

立法會
Legislative Council

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by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 4 July 2005 at 9:00 am
in the Chamber of the Legislative Council Building

- Members present** : Hon Bernard CHAN, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon LEE Cheuk-yan
Dr Hon David LI Kwok-po, GBS, JP
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon SIN Chung-kai, JP
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS
Hon CHIM Pui-chung
Hon Albert Jinghan CHENG
Hon TAM Heung-man
- Member attending** : Hon Howard YOUNG, SBS, JP
- Member absent** : Hon Albert HO Chun-yan

**Public officers
attending**

: Agenda Item III

Mr Raymond LI, JP
Deputy Chief Executive (Acting)
Hong Kong Monetary Authority

Agenda Item IV

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Eddie YUE, JP
Executive Director
Hong Kong Monetary Authority

Agenda Item V

Mr Richard YUEN, JP
Commissioner of Insurance

Ms Maisie CHENG
Deputy Commissioner for Tourism

Mr Ros LAM
Assistant Commissioner of Insurance (Policy)

Ms Cora HO
Principal Assistant Secretary for Financial Services and
the Treasury (Financial Services) 3

Agenda Item VI

Mr Frederick MA, JP
Secretary for Financial Services and the Treasury

Mr Kevin HO, JP
Permanent Secretary for Financial Services and the
Treasury (Financial Services)

Mr Albert LAM
Deputy Secretary for Financial Services and the Treasury
(Financial Services)

Mr Gordon W E JONES, JP

Registrar of Companies

Attendance by invitation : Agenda Item III

MasterCard International

Mr Danny CHEUNG
Vice President & Greater China Business Manager

Mr Barry WONG
Director, Regional Support, Security & Risk Management

Visa International

Miss Prudence CHAN
Country Manager, Hong Kong/Macau

Mr Michael CHAN
Country Risk Manager, Greater China Region

Clerk in attendance : Miss Salumi CHAN
Chief Council Secretary (1)5

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Ms Connie SZETO
Senior Council Secretary (1)4

Ms May LEUNG
Legislative Assistant

I. Confirmation of minutes of meetings

(LC Paper No. CB(1)1918/04-05 — Minutes of meeting of the Panel on Financial Affairs (FA Panel) on 6 May 2005

LC Paper No. CB(1)1951/04-05 — Minutes of joint meeting of Panel on Planning, Lands and Works (PLW Panel) and FA Panel on 24 May 2005

LC Paper No. CB(1)1919/04-05(01) — List of outstanding items for discussion

LC Paper No. CB(1)1919/04-05(02) — List of follow-up actions)

Confirmation of minutes of meetings

The minutes of the FA Panel meeting held on 6 May 2005 and the minutes of the joint meeting of the PLW Panel and FA Panel on 24 May 2005 were confirmed.

Comprehensive review of the Inland Revenue Ordinance

2. Miss Mandy TAM said that in response to her call for the Administration to conduct a comprehensive review of the Inland Revenue Ordinance (Cap. 112), five organizations/individuals had forwarded their submissions to the Panel expressing views on the subject. Miss TAM suggested that the Administration and the relevant organizations/individuals be invited to attend a meeting of the Panel in the 2005-06 session for discussion of the subject.

3. The Chairman said that the five submissions had been forwarded to the Administration for written response. The Clerk added that according to the Financial Services and the Treasury Bureau, it had been working closely with the Inland Revenue Department on how the submissions should be followed up, and would provide the Panel with a written response in due course. Members agreed that Miss Mandy TAM's suggestion for discussion of the subject should be considered at a later stage, i.e. after receipt of the Administration's written response.

(Post-meeting note: The submissions on the subject and the Administration's written responses were circulated to members vide LC Paper No. CB(1)2260/04-05 on 13 September 2005. As directed by the Chairman, the Administration was invited to update the Panel in writing on the progress of its actions on some issues raised in the submissions before the end of December 2005.)

II. Information paper issued since the last meeting

4. Members noted that an information paper on "Mandatory Provident Fund Schemes Statistical Digest — March 2005 (LC Paper No. CB(1)1733/04-05)" had been issued since the last regular meeting held on 6 June 2005.

III. Protection of credit cardholders' personal data

(LC Paper No. CB(1)1919/04-05(03) — Paper provided by the Hong Kong Monetary Authority

LC Paper No. CB(1)1953/04-05(01) — Submission dated 29 June 2005 from MasterCard International

LC Paper No. CB(1)1953/04-05(02) — Submission dated 29 June 2005 from Visa International

LC Paper No. CB(1)1953/04-05(03) — Submission dated 29 June 2005 from American Express International Inc.)

