HKMA register should be a matter for the HKMA.

5 Marketing and communications

As a general comment, we find it confusing that provisions relating to advertising, solicitation and communications are set out in various different Parts of the Bill. In particular Part IV relates to marketing of investments, and to misrepresentations inducing investment transactions, yet misrepresentations are also addressed in Part X of the Bill (Clause 208 - liability for public communications) and Parts XIII and XIV, which otherwise cover insider dealing and market manipulation. Marketing is also addressed in Part VII (Clause 169 on unsolicited calls).

5.1 Marketing to the public

Part IV of the Bill regulates the marketing of investments to the public. This is not defined and its meaning is unclear. There is a safe harbour for marketing to professional investors as defined in Schedule 1 to the Bill. Subject to any rules to be made under Clause 384 of the Bill to extend this definition, it is in some respects narrower than the existing safe harbour in the Protection of Investors Ordinance, which covers persons “whose business involves buying, selling or holding securities, whether as principal or agent”. We propose that the definition of professional investor be expanded to cover such persons, and also to cover individual investors of whose net worth exceeds a certain amount, to be specified in the definition.

5.2 Offers of securities

Clause 108 of the Bill, as drafted, extends the scope of the current Section 72 of the Securities Ordinance. The reasons for this provision are unclear and, in our view, it will seriously constrain entirely proper communications between intermediaries and their clients.

5.3 Civil liability for misrepresentations

In view of Clause 107 of the Bill we see no reason for Clause 208, which is extremely widely drafted and may encourage unmeritorious law suits against banks and other financial market participants with “deep pockets”.

5.4 Unsolicited calls

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.

We note 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. We suggest that (analogous to Clause 169(2)(b) relating to securities margin financing) the Bill should itself state that such calls are exempt, without the SFC having to declare this in a separate rule.

6 Part XIII and XIV of the Bill - market misconduct

6.1 Insider dealing

While we have no objection in principle to strengthening the existing law on insider dealing by making it a criminal offence, and creating a civil right of action for investors who suffer loss as a result of insider dealing, we are concerned that the exemptions as currently drafted are inadequate to create appropriate safe harbours for legitimate dealing activities that, arguably, are technically within the scope of the insider dealing prohibition.

By way of example:

- insider dealing is extended under the Bill to dealings, or counselling or procuring dealings, in shares as yet unissued and unlisted. Therefore, there should be wider defences for pre-IPO marketing and underwriting.
- Clause 140 has been extended to cover the situation where a person receives relevant information in the capacity of an Exchange participant, or an officer or employee of an Exchange participant. An Exchange participant may receive from a client a large order which, if it were known to the market, would materially affect the price of the company's securities. Knowledge of the order would therefore be inside information, and the Exchange participant might therefore be prevented from executing the order. There should be an exemption (as under the United Kingdom legislation, on which the Hong Kong legislation is based) for persons who deal in connection with a proposed acquisition or disposal, and with a view to facilitating the accomplishment of the acquisition or disposal.
- As in the United Kingdom, further exemptions for transactions effected in conformity with the price stabilisation rules, and exemptions for market makers, would be welcome.
- In our previous submission, we proposed an exemption for mortgagees of shares, when disposing of those shares upon default by the mortgagor, where such default may be material but is not as yet public. In the Legislative Council Brief on the Bill, the Financial Services Bureau did not support an exception and stated that it was not aware of any such exception in any comparable foreign market. However, there is an exemption from the Australian insider dealing legislation, under the Australian Corporations Regulations (para. 7.11), for sales of securities under a mortgage or charge. We remain of the view that such an exemption is essential to protect lenders who wish to enforce their security, and that an exemption should be introduced in the legislation.

6.2 Other market misconduct

While there has been some streamlining in the drafting of Parts XIII and XIV as compared with the White Bill, and a reduction in the number of offences of strict liability, a number of concerns remain.

There is still extensive overlap between categories of "false trading", "price rigging" and "stock market manipulation".

We consider that the category of "false trading" (Clauses 265 and 287) should be confined to conduct engaged in with the intention of, or being reckless as to whether it has the effect of, creating a false or misleading appearance of active trading, or with respect to the market for or the price of dealings in securities or futures contracts. It seems unnecessary, and unduly

broad, also to include within these Clauses transactions which may create an “artificial price” for securities. This concept is very uncertain, and may be interpreted by the courts as catching hedging transactions, arbitrage transactions and other legitimate market activities.

