

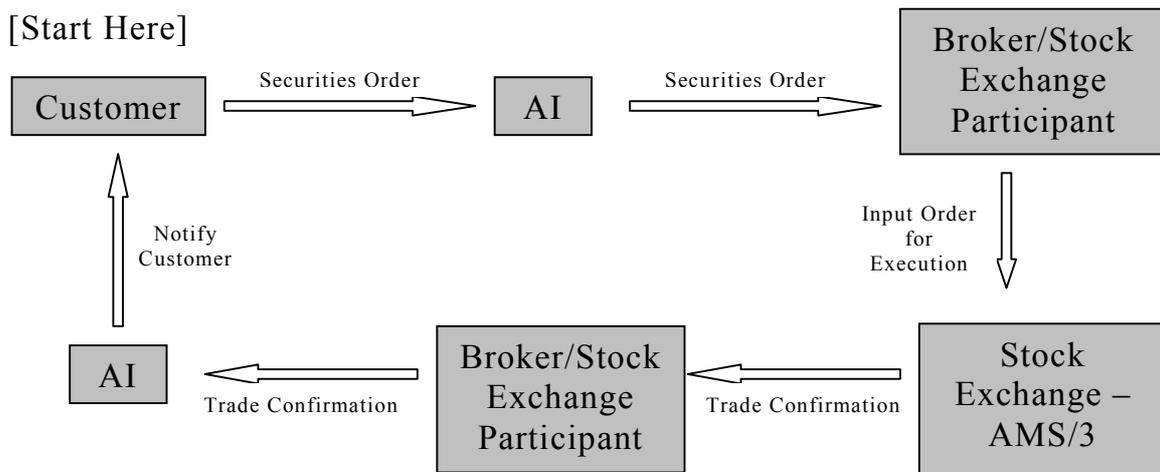
**Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000**

**Involvement of Authorised Institutions in
the Securities, Insurance and MPF Businesses**

At the Bills Committee meeting held on 16 February 2001, some Members asked if Authorised Institutions (“AIs”) should be required to conduct their securities trading business through a subsidiary. The following analysis shows that to do so would not be in the best interests of investors and does not address the supervisory overlap between the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC). Furthermore, compelling AIs to set up subsidiaries to operate securities business is not in line with the practice adopted for their conduct of insurance- and mandatory provident fund (MPF)-related business. With increasing market sophistication, it is also difficult to draw any artificial line between banking and securities services.

Role of AIs in Securities Trading

2. AIs offering securities trading services to customers only play the role of agents at present. They collect customer orders and pass such orders to a Stock Exchange participant for execution in the following manner :



3. The above arrangement results from the fact that AIs cannot become Stock Exchange participants, and therefore have no access to the

trading system (“AMS/3”) of the Exchange. The rules of the Stock Exchange require that its participants should be registered with the SFC as a dealer. Thus, in their capacity as exempt dealers, AIs are not eligible to obtain the participant status from the Stock Exchange. In order to execute customers’ securities orders, AIs have to secure the service of a Stock Exchange participant, and in doing so, have to pay to the participant concerned the requisite commission based on the value of transactions executed (a minimum of 0.25%).

4. There are at present 110 exempt AIs but only 79 actually conduct some forms of securities business. Some AIs choose to establish their own subsidiaries in order to be registered with the SFC and become a Stock Exchange participant, as only SFC registrants may become Stock Exchange participants. This is because they perceive commercial and management benefits in setting up a separate entity specialising in the securities business. In the same way, AIs may establish subsidiaries to specialise in other types of business such as finance, leasing or credit card companies. There are at present 47 SFC registered dealers that are owned by 45 AIs/AI groups. Other AIs choose to enter into strategic alliance with independent Stock Exchange participants in handling customer orders. The decision of whether to set up their own subsidiaries for this purpose is a business decision for individual AIs. Nevertheless, even if they do so, the AIs will generally still provide their customers with the ability to deal in securities through the AIs. It is also common practice for the AIs concerned to secure the services of one or more other Exchange participants to cater for the order flows during busy trading days and as a contingency arrangement in case of system failure at their own subsidiary brokers.