5. The Chairman advised that the recent incident of breach of security standards by the CardSystems Inc. (CardSystems) in the United States (US) had aroused considerable public concern about the protection of credit cardholders' personal data. The Panel therefore invited the Hong Kong Monetary Authority (HKMA) and the card companies concerned to the meeting for discussion of the subject, in particular the causes of the incident; impact of the incident on credit cardholders in Hong Kong; liability for financial loss arising from the incident; follow-up actions taken/to be taken by HKMA, card companies and other concerned parties; and measures for enhancing protection of customer data in credit cards to prevent recurrence of similar incident in future.

6. The Chairman welcomed representatives of HKMA, MasterCard International (MasterCard) and Visa International (Visa) to the meeting. He reminded representatives of MasterCard and Visa that when addressing the Panel, they were not covered by the protection and immunity provided under the Legislative Council (Powers and Privileges) Ordinance (Cap. 382). The Chairman also drew members' attention that while the representative of American Express International Inc. (AE) was not available to attend the meeting, AE had provided a submission on the subject.

Briefing by HKMA

7. At the Chairman's invitation, the Deputy Chief Executive (Acting), Hong Kong Monetary Authority (DCE(Atg)/HKMA) briefed members on the subject. He highlighted the following points:

- (a) The major parties involved in the credit card system included the network operators, such as MasterCard, Visa and AE; card issuers and merchant acquirers which were mainly banks (i.e. Authorized Institutions (AIs) in Hong Kong); merchants; cardholders; and third party service providers including third party processors and information technology (IT) processors. When a cardholder initiated a purchase, the merchant would

submit the transaction details (including the cardholder's personal data) to the card issuer for authorization through the third-party processor, merchant acquirer and network operator. The merchant acquirer would pay the merchant, and then the network operator would clear and settle the transaction with the card issuer and the merchant acquirer. The clearing and settlement processes would normally be completed within one and three days respectively. The card issuer would then issue the bill to the cardholder;

- (b) CardSystems was a third party processor providing authorization and validation processes on behalf of the merchant or merchant acquirer in the US. CardSystems reportedly breached the security standards set by the network operators by retaining sensitive cardholder data after completion of authorization process and failing to encrypt the data should such data be retained for special business, legal or regulatory purposes. The cardholder data kept by CardSystems was hacked and the compromised data could be used for fraudulent card transactions;
- (c) Cardholders in Hong Kong might be affected if they had used their cards for payment to the retail outlets in the US either at the point-of-sale or through internet, and the retail outlets in the US had submitted the transaction information to the merchant acquirer through CardSystems. About 12 000 credit cards issued by AIs in Hong Kong were potentially affected by the incident. So far, a total of 134 cards had been reported to have unauthorized transactions involving an amount of \$740,000. AIs had contacted most of the potentially affected cardholders for card replacement. For those cardholders who could not be reached at the moment, transactions conducted through their cards were monitored closely;
- (d) As provided under sections 30.1(c) and (d) of the Code of Banking Practice (the Code), the card issuers would bear the full loss incurred when faults had occurred in the terminals, or other systems used, which caused cardholders to suffer direct loss; or when transactions were made through the use of counterfeit cards;
- (e) As regards follow-up actions for the incident, HKMA had requested AIs to re-assess the adequacy and effectiveness of controls over customer data security, retention and confidentiality (including AIs and their service providers). HKMA had also requested credit card companies, consumer credit bureau and debit card operators to assess the security controls over internal and outsourced processing of consumer and transaction data and to strengthen their security control systems where necessary. Moreover, HKMA had liaised with the Office of the Privacy Commissioner for Personal Data on the need for enhancing the protection for cardholders' personal data; and

- (f) The risk of occurrence of similar incident in Hong Kong was relatively low. HKMA had issued comprehensive guidelines to AIs for management and protection of IT systems, and had been conducting regular inspections on AIs and their service providers to ensure compliance with data security standards.

