

**Bills Committee on
Securities and Futures (Amendment) Bill 2005**

Follow-up to the third meeting on 30 May 2005

This paper sets out the Administration's response to the issues raised at the third meeting of the Bills Committee held on 30 May 2005.

- (a) **To consider stipulating the division of roles and responsibilities between the non-executive Chairman and the Chief Executive Officer (CEO) of the Securities and Futures Commission (SFC) in the legislation.**

We have reconsidered the matter and maintain the view that it is inappropriate to stipulate rigidly in the legislation the division of roles and responsibilities between the Chairman and CEO of the SFC. Our reasons are detailed as follows :

- (a)(i) The current provisions in the SFO do **not** stipulate the duties and division of responsibilities between Chairman, Executive Directors (EDs) and Non-Executive Directors (NEDs) but there is at present clear division of responsibilities between them. Such division of responsibilities is not statutory but is implemented by administrative means and has worked very well for over 16 years since the establishment of the SFC in 1989. We are not aware of any circumstances or evidence suggesting that the current administrative division of work cannot succeed in the division of responsibilities between Chairman and CEO.
- (a)(ii) The Administration has already set out the broad principles governing the division of roles and responsibilities between the Chairman and CEO in our various papers to the Legislative Council, including the Panel on Financial Affairs and the Bills

Committee. The SFC governing body¹ will be invited to comment and agree on those broad principles, after which it will be requested to start drawing up the detailed division of work as well as the arrangements governing the implementation of the division of work.

- (b)(i) In the local experiences we made reference to, such as the Mass Transit Railway Corporation Limited (MTRCL), Kowloon Canton Railway Corporation (KCRC), Airport Authority and the Mandatory Provident Fund Schemes Authority (MPFA) etc., the detailed division of responsibilities of their Chairmen, members or directors are not prescribed in the relevant legislation, but implemented by administrative means and has been proven successful.
- (b)(ii) For instance, in the case of the MTRCL, the division of responsibilities between the Chairman and CEO is not prescribed in the Mass Transit Railway Ordinance (Cap. 556) but set out in the annual report of MTRCL. As for the delegation of the day-to-day management responsibilities to the Executive Directors, they are set out in the Articles of Association and Protocol adopted by the MTRCL Board.
- (b)(iii) In the case of KCRC, the KCRC Ordinance (Cap. 372) was amended in 2001 to provide for the separation of the post of Chairman into a non-executive Chairman post and CEO post. While section 3(2A) of the KCRC Ordinance provides that “the functions of the Chairman and the Chief Executive Officer shall be the functions assigned to them by this Ordinance and any functions that the Corporation may assign to them”, the division of roles and responsibilities between the Chairman and CEO are not spelt out in the legislation but set out in the Legislative Council Brief issued on 27 September 2001².

¹ Under the Securities and Futures Ordinance, the Commission shall consist of Chairman, Executive Directors and Non-executive Directors (section 1, Part 1 of Schedule 2). To distinguish between the Commission and its employees /staff, the term “governing body” is used to represent “the Commission” in this paper.

² Legislative Council Brief on Kowloon-Canton Railway Corporation (Amendment) Bill 2001 of 27 September 2001 (File Reference : TBCR 3/1015/98 Pt.3)