Under Clause 265(5) a transaction that does not involve a change in beneficial ownership, and/or the input of “matched orders”, is deemed to constitute false trading (subject to a defence if the person can prove that his purpose was not to create a false or misleading appearance).

We understand that these provisions are intended to prohibit “wash trades”. However, as drafted, it seems that a significant number of legitimate transactions would fall within these provisions, and it seems wrong in principle that these transactions would constitute criminal offences and/or market misconduct unless the contrary can be proved by the person who effected the transaction.

The category of “price rigging” (under Clauses 266 and 288) very considerably duplicates the provisions on false trading. Creating a separate offence of price rigging goes further than the Australian Corporations Law, on which Parts XIII and XIV of the Bill are based, and we see no justification for retaining Clauses 266 and 288 in the Bill.

Generally, because of the widely drafted categories of market misconduct in Parts XIII and XIV of the Bill, if the provisions remain as drafted we believe that it will be essential for the SFC to exercise its power to create “safe harbours” to cover stabilisation, arbitrage and hedging activities.

Under Clause 290, it is a criminal offence to disseminate false or misleading information, being negligent as to whether the information is false or misleading. Generally, criminal liability is imposed under the laws of Hong Kong and comparable jurisdictions for misrepresentations made intentionally or recklessly. It seems extremely harsh to extend criminal liability (with a maximum penalty of ten years imprisonment and a fine of HK\$10 million) for negligence. We propose that Clause 290 should be restricted to representations made intentionally or recklessly.

Furthermore, we question the need for Clause 290 at all, as it substantially overlaps with Clause 106 of the Bill (offence to fraudulently or recklessly induce others to invest money).

6.3 “Market misconduct” by officers

Clause 270 of the Bill requires every officer of a corporation to take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the corporation from engaging in market misconduct.

Under Clause 250, if the Market Misconduct Tribunal determines that a corporation is guilty of market misconduct which is attributable to a failure of any person to take the measures required by Clause 270, the Tribunal can make any order against that person which it could make against the corporation. This is tantamount to treating a person as having engaged in market misconduct, even though he had no personal involvement in the wrongdoing, if he is regarded by the Tribunal as having been insufficiently diligent in taking preventative measures. It seems unjust to treat this as market misconduct, and we propose that Clause 250 be deleted.

7 Supervision, investigation and disciplinary action

7.1 Listed corporations

7.1.1 Authorized institution which is a listed corporation

The SFC can, under Clause 172(1) and (9), give a direction requiring information from an authorized institution which is a listed corporation where:

- it appears to the SFC that members of the corporation have not been given all the information with respect to its affairs that they might reasonably request; or
- the SFC is assisting an overseas regulator's investigation into the corporation in respect of a matter which suggests that the members of the corporation have not been given all such information.

The SFC must consult with the HKMA before giving a direction to the authorized institution.

This power is very widely drafted. For example, if there were any concerns about fraud in the conduct of an institution's banking business (which is a matter that should be dealt with by the HKMA pursuant to its powers in the Banking Ordinance) the SFC could easily conclude that the alleged fraud was something of material interest to shareholders but which had not been disclosed to them and therefore that the SFC could investigate under Clause 172(9). In our view, either Clause 172 should be amended so as not to permit the SFC to give any direction under Clause 172(1) in respect of a listed corporation which is an authorized institution, or the HKMA's prior approval should be required before a direction can be given.

Also, under Clause 172(1)(iii), (iv) and (v), the SFC can (without even consulting the HKMA) seek records or documents from third parties (including auditors) in relation to the affairs of a listed corporation which is an authorized institution, (and arguably, not just where it appears to the SFC that members of that corporation have not been given all the information with respect to its affairs that they might reasonably request). Either these sub-clauses should be disapplied in respect of listed corporations which are authorized institutions, or HKMA's prior approval should be required before any direction is given under those sub-clauses to obtain information in respect of a listed corporation which is an authorized institution.

7.1.2 Authorized institution which has had dealings with a listed corporation

We are concerned that Clause 172(1)(iii) undermines an institution's obligation to treat its customers' banking affairs as private and confidential. In our opinion the SFC should be obliged to obtain the prior approval of the HKMA before making the request. The HKMA should only give its consent if it is satisfied that the production of the record or document is necessary for the purposes of the SFC's investigation.