5. AIs and Stock Exchange participants (including broker subsidiaries of AIs) therefore operate with a clear division of responsibilities. In their capacity as “agents”, AIs provide additional convenience to investors. They serve as retail outlets for investors to place their securities order and thereby enhance the order flows to the Stock Exchange participants which then execute the orders. The fact is that there are quite a significant number of investors who maintain securities trading accounts with AIs and it would be inappropriate to deny such investors access to bank facilities for placing securities orders. Investors should be allowed to choose whether to conduct their securities trading through an AI or with a broker. The involvement of AIs is beneficial to the overall development of the stock market. **To compel AIs to subsidiarise their securities business would not serve the best interests of investors.**

6. The subsidiarisation proposal would give rise to practical problems. Given the increasing sophistication of financial markets nowadays, banking and securities services are becoming increasingly intertwined. It is therefore difficult, if at all possible, to impose any artificial barrier between

the two types of services. A good example is private banking, where tailor-designed banking and investment services are packaged and offered to customers. It would be impractical and contrary to market trends to require AIs to dissociate the banking and investment elements of their products and to subsidiarise the latter.

Regulatory Overlap

7. In line with international practice, the HKMA exercises consolidated supervision of AIs (e.g. the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of AIs concerned in certain prudential returns submitted to the HKMA regularly). This reflects the fact that the HKMA has an overall supervisory concern over the financial subsidiaries of AIs, including broker subsidiaries regulated by the SFC. Furthermore, the Memorandum of Understanding agreed between the two regulators states that it is necessary to ensure that information relating to groups containing entities supervised by the HKMA and the SFC should be available to both regulators on a timely basis and that appropriate regulatory action is taken. The coordinator to be chosen for regulating those groups is the regulator of the activity that is more substantial or significant. Thus, while the day-to-day supervision of broker subsidiaries of AIs is conducted by the SFC, the HKMA and the SFC in fact share the regulatory oversight for groups involving AIs and broker subsidiaries.

8. The Securities and Futures Bill provides an effective solution to minimise regulatory overlap. Under the proposed framework, the HKMA will continue to conduct day-to-day on-going supervision of AIs' securities business while the ultimate regulatory authority rests with the SFC. This arrangement avoids subjecting AIs simultaneously to two separate regulatory processes administered by the HKMA and the SFC, which would otherwise increase regulatory costs without generating any extra regulatory benefits.

9. The proposal to oblige AIs to subsidiarise their securities business would vest the day-to-day supervision of such securities business with the SFC. This would appear to make the division of supervisory responsibilities more clear-cut. But, as noted above, it would be at the expense of imposing an artificial separation between banking and securities business. This would cause inconvenience to investors who wish to enjoy integrated banking and securities services, and impose additional administrative overheads on AIs. Furthermore, the proposal would not eliminate the issue of regulatory overlap between the SFC and the HKMA. The HKMA would continue to have an overall supervisory responsibility for the totality of business conducted within a banking group, including that conducted within securities subsidiaries. What this means is that it is not possible to "compartmentalise" supervisory responsibilities in a way that avoids regulatory overlap. The issue is whether the division of these

supervisory responsibilities makes sense in the context of the particular circumstances of Hong Kong, provides the requisite degree of protection for investors, and minimises the regulatory burden on the supervised institutions. We believe that the arrangements embodied in the Securities and Futures Bill meet these objectives.

Insurance and MPF Industries

10. A detailed analysis of the possible roles played by AIs in the insurance and MPF industries is provided separately in Paper No. 5C/01 circulated to Members in parallel.

11. As explained in paragraphs 2-5 above, AIs play the role of an “agent” in collecting securities orders from customers and relaying those orders to a Stock Exchange participant. This is similar to the role of AIs as “insurance agent” and “MPF intermediary”, through which they bring business to insurers and MPF scheme operators. There is **no requirement for AIs to subsidiarise their business as “insurance agent” or “MPF intermediary”**, and the HKMA remains the frontline regulator for the operations of AIs in those areas. This is in line with the framework proposed in the Securities and Futures Bill.

12. It is also relevant to note that, at the individual staff level, the HKMA currently requires AIs to ensure that their securities staff meet the SFC Fit and Proper Criteria and observe the relevant SFC codes and guidelines (such as the Code of Conduct). The framework stipulated in the Securities and Futures Bill will strengthen this arrangement by applying the relevant SFC codes and guidelines directly to AIs. The Fit and Proper Criteria will also continue to apply to individual AI staff, whose names will be included in a new register to be maintained by the HKMA. This “register” concept regarding AIs’ securities staff is similar to the registration system for the staff of insurance agents and MPF intermediaries. For example, details of the technical representatives of insurance agents who meet the fit and proper criteria are included in a register maintained by the self-regulatory industry body which performs the vetting. In the case of MPF, the fit and proper representatives of MPF intermediaries are also included in a register kept by the Mandatory Provident Fund Schemes Authority subject to basic vetting.