- (b)(iv) In the case of the Airport Authority, section 3(6) of the Airport Authority Ordinance (Cap. 483) only provides that the Chairman shall perform such duties and responsibilities as pertain to the office of a Chairman, in particular, the Authority's policy and external affairs, and assign functions to the Chief Executive officer. The Ordinance does not spelt out in detail the duties and division of responsibilities between the Chairman and the CEO.
- (b)(v) In the case of the MPFA, the division of responsibilities between the non-executive Chairperson, Managing Director and other Directors are also not provided in the Mandatory Provident Fund Schemes Ordinance (Cap. 485). Section 6B of the Ordinance only provides that the Managing Director is the administrative head of the Authority and has such other responsibilities as may be assigned by the Authority”.
- (c) The division of responsibilities between the Chairman and the CEO of the UK Financial Services Authority (FSA) is also not laid down in the Financial Services and Market Act but only set out in the FSA's Annual Report.
- (d) Having regard to the current SFO as well as local and overseas experiences which also do not stipulate rigidly the division of responsibilities between Chairman and CEO in the relevant legislation, we are of the view that duties and responsibilities would evolve over time and it is prudent to provide flexibility to the governing body to fine-tune and adjust the duties and relationship between Chairman and CEO; executive and non-executive directors, in order to suit the operational needs of that particular body in accordance with its statutory objectives, functions, powers and duties. Such a flexibility should also apply in the case of the SFC.

(b) To explore the feasibility of drawing up the proposed delineation of roles and responsibilities in consultation with the SFC.

2. The Administration considers the suggestion of the Bills Committee feasible. As a first step, the Administration has written to the governing body of the SFC inviting the latter to comment on the broad principles set by the Administration in delineating the roles and responsibilities of the future Chairman and CEO of the SFC. As soon as the broad principles are agreed, the Administration will invite the governing body to consider and draw up the proposed details and arrangements governing the division of responsibilities, which will be attached to the appointment letter of Chairman and the employment contract of the CEO. Such details and arrangements will also be made known to the public in the form of a press release and uploaded onto the website of the SFC.

(c) To re-consider the proposed level of remuneration for SFC Chairman.

3. The Administration wishes to reiterate that the future Chairman post is not an employment with the SFC but a voluntary service to the community of Hong Kong. It is generally accepted by the public and members of advisory and statutory bodies that public service to such bodies is on a voluntary service principle.

4. Having carefully considered that on the one hand the post is a service to the community and on the other hand the post comes with heavy responsibilities and high public expectations, we have already struck a balance by proposing to set the remuneration at around \$702,000, which is three times the remuneration for NEDs of SFC. To people with a commitment to serve Hong Kong, we believe remuneration is not a key consideration in deciding whether to accept an appointment of public service. As evident in many appointments in statutory organizations, we can see that there are many people who are willing to serve the community and devote a lot of their time and efforts in taking up public appointments with little or no remuneration. Some of these examples can be found in appointments to the Hospital Authority, Airport Authority, KCRC, etc.

- (d) To conduct an objective and broad-based search for the candidate for the chairman post instead of adhering to the existing mechanism for making appointments to public and statutory bodies by appointing someone from a limited pool of candidates.**

5. The appointment of the SFC Chairman is to be made by the Chief Executive pursuant to section 1, Part 1 of Schedule 2 of SFO. The appointment system will be in accordance with the present appointment system for advisory and statutory bodies, of which appointment on merit is the basic principle. The system has been operating efficiently and effectively in the appointment of members of some 500 advisory and statutory bodies, totaling about 5,000 individual members from a wide range of backgrounds.

6. We have previously set out the objective selection criteria of the Chairman in our various papers to the Panel on Financial Affairs and Bills Committee and they are recapped as follows :

- (i) good understanding about Hong Kong ;
- (ii) extensive experience in or good understanding about our business environment and the financial and securities market; and
- (iii) knowledge of or experience in the international financial markets;

7. These objective criteria will form the objective basis for the Government in the search of suitable candidates for the SFC Chairman post from various sources, including views from the industry and the community.

8. Through various sources, the FSTB will be able to trawl an initial list of suitable candidates possessing the above objective criteria. The list will then be further considered with regard to the following essential qualities required of the prospective candidate : -

- (i) integrity;
- (ii) commitment to serve the community;
- (iii) vision;
- (iv) leadership;

- (v) ability to communicate with the public and relevant stakeholders; and
- (vi) ability to establish a rapport with relevant bodies in other jurisdictions.

A final list of qualified and suitable candidates with all the relevant background information will then be drawn up and submitted to the Chief Executive for his consideration.