7.2 Supervision of intermediaries and their associated entities

Under Clause 173, the SFC has the power to enter premises of an exempt AI, or its associated entities, including an associated entity AI, at any reasonable time to inspect and make copies of documents and make inquiries, provided it is for the purposes of establishing whether the exempt AI (or an associated entity) is complying with (inter alia) any provision of the Bill.

The SFC may also make enquiries of any other person where the SFC has reasonable cause to believe that he has information relevant to the business conducted by an intermediary or associated entity.

In the case of an authorized financial institution, which is not an exempt AI, the HKMA must be consulted before the SFC exercises its power. In addition, where the authorized financial institution is not an exempt AI, it shall not be required to disclose any information or produce any record or document relating to the affairs of a customer unless the HKMA certifies in writing that it is satisfied that the disclosure or production is necessary for the purposes of the clause (Clause 173(9)).

There appears to be a drafting flaw because Clause 173(9) and (10) do not apply where an authorized institution is an exempt AI. However, these protections should be available where an institution is an exempt AI but receives an inquiry, under Clause 173(1)(c)(iii) or (3)(c), not in relation to its own regulated business but in relation to its dealings with another intermediary.

There is a privilege against self-incrimination in Clause 180 in connection with explanations or statements given under Clause 172, however, this does not extend to information given under Clause 173. We suggest that it should do.

7.3 Discipline

The only disciplinary sanction available to the SFC with respect to exempt AIs under Part IX of the Bill is to revoke the exemption, in whole or in part, following consultation with the HKMA. Clauses 190(1)(a) to (f) set out the grounds under which the power can be exercised. To achieve consistency with the provisions of the Bill relating to grant of exempt status, we believe that exempt status should only be revoked on the advice or with the approval of the HKMA.

The new draft Section 58A(2) of the Banking Ordinance provides that an exempt AI must, before being reprimanded, have an opportunity of being heard. This should be amended to refer to a reasonable opportunity (consistent with Clause 190 of the Bill).

As discussed above, we are also concerned about the SFC's power under the Bill to make rules applying to exempt AIs and licensed corporations, a breach of which "without reasonable excuse" would constitute a criminal offence. This would give the SFC the ability to prosecute authorized institutions, even in respect of what might be fairly technical infringements of rules committed inadvertently. The implications, in Hong Kong and elsewhere, of an authorized institution being convicted of a criminal offence could be extremely serious and out of all proportion to the gravity of the rule breach. In our view, the SFC should not be able to make rules attracting criminal sanctions.

8 Disclosure of Interests in Shares

8.1 General

Part XV of the Bill reduces the threshold for disclosure of interests in shares to 5 per cent., and the disclosure period to three business days. This is in line with other markets and we do not object to these changes.

However, the definition of “interests” requiring disclosure, and the information to be disclosed, are far more extensive than in other markets. The Bill substantially expands the scope of the current legislation by requiring disclosure of:

- interests in unissued shares
- interests arising under cash-settled derivatives
- short positions
- changes in the nature of a person’s interest.

For banking groups with significant securities dealing, asset management and custodial businesses, substantial on-going costs will be incurred in monitoring the level of interests, and very frequent disclosures may be needed. We question whether the information required to be disclosed will be of real value to listed corporations, regulators and investors, and consider that any benefits arising from wider disclosure will be outweighed by the cost burden imposed, on substantial shareholders, directors and listed corporations advice, under the new regime.

Because of the complexity of the disclosure requirements, errors or delays in compliance are likely to occur frequently, and we are concerned that any such error or delay, even though inadvertent, is a criminal offence punishable by imprisonment and a fine.

8.2 Asset management, custody and trusteeship

In the context of asset management, trusteeship and custodial business, Clause 307(5) has the effect that if these businesses are carried on in corporations separate from the rest of the group, and rights in respect of the shares in which those corporations are interested are exercised separately from the rest of the group, it is not necessary for the group to aggregate the interests held by those corporations with the rest of the group’s interests in the relevant shares for disclosure purposes.

However, this relaxation is of limited use, because it would not apply if the asset management, custodial or trustee functions are carried out in the authorized institution itself, rather than through a dedicated subsidiary. It would not be sufficient that the activities are carried out in a separate division of the institution, with Chinese Walls in place.