Briefing by MasterCard International

8. At the Chairman's invitation, Mr Danny CHEUNG, Vice President & Greater China Business Manager, MasterCard International briefed members on the follow-up actions taken by MasterCard for the incident. He highlighted the following points:

- (a) On 17 June 2005 (US time), MasterCard announced that it had identified a significant security breach at CardSystems in the US and subsequently alerted card issuers and the public of the incident. MasterCard first received the list of affected account numbers from CardSystems on 16 June 2005 (US time). The communication to all affected card issuers began on 17 June 2005 and was completed on 18 June 2005;
- (b) It was initially believed that 13.9 million MasterCard branded accounts globally might have been at risk. After examination of the account numbers sent by CardSystems, approximately 10.1 million of the possibly compromised accounts worldwide were MasterCard branded cards. The data retrieved from CardSystems revealed that a potential maximum number of 10 113 accounts could have been impacted in Hong Kong. However, the data maintained by CardSystems contained numerous duplicate and invalid account numbers. These numbers were expected to be significantly reduced. Hong Kong cardholders would not be held responsible for unauthorized card transactions;
- (c) The Federal Bureau of Investigation was investigating the crime, and regulators in the US were reviewing CardSystems' security protocols. In Hong Kong, MasterCard had informed cardholders through the media and member financial institutions' card call centers; and
- (d) MasterCard continued to stay vigilant and work with member financial institutions to monitor any unusual transactions or card activities. MasterCard had put in place a number of fraud detection and prevention initiatives to help members and merchants fight fraud. Furthermore, MasterCard was working on a programme which would alert the regulatory authorities of a security breach or potential fraud situation in the markets across Asia Pacific. This advisory would be disseminated at the same time as MasterCard's advisory to members to inform them of

potential fraud or compromised accounts. The regulatory advisory system was expected to be in place by end of July 2005.

Briefing by Visa International

9. Upon the Chairman's invitation, Miss Prudence CHAN, Country Manager, Hong Kong/Macau, Visa International briefed members on the follow-up actions taken by Visa for the incident. She highlighted the following points:

- (a) Approximately 40 million cards across all payment brands were involved in the incident. The vast majority of these cards were issued in the US. Around 205 000 accounts at risk were Visa cards issued by banks in Asia Pacific. Visa identified 9 122 accounts in Hong Kong that were potentially compromised by the security breach of CardSystems and therefore considered "at risk". It should be noted that 92% of the compromised information of Hong Kong cardholders did not contain the full magnetic stripe information needed to create counterfeit cards. Even for the remaining 8% of the accounts, there was not necessarily a link between accounts at risk and subsequent fraud, because of the fraud detection systems and processes installed by Visa and the issuers to monitor fraud and to help stop it from happening;
- (b) Full details of the compromised accounts were made available to Visa Asia Pacific on 19 June 2005 and to Hong Kong on 20 June 2005. Visa provided card-issuing banks in Asia Pacific with full details of the accounts involved within two days of receiving the data so that they could monitor the accounts independently and if warranted, cancel and reissue cards. Banks were taking appropriate action with their individual cardholders;
- (c) It was the practice of Visa's member banks in Hong Kong to absorb the cost for any fraudulent transactions made on accounts identified as "at risk" reported by Visa to issuers;
- (d) Visa had reached out to the media and addressed public concerns in Hong Kong through a number of channels including the media and Visa's website. Visa had worked with the media to inform cardholders of the situation, reassure them that they were not liable for fraudulent charges, advise them on measures they could take to help prevent fraud, and explain what was being done by Visa and the issuing banks in their fight against fraud;
- (e) Visa and its members had been undertaking extensive measures to monitor and protect the Visa system and engaged in cooperative efforts to deal quickly with any breach. Fraud within the global Visa system was at an all-time low of just seven cents per \$100 transacted. In Asia Pacific,

the rate was less than half the global rate at three cents per \$100 transaction. Members of Visa were required to ensure that all merchants and processors participating in the Visa payment system that stored, processed or transmitted Visa cardholder account and/or transaction information met the minimum security requirements as defined by the Account Information Security (AIS) standard, including standards for data encryption, the timely adoption of security updates and the destruction of data that was not needed. The two most important principles of the program were, “Don’t store the data unless you absolutely need it,” and “If you need to store the data, encrypt it”; and

- (f) On the enhancement of security features for the protection of consumers’ data, besides personal identity number protection, Visa had established a global standard, EMV (Europay, Mastercard, Visa), for chip-based debit and credit transactions with Europay and MasterCard. The EMV standard ensured security and global interoperability. EMV chip cards offered the best long-term solution to the problem of counterfeit fraud. Visa continued to work towards the establishment of a comprehensive EMV chip card infrastructure in Asia Pacific.

Discussion

Breach of security requirements by CardSystems

10. Given the worldwide impact of the incident and the need to restore confidence in the credit card system, Mr CHAN Kam-lam stressed the importance for the regulatory authorities and parties concerned to conduct thorough investigation into the incident and strengthen monitoring of the handling of cardholders’ information. He expressed concern whether there were loopholes in the monitoring system of third party processors and enquired about the liability of CardSystems for having breached the security requirements.

