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30 June 2003

Ms Connie Szeto
Clerk to Panel on Financial Affairs
Legislative Council
Legislative Council Building
8 Jackson Road
Central

Dear Ms Szeto,

Panel on Financial Affairs

Follow-up to special meeting on 13 June 2003
Item II – Discussion on the Report by the Expert Group to Review
the Operation of the Securities and Futures Market Regulatory Structure

Thank you for your letter of 16 June 2003.

In response to Hon Sin Chung-kai's specific request, I attach herewith a copy of the written submission dated 19 November 2002 from the Secretary for Financial Services and the Treasury to the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure (Expert Group).

We note that at the Panel meeting on June 13, some members considered that the timeframe for conducting the post-Expert Group consultation was about right; whereas some other members suggested that the timeframe should be shortened. In response to Members' comments, we aim to commence the consultation process in the third quarter of this year. As for Hon Emily Lau's

request for an update on our progress in following up the Expert Group report, we shall be pleased to update the Panel of the consultation exercise and our colleagues will discuss with you the updating arrangements in due course.

Yours sincerely,

(Mrs Avia Lai)
for Secretary for Financial Services and the Treasury

c.c. PSFS
AA/FS
C/HKEx
C/SFC

財經事務及庫務局局長

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SECRETARY FOR FINANCIAL
SERVICES AND THE TREASURY

Central Government Offices,
Ice House Street,
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19 November 2002

Mr Alan Cameron
Chairman
Expert Group to Review the Operation of the
Securities and Futures Market Regulatory Structure
Room 716 Main Wing
Central Government Offices
18 Lower Albert Road
Central
Hong Kong

Dear Mr Cameron,

**REVIEW OF THE OPERATION OF
THE SECURITIES AND
FUTURES MARKET REGULATORY STRUCTURE**

Thank you for your letter of 12 October 2002.

Further to our meeting with the Expert Group on November 5, we write to set out our thoughts on the regulatory arrangements for listing functions; and the lines of communication between the Government, the Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx).

Regulatory Arrangements for Listing Functions

We believe that for Hong Kong to strengthen its position as an international financial centre and sharpen its competitive edge as the premier capital formation centre for the Mainland, we must place emphasis on enhancing our corporate governance regime. This is the key to ensure a

quality market capable of instilling confidence in investors and adding value to corporations.

Good corporate governance requires effective regulatory arrangements for listing functions. As more than 70% of Hong Kong's listed companies are incorporated overseas and hence fall outside the bulk of regulatory requirements in the Companies Ordinance, we have to rely largely on the non-statutory HKEx Listing Rules to regulate the issuers. Improvement to both the contents and interpretation of the Listing Rules is the key to upholding market quality.

Against this background we submit that the effectiveness of any proposed regulatory arrangements for listing functions must be assessed by reference to its ability to allow for -

- (a) flexible adjustment and timely improvement to listing requirements for issuers in light of changing market development needs and international regulatory standards; and
- (b) fair, consistent and sound enforcement of the listing requirements, including the supervision of the listing process and the ongoing compliance by issuers, with effective deterrents for upholding market quality and hence better protection of investors.

We also submit that the regulatory arrangements should take into account the factors set out in the ensuing paragraphs.

Nature of the listing requirements: Statutory or Non-statutory?

The status of the Listing Rules has a direct impact on their enforceability and hence deterrent effects against breach.

As part of the securities law reform exercise, we consulted the public in July 1999 on a proposal to give statutory backing to the Listing Rules to empower the SFC to apply to the Court for orders compelling compliance with the Listing Rules. Given the state of law in Hong Kong, we were subsequently advised that such a move would give the status of law to the Listing Rules, which will in effect become statutory provisions subject to normal rules of legislative interpretation and procedures for amendment.

The market welcomed measures to strengthen the enforceability of the Listing Rules, but considered that the Rules should remain non-statutory to allow for flexibility in both their contents and interpretation so that they may

evolve in keeping with market development and innovation. As a compromise, we have in its place adopted alternative measures under the newly enacted Securities and Futures Ordinance to enhance the quality of corporate disclosure under the Listing Rules e.g. “dual filing” and civil right of action for damages resulting from false or misleading disclosure. In addition to these latest efforts, we have an open mind on which listing requirements should become statutory so as to enhance their enforceability. We should however not lose sight of the need to preserve the flexibility and expeditious interpretation of the Rules that are considered to be vital for market development.

Lead agency to update listing requirements?

The law empowers the HKEx to make non-statutory rules governing listing requirements. These HKEx rules are subject to SFC approval before they may take effect. The SFC may direct the HKEx to make or amend its non-statutory rules. The law also empowers the SFC to make statutory rules to govern listing. These SFC rules are subject to vetting by the legislature. At present the HKEx is looked upon as the lead agency in updating listing requirements through amendments to its non-statutory Listing Rules. The HKEx has delegated this function entirely to its Listing Committee to avoid conflict of interest. In performing this function, as for other public functions, the HKEx is required by law to take into account public interest, and where the public interest is in conflict with its shareholders’ interest, the public interest should prevail.