9. Hong Kong is a place full of talents and expertise. The Administration would be very careful in identifying the most suitable candidate for the Chairman post based on the objective criteria and the above-mentioned essential qualities. We welcome views from the industry and the community on the criteria, essential qualities and names of potential candidates.

(e) To stipulate who bears the ultimate accountability for the affairs of the SFC and to reflect this policy intent in the legislation.

10. In his speech to the Bills Committee on 19 May 2005 (see para 6 of Annex A), the incumbent Chairman of the SFC said that -

“The current law is very clear on who is the ultimate fully accountable face and head of the Commission. The Chairman is a full-time executive director of the Commission, ultimately responsible for the affairs of the Commission.”

However, the Administration wishes to reiterate that the current provisions in the SFO do not stipulate the division of responsibilities between Chairman, EDs and NEDs. Furthermore, there is no express provision in the SFO stipulating to the effect that the Chairman is the ultimate accountable face and head of the Commission.

11. In accordance with the SFO, it is the responsibility of the Commission (i.e. governing body) to perform the statutory duties, functions and exercise the statutory powers of the Commission. What stand behind functions, powers and duties are accountability and responsibility, which should go hand in hand. As a general principle, the SFC governing body is therefore ultimately responsible for the performance of the Commission under the SFO.

12. Notwithstanding the above general principle, according to section 10 of the SFO, save for the non-delegable functions specified in Part 2 of Schedule 2 of SFO, the governing body may delegate any of its functions to any member, staff or committee established by the SFC. Under the splitting proposal, the Chairman will continue to be accountable for the policies of the Commission as well as functions (about 8 of them) vested in Chairman in the SFO (Annex B), while the CEO will be accountable for operational matters of the Commission. In the cases of non-delegable functions which are matters for the governing body to consider, decide and carry out collectively, the governing body will be collectively accountable for the ultimate responsibility.

Financial Services and the Treasury Bureau
7 June 2005

Bills Committee on
Securities & Futures (Amendments) Bill 2005

Meeting on Thursday, 19 May 2005 at 10.45 a.m.

Opening Statement by Mr. Andrew Sheng
Chairman of the Securities and Futures Commission

Mr. Chairman,
Honourable members of the Bills Committee,

1. I am honoured to be invited to provide my views to the Honourable members of the Bills Committee on this important proposal of the Administration to change the SFC's governance structure.
2. Honourable members may recall that I attended the Financial Affairs Panel meeting on 3 January 2005 and presented my views on the Administration's proposal in that forum.
3. The position of the Commission has already been set out in our previous submissions to the Financial Affairs Panel. In relation to the specific questions raised by the Bills Committee in its first meeting on 22 April 2005, the Commission's views have been set out in Annex A to the Administration's follow-up response dated 12 May 2005. Since this is such an important proposal that will change the governance structure of the Commission and its operation, I welcome the opportunity to share my personal views and experience on the practical issues in implementing the proposed changes.
4. First, the objective of the proposal is to enhance the governance structure of the SFC in line with best governance practice both locally and internationally. As currently proposed, the role of the SFC Chairman should be separate from that of the executive arm to further enhance the internal checks and balances of the SFC. This, according to the Administration, creates the conditions for enhancing the independence of the governing body and hence its ability to discharge its supervisory functions over senior management.
5. There are three key questions that should be considered here:
 - a. The clarity of accountability of the head of the Commission;