11. Mr Danny CHEUNG said that recognizing the public concern about the incident, MasterCard had immediately communicated with the card issuers concerned so that they could alert the affected cardholders of the problem. Furthermore, MasterCard had requested CardSystems to step up security of its system and destroy all transaction data which was no longer needed. CardSystems was required to provide written confirmation of its full compliance with MasterCard’s security standards before it would be allowed to continue participating in MasterCard payment system. Miss Prudence CHAN advised that Visa had immediately informed the card issuers concerned and alerted the public of the problem. It had also requested CardSystems to ensure its compliance with the AIS standards. As regards CardSystems’ liability for the incident, Mr CHEUNG and Miss CHAN advised that the incident was still under investigation by the law enforcement agencies in the US.

Impact of the incident on cardholders in Hong Kong

12. Noting that there were differences in the information on the number of credit cards potentially affected in Hong Kong as provided by HKMA, MasterCard, Visa and AE, Ms Emily LAU sought clarification on the number of cards issued in Hong Kong that might be affected by the incident.

13. In response, DCE(Atg)/HKMA advised that the number of 12 000 potentially affected cards was worked out from AIs' reports which had included figures provided by all network operators. Mr Danny CHEUNG said that while data from CardSystems revealed that a potential maximum number of 10 113 MasterCard accounts could have been impacted in Hong Kong, it was currently estimated that less than 2 900 accounts could be affected. It was because the data maintained by CardSystems contained numerous duplicate and invalid account numbers. Miss Prudence CHAN advised that the number of 9 122 potentially affected Visa accounts in Hong Kong was provided by Visa USA. She believed that the figures provided by HKMA should reflect the up-dated situation in Hong Kong. Upon Ms Emily LAU's request, DCE(Atg)/HKMA undertook to provide information on the exact number of credit cards issued by AIs in Hong Kong which were potentially affected by the incident.

14. Notwithstanding that cardholders would not be required to bear the financial loss for fraudulent transactions arising from the incident, Ms Emily LAU expressed concern that compromised card data might be used for fraudulent transactions later and that cardholders could suffer financial loss as a result. In this connection, Ms LAU enquired whether card issuers would set a time limit for absorbing the financial loss for fraudulent transactions arising from the incident.

15. DCE(Atg)/HKMA explained that the Code provided that a cardholder could raise with the AI concerned on unauthorized transactions within 60 days after issuance of the card statement. It was believed that in view of the impact of the incident, AIs would not apply the 60-day rule strictly. DCE(Atg)/HKMA also pointed out that as AIs had obtained information on the potentially affected cards, they should not have problem in identifying fraudulent transactions from these cards. Miss Prudence CHAN re-iterated that Visa would continue to monitor the affected cards. Cardholders would not bear financial loss for fraudulent transactions arising from the incident. Mr Danny CHEUNG advised that since card issuers had been making arrangement with affected cardholders to replace their cards, the potentially affected cards would eventually be cancelled and the compromised data contained therein would become invalid.

Follow-up actions taken by HKMA and network operators for the incident

16. Mr Ronny TONG pointed out that cardholders were normally required to inform card issuers of unauthorized transactions relating to their cards. In this connection, he enquired whether HKMA had worked out a list showing the information of all potentially affected cards to facilitate the cardholders to monitor whether their cards had been used for fraudulent transactions.

17. In response, DCE(Atg)/HKMA said that the network operators had provided AIs with lists of potentially affected credit card accounts. HKMA had required all AIs to take immediate follow-up actions with the cardholders concerned. It was noted that AIs had succeeded in replacing cards for the majority of the affected cardholders. For those cardholders who could not be reached at the moment, AIs could consider taking interim actions including closely monitoring the transactions involving these cards, or cancelling the cards. However, while cancellation of the affected cards would prevent fraud, this might cause inconvenience to cardholders. DCE(Atg)/HKMA also pointed out that network operators and card issuers had put in place effective measures to monitor unusual card transactions or activities and to detect fraud. As regards the duty for cardholders to monitor their own accounts on an on-going basis through checking regular statements, DCE(Atg)/HKMA remarked that this was an effective measure for cardholders to protect their own interests. When unauthorized transactions were identified, cardholders should raise the matter with the card issuers. All along, issuers had been handling cases of unauthorized card transactions in a reasonable manner. In the past three years, HKMA had only received one complaint in this aspect and the case had been resolved.