We note that since the merger there has been public debate as to whether the arrangement for the HKEx to take the lead in updating the listing requirements is a satisfactory one. Amendments to the Listing Rules that touch the nerve of vested interest groups will attract diametrically opposed views from the stakeholders and may turn into a political debate. To bring these amendments into effect in the public interest requires both determination and, the necessary political mandate. This has raised the question as to whether the HKEx is in the position to perform this function independently and without being distracted from its other market development commitments. This has also cast doubt in the public eyes on whether, given these constraints in performing this function, the HKEx is able to align itself with our overall policy in enhancing corporate governance.

Lead agency to enforce listing requirements?

We recognise that for any agency to enforce the listing requirements effectively it must be vested with proportionate powers to investigate into the conduct of the intermediaries and issuers involved and

verify the information disclosed. There is a limit to which the HKEx as a for-profit listed company could be vested with such powers. With the coming into effect of the Securities and Futures Ordinance the SFC will be vested with more extensive inquiry and investigative powers to look into corporate misconduct. In this regard the SFC is in a position to enforce listing requirements effectively and independently.

Nature of sanctions and deterrent effects

The primary objective of the above-mentioned July 1999 consultation exercise was to enhance the deterrent against a breach of listing requirements without turning the latter into statute. Failing this, we recognise that the existing choice of sanctions available to a breach of listing requirements, which are basically contractual obligations, by issuers and their intermediaries are limited, and sometimes disproportionate to the seriousness of the breaches which may undermine investors' confidence in the market.

Even if the Listing Rules are to be uplifted into the law, there is a limit to which the sanctions may be enhanced if they are to remain a civil regime. Given the Bill of Rights (BOR), past legal advice is that excessive civil sanctions may turn the regime into a criminal one, that is, requiring all safeguards necessary for a criminal regime which would render the listing functions highly inflexible. But if the SFC is to establish a nexus with the issuers so that they become members of SFC's direct regulated class, it may apply tougher sanctions on the issuers without breaching the BOR. This however will have to be subject to further legal advice.

More immediate solutions may lie in vigorous enforcement by the SFC and the Police of criminal offences in existing laws like false disclosure, market misconduct, theft and fraud by issuers and their intermediaries, supplemented by regulatory sanctions by the SFC against those, who are in its regulatory net and have breached its regulatory requirements. With the commencement of the Securities and Futures Ordinance, the SFC will be able to impose a civil fine of up to \$10 million on its licensees, including those licensees acting as intermediaries for issuers in the listing process. It may also consider promulgating guidelines governing the conduct of IPO intermediaries including investment bankers, accountants and valuers. Compliance with such guidelines may become one of the conditions for the SFC to take into account in considering whether to veto a listing application under the "dual filing" regime.

Expertise a must: Market savvy and risk taking ethos

We believe that effective performance of the listing functions requires an expert team of executives who possess the necessary market savvy and are able to strike a reasonable balance between promoting new products and controlling their quality when vetting applications from issuers. They should be close to, but not cosy with the market in understanding the market development needs. To do so they must have access to the advice of market practitioners with the relevant experience and expertise, possibly through a listing committee of some form.

The listing executive should be free from bureaucratic red tape and prepared to remove unnecessary procedures. They should be prepared to look beyond the work process and documentation. They should be willing to assume reasonable risks in exercising their discretion in interpreting listing requirements having regard to market consensus and be able to defend their decisions. In their ongoing supervision for compliance with listing requirements, they should stand ready to impose sanctions in a consistent and transparent manner without fear or favor.

More importantly the listing authority should consider itself as a partner with the market, not merely as a regulator, and be prepared to listen to the market users.

Conflict of interest?

Since the merger, there has been public debate on the potential conflict of interest for HKEx, a for-profit listed company, being the authority in making listing requirements, vetting listing applications and supervising ongoing compliance with the requirements. The philosophy behind the distribution of frontline regulatory work between the SFC and HKEx after the merger stems basically from the belief that the HKEx should be allowed to achieve quality assurance which is essential to attract business and that regulatory overlap should be avoided as far as possible. We recognise that it has left a perception issue unresolved, despite the checks and balances enshrined in the Exchanges and Clearing Houses (Merger) Ordinance.

We are however equally aware that there would also be perceived constraints for a non-profit body independent of HKEx to perform the listing functions, in that the independent body would aim to minimise its reputational risks in vetting new listing applications and supervising ongoing compliance, and that this might be at the expense of market innovation and development. This might overkill the market.

To provide a reality check on the performance of functions by the listing executive, no matter where they are stationed i.e. in the HKEx or a body independent of the HKEx, the executive should be subject to the advice of an independent committee comprising intermediaries, issuers and investors who are broadly based and representative of the market users. The committee may be appointed by the regulator. It should play a pivotal role in the decision-making process for listing matters and monitoring the performance of the listing executive.