Furthermore, even if a banking group carries out its asset management, trustee and custodial functions through an entity separate from the authorized institution, it may still be unable to rely on the exemption from aggregation. This is because the exemption is only available in respect of interests in shares held by a custodian or trustee, where a person’s principal business is to act as custodian, or as trustee (as the case may be). It may be common to provide trusteeship, custodian and other agency functions through a single corporation, in which case the exemption would not apply.

We would urge the Government to consider granting wider safe harbours from the disclosure requirements in Part XV in respect of investment managers, custodians and trustees (expanding on the exemptions in Clause 314) or, failing this, to create a wider exemption from aggregation of interests in Clause 307(5) by allowing the exemption to apply irrespective of whether the asset management, custodial and trustee activities are carried out in separate corporations.

8.3 Changes in the nature of a person's interest

The introduction of a requirement to disclose changes in the nature of a person's interest (Clause 304(1)(d)) is likely to be particularly onerous. For example, if a custodian has power to lend out shares in its custody (and, overall, the custodian is holding 5 per cent. or more of a particular class of shares) it seems that whenever a loan is made, this constitutes a change in the nature of the custodian's interest in the stock. This would trigger a disclosure obligation by the custodian, as would the return of the stock at the end of the loan. This could result in disclosures being made on a daily basis.

It would be far more satisfactory if a change in the nature of a person's interest was defined in such a way as not to include a stock lending. Instead, the Bill includes an exemption, in Clause 304(11), for "conduit" stock lending and borrowing. This exemption would not apply to a custodian and, in our view, will not reduce the compliance burden imposed in relation to stock lending activities under the new disclosure regime.

8.4 Exempt security interests

Under Clause 314, an authorized institution which holds shares as security is not to be treated as having a discloseable "interest" in those shares if that interest is an "exempt security interest". However, an interest ceases to be an exempt security interest in the circumstances set out in Clause 314(6). This includes the situation where the power of sale under the charge has become exercisable, and the chargee has offered the shares for sale. The HKAB considers that the meaning of this is unduly uncertain to act as a trigger for the interest ceasing to be an "exempt security interest". The chargee may be interested in selling the shares if it can reach an acceptable price, and may have preliminary discussions with possible purchasers over a protracted period of time. However, unless and until the chargee sells the shares through an on-market transaction, or enters into a firm and legally binding commitment to sell the shares in an off-market transaction, we believe that the benefit of the "exempt security interest" exemption should remain.

Clause 314(6) also provides that an interest ceases to be an exempt security interest if the chargee has:

- (A) evidenced an intention to exercise the voting rights or control their exercise; or
- (B) taken any steps to exercise the voting rights or control their exercise.

There may be considerable scope for uncertainty as to whether (A) has or has not occurred. In the light of (B), paragraph (A) appears unnecessary and should be deleted to remove the uncertainty.

8.5 Investigations by listed corporations

Under Clause 320 of the Bill, a listed corporation may make enquiries as to any "interests" or "short positions" in its shares or in equity derivatives relating to those shares over a period of up to 3 years prior to the date of the enquiry. The exemptions from disclosure in Clause 314 do not apply.

While this power of investigation is based on the existing law (Section 18 of the Securities (Disclosure of Interests) Ordinance), the extended definition of “interest” and the requirement for disclosure of short positions may make it much more onerous to comply with enquiries made (for example, because a banking group might be required to disclose all cash-settled derivatives transactions relating to the listed corporation’s shares entered into in the preceding 3 years).

A response to the enquiry must be made within such “reasonable time” as is specified in the enquiry notice, and what is “reasonable” is very unclear, particularly where the enquiry will require large amounts of information to be provided. As an error or delay in compliance with an enquiry notice constitutes a criminal offence, this will put recipients of such notices in a very difficult position.

Listed corporations have a legitimate interest in being able to investigate possible stake-building in their issued share capital (as under the existing legislation). However, there seems no good reason for listed corporations to be able to conduct wider investigations. Indeed, this power could well be abused by corporations that had no good reason for making enquiries, resulting in the imposition of substantial compliance costs on banking groups and other financial markets participants. We suggest that the power of investigation should relate solely to a listed corporation’s issued share capital, as under the existing law.