18. Mr Albert CHENG considered that HKMA had the responsibility to ensure AIs' compliance with the necessary security requirements in handling cardholders' personal data. He enquired about the measures taken by HKMA in monitoring AIs' compliance in this respect.

19. In response, DCE(Atg)/HKMA re-iterated that HKMA had issued comprehensive guidelines to AIs on matters relating to outsourcing, technology risk management and supervision of internet banking in handling of customers' data. AIs were required to obtain prior approval from HKMA before entering into an outsourcing contract. All major AIs were required to submit annual IT control self-assessment reports to HKMA. To ensure AIs' compliance with these requirements, HKMA's on-site examinations would cover review of AIs' IT control systems and their service providers. The right for HKMA to review the control systems of AIs' service providers was explicitly stipulated in the outsourcing contract between AIs and the service providers. HKMA considered that the existing guidelines were sufficient in preventing recurrence of similar incident in Hong Kong. Nonetheless, HKMA would conduct review of the guidelines in the light of the incident with a view to identifying areas for improvement.

20. Noting that HKMA was not notified of the incident by the network operators immediately after the security breach had been identified, Ms Emily LAU considered it necessary to enhance the communication between HKMA and the network operators on issues relating to credit card fraud and protection of cardholders' personal data.

21. In response, DCE(Atg)/HKMA pointed out that at present, HKMA had no statutory oversight for the network operators. The incident revealed that there was room for improvement in the communication between HKMA and the network operators regarding the problem of credit card fraud. A mechanism would be established between the two to facilitate communication and exchange of information on issues of mutual concern. Mr Danny CHEUNG re-iterated that MasterCard was working on a programme which would disseminate advisory of security breach and potential fraud situation across Asia Pacific to member financial institutions and regulatory authorities in the region simultaneously.

22. Members requested HKMA to provide results of its follow-up actions mentioned in paragraph 7(e) above.

Role of AIs in protection of customers' personal data

23. Mr WONG Ting-kwong enquired about for how long cardholders' personal data would be retained in the credit card payment system. Mr Danny CHEUNG replied that it would take a few seconds to complete the authorization process and the data would usually be retained for no more than two days to facilitate clearing and settlement of the transaction.

24. Mr Albert CHENG and Mr SIN Chung-kai considered that apart from HKMA and credit card network operators, AIs played an important role in the protection of cardholders' personal data. They suggested that the Hong Kong Association of Banks (HKAB) be invited to give views on the subject. Members agreed that HKAB be invited to provide written views on the subject, in particular on the following items:

- (a) Impact of the CardSystems incident on credit cardholders in Hong Kong;
- (b) Liability for financial loss arising from the incident;
- (c) Follow-up actions taken/to be taken by HKAB members for the incident;
- (d) In arranging card replacement for the potentially affected cardholders after the incident, whether the card-issuing banks had explained the reasons for replacement to the cardholders; and

- (e) Measures to be taken by HKAB members and HKAB (e.g. review of the Code) for enhancing the protection of customer data in credit cards to prevent recurrence of similar incident in future.

(Post-meeting note: HKAB's written reply was issued to members and non-Panel Members vide LC Paper No. CB(1)2175/04-05 on 8 August 2005.)

Measures to protect credit cardholders' personal data

25. Given that the incident had aroused considerable public concern about protection of credit cardholders' personal data, Mr Jeffrey LAM enquired about the devices for encrypting cardholders' personal data, treatment of sensitive information after cancellation of cards, and measures to safeguard against misuse of cardholders' personal data by the parties involved in the credit card system.

26. Mr Danny CHEUNG advised that with the advance in IT, card issuers had been making improvement in encryption devices to enhance security of cardholders' personal data involving the use of computerized secret codes where access was restricted to limited parties. Miss Prudence CHAN re-iterated that Visa's AIS programme aimed to ensure that all parties participating in the Visa payment system met the required security standards. The most important requirement was the destruction of the data that was no longer needed. She assured members that the risk of similar incident happening in Hong Kong was relatively low because AIs normally took up the work of the merchant acquirer instead of contracting out the work to a third party.