- b. The checks and balances over the policy direction and execution of the policies of the Commission; and
 - c. The checks and balances over the internal management and administration.
6. The current law is very clear on who is the ultimate fully accountable face and head of the Commission. The Chairman is a full-time executive director of the Commission, ultimately responsible for the affairs of the Commission. His authority can be delegated to other staff, but the responsibility cannot be delegated. As I have said before, there can be only one captain in one ship. The amendment proposal makes this less clear, since the Chairman is neither an executive director nor a non-executive director. The work and authority will be split between two persons, the Chairman and Chief Executive Officer (CEO).
 7. The current trend in listed companies to split the chairman's job from that of the CEO is because, in theory, the chairman is supposed to represent the shareholders' interests relative to management interests. In the case of statutory and regulatory bodies, both persons must represent the public interest, hence the question of direct accountability becomes even more important.
 8. The need for a full-time executive Chairman is because it would be difficult, if not impossible to avoid getting into a conflict of interests position (real or perceived) if s/he, as a regulator, were to work part-time and hold other positions. The SFC Chairman's position heading up a regulatory body involved in investigation, prosecution and disciplinary actions on a wide range of persons puts him/her in a similar position to judges or police in terms of the need to avoid and be seen to avoid any conflict of interests. The Commission is sometimes characterised as a cop for the securities markets. For example, I know of no jurisdiction where the commissioner of police is a part-time, non-executive person.
 9. The reason for having full-time executives in charge is best explained by the Australian Securities and Investments Commission (ASIC) in its Annual Report 2003-04 on its Governance in which the following is stated:

"Three full-time Commissioners directed ASIC's affairs. Full-time membership let Commissioners monitor and direct ASIC's complex and wide-ranging activities, and avoided conflicts of interest that might otherwise affect part-time Commissioners still active in business, law or accounting" (at p.50).
 10. Following the collapse of the HIH insurance company in Australia, the governance structure of the Australian Prudential Regulatory

Authority (APRA) changed from a non-executive Board, with a non-executive chairman with the CEO as the only executive board member, to an executive Board, which comprises the executive chairman and two executive commissioners carrying the responsibility, and accountable to the government for the operations of the APRA. This echoes what happened in Hong Kong back in 1989 when the old system of a non-executive chairman and executive Commissioners of Securities and Commodities was replaced with the creation of the SFC headed by an executive chairman with a board comprising executive and non-executive directors. At that time, the Hay Davison Report was critical of the part-time role of the Securities Commission and the Commodities Trading Commission, since *“as part-time bodies, the Commissions cannot properly discharge their statutory duties of overseeing the Exchanges and ensuring investors are protected on a day-to-day basis”* (paragraph 9.26).

11. There are two technical points on the need for clarity in the law. The Administration in its letter to the Legal Services Division of the Legislative Council Secretariat dated 1 April 2005 stated that the SFC Chairman will not be regarded as an executive or non-executive director of the SFC. The SFC Chairman will simply be the “chairman”. As Section 2 of Part 1 of Schedule 2 to the SFO would no longer exist, s/he will not be included for the purpose of calculating the requisite majority or quorum under the Schedule 2 provisions that expressly refer to executive directors or non-executive directors. It seems odd that the SFC Chairman will be invisible for quorum purposes but still have a casting vote.
12. The same letter states that the SFC Chairman will be the head of the Commission and will sign the financial statements of the Commission, but the CEO, who will be responsible for the day-to-day affairs of the Commission will not sign the financial statements. Since the accounts must be signed by an NED anyway under the SFO and given the role to be played by the CEO it might make more sense to enable the CEO to sign off on the accounts instead, particularly if the SFC Chairman is non-executive and not full time.
13. The nature of the regulatory work of the Commission, which is highly legalistic and procedural, requires anyone accountable for the work to devote his or her full time attention to that work, particularly since what appears to be an individual case can set precedent for other cases or have wide policy implications. This in practice requires full time attention.
14. In other words, in practical terms, under the new system it will be difficult to say that the CEO is responsible for day-to-day decisions of the SFC and the SFC Chairman is fully accountable as the Head

of the Commission. If the CEO reports to the Chairman, then in practice, he is not the Chief Executive. All in all, the practical implications of the proposal cannot be ignored and must be carefully thought through.