Clear ownership

For any proposed regulatory arrangements for listing functions to be viable in the present-day political landscape, the ownership and hence accountability in updating the listing requirements, their interpretation and hence vetting of listing applications and ongoing supervision, must be clearly articulated for the respective owners to perform their duties and for the public to monitor and assess. The arrangements should seek to minimise any overlap in regulatory efforts and duplication of regulatory requirements, as well as to remove any regulatory gaps in between owners. It should seek to encourage necessary action by the listing authority in a responsive and responsible manner for protecting the investors and preserving market integrity. In this regard we note the risk inherent in co-ownership of regulatory responsibilities.

Lines of Communication in the Tiered Regulatory System

The powers, functions and duties of the Administration, SFC and HKEx are set out clearly in existing Ordinances, now consolidated and re-enacted in the Securities and Futures Ordinance, in particular Parts II and III thereof.

Administration and the SFC

For the proper exercise of these powers and performance of these functions and duties, we have over the years established some administrative procedures and practices with the SFC for the following matters –

(a) preparation of legislation affecting the work of the SFC

One of SFC's regulatory functions, as enshrined in the Securities and Futures Ordinance, is to recommend reforms of the law relating to the securities and futures industry. These cover both primary legislation and subsidiary legislation. Subsidiary legislation includes rules and regulations made by the SFC e.g. rules governing the handling of clients' assets by brokers,

or the Financial Secretary and the Chief Executive in Council e.g. levy rules, all subject to vetting by the legislature. The Administration assumes responsibility for primary legislation and subsidiary legislation made by the Financial Secretary and the Chief Executive in Council, whereas the SFC assumes responsibility for the subsidiary legislation made by it.

(b) Management of inter-agency/cross-sectoral projects for financial services

The Administration plays a coordinating and facilitating role in bringing the SFC and other concerned parties together for the design and execution of cross-sectoral projects e.g. SCEFI and market contingency rehearsals, to enhance market efficiency and quality and better manage systemic risks.

(c) Interface with LegCo

From time to time, the Legislative Council invites the Administration to speak on matters falling within the purview of the SFC and/or the HKEx e.g. regulation of listed companies, IT glitches of exchange trading systems, amendments of listing requirements, etc. The Administration acts as a shepherd in bringing the SFC and/or the HKEx to these meetings with the Legislative Council and may speak on relevant policy issues.

(d) Checks and balances

Under the law, the Administration is required to perform certain functions, which are seen by the public as checks and balances promoting the proper performance of functions by the SFC. These include –

- (i) appointment of the SFC governing body and its Advisory Committee
- (ii) institution of hearings by the Insider Dealing Tribunal for referrals from the SFC
- (iii) approving SFC budgets and laying them before the Legislative Council receiving SFC annual reports and laying them before the Legislative Council

- (iv) appointment of an appeal body to review the merits of SFC regulatory decisions

The Administration maintains a close liaison with the SFC for discharging these statutory duties.

In addition to these statutory checks and balances, the Administration has also established a Process Review Panel in late 2000 to review the regulatory procedures and processes of the SFC to ensure that they are consistently and fairly followed.

We are considering the need to articulate the relationship between the Administration and the SFC in a form of publicly available documents. The aim is to promote better understanding by the public of the roles and duties of the Administration and the SFC under the tiered regulatory framework and to assist the Administration and the SFC in closing any gap in public expectation.

Administration and HKEx

The Administration does not maintain any day-to-day dialogue with the HKEx. It is conscious of the role of the SFC as the regulator for HKEx and that under the tiered regulatory structure the SFC has the statutory responsibility to supervise, monitor and regulate the activities of the HKEx. Its communication with the HKEx is usually routed through the SFC or conducted during the FSTB/SFC/HKEx Tripartite Meetings, which are held on a bimonthly basis to consider major issues of general market concern.

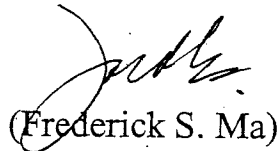
Under the law, the Administration's nexus with the HKEx lies mainly in the statutory requirements regarding approval of appointment of HKEx Chairman, appointment of public interest directors to the HKEx Board, and appointment of members to the HKEx Risk Management Committee. These are safeguards built into the merger legislation to promote proper performance of public functions by the HKEx. The Administration maintains a close dialogue with the SFC and HKEx in making these arrangements.

There is the expectation in certain quarters of the community that as the Administration is responsible for making these appointments to the HKEx,

it should also be held accountable for the performance of public functions, and indeed any functions, by the HKEx. We are prepared to articulate the Administration's role further in a public statement. We are however aware that this may not be effective in closing the expectation gap.

We hope the above will be useful for the Expert Group's deliberations on these important matters.

Yours sincerely



(Frederick S. Ma)
Secretary for Financial Services and the Treasury

cc PSFS
AA/FS