27. On Mr Jeffrey LAM's concern about the misuse of cardholders' personal data by the parties involved in the credit card system, DCE(Atg)/HKMA advised that there were provisions in the Personal Data (Privacy) Ordinance (Cap. 486) requiring the destruction of personal data by data users if the data was no longer needed. Moreover, HKMA's guidelines to AIs required the latter to obtain HKMA's prior approval before entering into an outsourcing contract with a third party. HKMA's on-site examinations covered review of AIs' service providers. DCE(Atg)/HKMA assured members that protection of cardholders' personal data and combat of credit card fraud remained issues of concern of the credit card industry, card issuers and regulators internationally. He was aware that the incident had been placed on the agenda of the meeting of the Committee on Payment and Settlement Systems of the Bank for International Settlements. It was believed that concerted efforts and cooperation in the international arena would enhance the protection of cardholders' personal data and help prevent credit card fraud.

28. With a view to preventing fraudulent card transactions, Mr CHAN Kam-lam suggested that card issuers should consider seeking cardholders' confirmation for transactions involving large amount before authorizing such transactions. In response, Miss Prudence CHAN welcomed the suggestion and undertook to explore its feasibility with card issuers.

29. Mr SIN Chung-kai expressed concern about the cost implication on AIs in adopting the EMV chip technology. He enquired about the plan for AIs to issue EMV chip cards in Hong Kong and whether HKMA would require AIs to adopt the technology for enhancing the protection of cardholders' personal data.

30. Miss Prudence CHAN concurred that EMV chip cards required huge financial investment in card infrastructure by card issuers, acquirers, and merchants. However, there was a strong business case for card issuers to adopt the advanced technology with a view to enhancing security of data and preventing card fraud. She added that Visa's commitment to EMV chip migration had seen national programs underway in four Asia Pacific markets. Many Visa members had been upgrading point-of-sale and transaction acquiring systems to prepare for the migration to EMV chip cards. As of March 2005, Visa had close to 33 million EMV-compliant chip cards and more than 743 000 EMV terminals deployed in the region. In Hong Kong, Visa members had issued around 220 000 EMV chip cards and major banks were either upgrading their systems for EMV chip migration or were in the project-planning stage. It was envisaged that about eight AIs would issue EMV Chip cards in 2006. These AIs had a market share of 80% in the local card industry.

31. Responding to Mr SIN Chung-kai's enquiry, DCE(Atg)/HKMA pointed out that HKMA did not have the legal mandate to require AIs to adopt EMV chip cards. Upon members' request, he undertook to provide information on the up-to-date position of AIs in issuing EMV chip cards, and AIs' plan in upgrading their infrastructure for EMV chip migration.

(Post-meeting note: HKMA's written response to members' requests mentioned in paragraphs 13, 22 and 31 above was issued to members and non-Panel Members vide LC Paper No. CB(1)2147/04-05(01) on 26 July 2005.)

IV. Briefing on the three refinements to the operation of the Linked Exchange Rate System

(LC Paper No. CB(1)1919/04-05(04) — Paper provided by the Hong Kong Monetary Authority

LC Paper No. CB(1)1585/04-05(01) — Letter dated 18 May 2005 from the Chief Executive of Hong Kong Monetary Authority enclosing a press release on the three refinements to the operation of the Linked Exchange Rate System)

Briefing by HKMA

32. At the invitation of the Chairman, the Executive Director, Hong Kong Monetary Authority (ED/HKMA) briefed members on the three refinements to the operation of the Linked Exchange Rate (LER) system introduced by HKMA with effect from 18 May 2005. He highlighted the following points:

- (a) The effects of the repeated episodes of capital inflow and pressure for the Hong Kong dollar to strengthen, which started in the third quarter of 2003, were getting stronger as the Hong Kong dollar was increasingly used as a vehicle for speculation on the revaluation of the renminbi (RMB). The Currency Board system functioned reasonably well, with the interest rate differential in time reversing the capital inflows and triggering the weak-side Convertibility Undertaking (CU). The situation had not, however, returned entirely to normal, and relatively easy monetary conditions continued to prevail;
- (b) Persistent market expectation on RMB revaluation and the complex market dynamics in the foreign exchange market had prevented the Aggregate Balance (AB) from returning to normal. Hong Kong dollar interbank interest rate persistently stayed below their US dollar counterparts throughout the period since the third quarter of 2003. A significant gap still existed between Hong Kong and US dollar interest rates in early May 2005;
- (c) Under the LER system, it was possible that domestic monetary condition might deviate from that of the anchor currency if there were market expectations of revaluation or devaluation. This was part of the normal adjustment through the real side of the economy under the Currency Board arrangements. However, the lack of a clear anchor on exchange rate expectation on the strong side of the Hong Kong dollar (as there was no explicit CU on the strong side) was a structural factor that had discouraged the interest rate arbitrage activities which helped the adjustments in the money and foreign exchange markets under the Currency Board arrangements. It was because gains on interest rate arbitrage could be quickly wiped out by losses from the strengthening of the Hong Kong dollar. This concern was further aggravated by persistent market expectations of an appreciation of RMB;
- (d) There was therefore a need to consider whether refinements to the Currency Board arrangements were needed to ensure that they could facilitate adjustments in the money and foreign exchange markets in the most efficient manner. With the agreement of the Financial Secretary following consultation with the Exchange Fund Advisory Committee (EFAC), HKMA announced on 18 May 2005 the introduction of the following three refinements to the operation of the LER system-