15. The second issue is which part of the governance of the current structure will the split role improve or enhance? Since both the Chairman and the CEO, and indeed the whole Board, serve the public interest, the key policy objective is to ensure that the Commission meets its statutory objectives and carries out its statutory functions. The current checks and balances on the Commission are already extremely transparent and world class, with non-executive directors chairing the Budget, Audit and Remuneration Committees, and with non-executive directors outnumbering the executive directors. The regulatory processes and decisions of the Commission are subject to checks such as the Ombudsman, the Process Review Panel, the SFAT or judicial review. The Commission is already fully accountable to the public on the extent to which it fulfils its statutory objectives and functions. How will the split role enhance that accountability?
16. The third part of the governance structure is internal management and administration. If the Chairman is also the CEO, then should there be further checks and balances on the internal management and administration? Currently, the Management Committee of the Commission is already chaired by the Chief Operating Officer. As mentioned earlier, the internal Budget, Audit and Remuneration Committees are all chaired by NEDs. Both the Audit and Remuneration Committees comprise only NEDs. An NED chairs the Budget Committee and the majority of its members are NEDs.
17. In the case of the Ontario Securities Commission where the Chairman and CEO have not been separated, the position of Lead Director was created, filled by a NED. Acting in consultation with the Chair and the Chairs of the Board Committees, the Lead Director is responsible for overseeing the operations of the OSC's Board of Directors to ensure that it carries out its responsibilities effectively. This includes providing greater assurance that the responsibilities of the Board and its Committees are well understood by Commission members and management, that its resources are adequate, that it receives relevant information on a timely basis and that its effectiveness is assessed on a regular basis. This is one possible model that can be examined.
18. On the international implications of the proposed amendment, I would just like to point out that all current Chairmen of the fifteen members of the IOSCO Technical Committee are executive chairmen and are full time. Since I am currently chair of the

Technical Committee, it would be helpful for the Legislative Council Secretariat to directly consult the Chairman of the Executive Committee of IOSCO and the Deputy Chairman of the Technical Committee of IOSCO for independent assessments of the questions posed on international implications and experience.

Concluding remarks

19. As previously mentioned, the Commission fully recognises that the decision regarding the split between SFC Chairman and a CEO is a policy decision that is the prerogative of the Government. However, given the importance of this policy decision, we feel that the Administration and Legislative Council should carefully weigh all the relevant factors and long-term implications. I personally believe that it would be important that the law is clear on who exactly is the fully accountable face of the Commission. As an international financial centre proud of its rule of law, we should have clarity of law in this matter. I wish to repeat that whatever change is made, it needs to be handled in a way which does not undermine the reputation or the authority of the SFC domestically or internationally, which could affect Hong Kong's standing as an international financial centre.
20. Thank you for giving me the opportunity to present my views.

Securities and Futures Commission
19 May 2005

**Powers, functions and duties to be exercised by the Chairman of the
Securities and Futures Commission under
the Securities and Futures Ordinance (Cap. 571)**

| Description | Section(s) |
|---|---------------------------------------|
| (i) Chief Executive to give written directions to the Commission <u>after consultation with Chairman.</u> | s.11(1) |
| (ii) Chairman and one non-executive director (NED) to sign the financial statements of the Commission | s.15(2)b |
| (iii) Chairman and at least one NED to sign the financial statements of the Investor Compensation Fund. | s.240(4) |
| (iv) Chairman to designate an executive director to act as chairman. | s.6, Part 1, Schedule 2 |
| (v) Chairman may convene meetings of the Commission and, if present, shall preside at the meeting. | s.14 and 15, Part 1, Schedule 2 |
| (vi) The chairman of the meeting has a casting vote in case of equal votes. | s.19, Part 1, Schedule 2 |
| (vii) Chairman or deputy chairman or other member as authorized shall authenticate the affixing of the seal. | s.25, Part 1, Schedule 2 |
| (viii) Chairman shall be a member of the Advisory Committee, may convene meetings and if present, shall preside at the meeting. | s.27-29, Part 1, Schedule 2 |