- (i) The introduction with immediate effect of a strong-side CU by HKMA to buy US dollars from licensed banks at 7.75;
 - (ii) The shifting of the existing weak-side CU by HKMA to sell US dollars to licensed banks from 7.80 to 7.85, so as to achieve symmetry around the Linked Rate of 7.80. This shift had been completed smoothly over five weeks by moving the exchange rate of the weak-side CU by 100 pips on every Monday starting with 7.81 on 23 May 2005 until it reached 7.85 on 20 June 2005; and
 - (iii) Within the zone defined by the levels of the CUs (the Convertibility Zone (CZ)), HKMA might choose to conduct market operations consistent with Currency Board principles. These market operations aimed at promoting the smooth functioning of the LER system, for example, by removing any market anomalies that might arise from time to time.
- (e) The refinements aimed at removing uncertainties about the extent to which the exchange rate might strengthen under the LER system and promoting the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements; and
- (f) After the introduction of the three refinements, the exchange rate of Hong Kong dollar had remained stable against the US dollar. The AB declined quickly. Hong Kong dollar interest rates had risen to levels close to US dollar rates.

Discussion

Operation of the three refinements

33. Ms Emily LAU enquired whether there were any deficiencies of the LER system which had necessitated the introduction of the three refinements. She further enquired about the need for introducing further refinements in future when there were changes to RMB exchange rate regime.

34. In reply, the Deputy Chief Executive, Hong Kong Monetary Authority (DCE/HKMA) explained that under the LER system, interest rate arbitrage activities operated in accordance with Currency Board principles would help adjustments in the money and foreign exchange markets to maintain a stable Hong Kong dollar exchange rate at 7.8. He noted that although the Hong Kong dollar had weakened to a level very close to 7.8 since the beginning of the year, it did not trigger the CU and the Hong Kong dollar interest rates had remained much lower than the US dollar interest rates for a prolonged period. Introduction of the three refinements would strengthen capability of the LER system in dealing with such market anomalies, and promote the smooth functioning of the money and foreign exchange markets by

increasing the effectiveness of normal interest rate arbitrage activities. Hence, the three refinements would enhance the ability of the LER system in withstanding possible negative impact on the markets arising from changes in RMB exchange rate regime in future.

35. Ms Emily LAU noted that under the LER system, Hong Kong dollar interest rates should follow the levels of US dollar rates. She enquired about the reasons for the gap between Hong Kong and the US dollar interest rates.

36. DCE/HKMA explained that under the LER system, Hong Kong dollar interest rates should be very close to the US dollar interest rates. It was because under the Currency Board system, when the interest rates of US dollar were higher than those of Hong Kong dollar, interest rate arbitrage activities would be triggered in the markets to gain from the higher interest rates. However, the lack of a clear CU on the strong side of the Link would create uncertainty about the extent to which the exchange rate of Hong Kong dollar might strengthen. This could discourage interest rate arbitrage activities as the gains from these activities could be quickly wiped out by losses from the strengthening of the Hong Kong dollar. By introducing a strong-side CU at 7.75, the uncertainty would be removed and adjustments in the money and exchange markets could be carried out smoothly.

37. Responding to Ms Emily LAU's enquiry about the mechanism in determining the interest rates in Hong Kong, DCE/HKMA advised that since the liberalization of interest rates in 2000, individual AIs could determine their own interest rates having regard to the market situation and their commercial considerations.

38. Mr Ronny TONG enquired about the bases for determining the CZ of 7.75 to 7.85. He was concerned that HKMA might need to introduce changes to the CZ which could adversely affect the credibility of the LER system. Miss Mandy TAM enquired whether HKMA would consider expanding the CZ.

39. DCE/HKMA advised that the CZ had been worked out after careful consideration of the market situation and the experience in the operation of the LER system in the past few years. The strongest fluctuation in the exchange rate seen from the third quarter of 2003 was 1 000 pips from 7.8. The CZ of 1 000 pips was therefore considered appropriate. DCE/HKMA further explained that it was necessary to provide a CZ with sufficient extent so as not to stifle the foreign exchange market in Hong Kong. There was no plan to introduce further changes to the CZ at the present stage.

40. Miss Mandy TAM enquired whether HKMA would conduct market operations when the Hong Kong exchange rate against the US dollar fell outside the CZ. She also expressed concern that the introduction of the CZ might attract speculative activities on Hong Kong dollar, and enquired about the measures that HKMA would take to curb such activities.

41. DCE/HKMA re-iterated that the main purpose of the three refinements was to remove uncertainties about the extent to which the Hong Kong dollar exchange rate against US dollar might strengthen. He explained that the CZ was to provide a clear message to the market that HKMA would conduct market operations to sell or buy US dollar from licensed banks as appropriate when the exchange rate hit the CUs, which defined the zone. The clear CUs on both sides of the linked rate of 7.80 should be able to frustrate the speculative activities on Hong Kong dollar and reduce the usage of the Hong Kong dollar as a vehicle for speculation on the revaluation of RMB.

42. Ms Emily LAU was concerned that HKMA's market operations might increase HKMA's influence over the markets. DCE/HKMA stressed that HKMA's market operations within the CZ would be conducted in accordance with Currency Board principles. He assured that HKMA would maintain high transparency in conducting market operations. HKMA would announce such operations immediately after they had been initiated. The relevant information would also be included in the monthly Reports on Currency Board Operations to the Currency Board Sub-Committee of the EFAC, which were published on HKMA website and in HKMA's Quarterly Bulletin.

43. Responding to Ms Emily LAU's enquiry, DCE/HKMA confirmed that implementation of the three refinements had no impact on the manpower requirements of HKMA.

Impact of the three refinements on mortgagees of residential property

44. While appreciating the benefits of the three refinements to the money and foreign exchange markets, Mr SIN Chung-kai noted that implementation of the refinements had led to increase in interest rates in Hong Kong. He expressed concern about the negative impact on mortgagees of residential property.

45. DCE/HKMA advised that if the interest rate differential between the US and HK continued to widen with the expected US interest rate hike, there might be a risk that the future "catch-up" of HK interest rates would be very sharp and abrupt. It was also possible that the interest rates could overshoot in such circumstances, which would bring even bigger shocks to the banking system and the mortgage payers. He emphasized that the three refinements would facilitate smoother operation of the LER system and help narrow the interest rate differential between Hong Kong and the US in a progressive manner, thus maintaining the stability of the Hong Kong dollar in the light of volatilities in the external monetary environment. ED/HKMA emphasized that the three refinements were introduced to address the structural factors in the LER system that could frustrate the effective interest rate arbitrage activities. The rise in Hong Kong dollar interest rates close to the US dollar rates would reduce the risks of overshooting in interest rates, development of bubble property market and rapid pick-up in inflation in Hong Kong. These risks might arise from persistent easy

monetary conditions and would have adverse impact on the monetary and financial stability of Hong Kong.

V. Proposed introduction of a new category of “travel insurance agents”

(LC Paper No. CB(1)1919/04-05(05) — Paper provided by the Administration

LC Paper No. CB(1)1919/04-05(06) — Submission dated 20 June 2005 from the Hong Kong Society of Certified Insurance Practitioners Ltd.

LC Paper No. CB(1)1919/04-05(07) — Submission dated 23 June 2005 from the Hong Kong Chamber of Insurance Intermediaries

LC Paper No. CB(1)1919/04-05(08) — Submission dated 23 June 2005 from The Hong Kong General Insurance Agents Association Ltd.

LC Paper No. CB(1)1919/04-05(09) — Submission dated 24 June 2005 from Professional Insurance Brokers Association

LC Paper No. CB(1)1919/04-05(10) — Joint submission dated 24 June 2005 from The Life Underwriters Association of Hong Kong and The General Agents and Managers Association of Hong Kong

LC Paper No. CB(1)1953/04-05(04) — Submission dated 27 June 2005 from The Hong Kong Confederation of Insurance Brokers

LC Paper No. CB(1)1953/04-05(05) — Submission dated 30 June 2005 from the Travel Industry Council of Hong Kong)

46. The Chairman declared interest as a member of the executive management of a number of insurance companies. He invited the Deputy Chairman to preside over the discussion of this item. The Deputy Chairman took over the chair.

Briefing by the Administration

47. At the Deputy Chairman's invitation, the Commissioner of Insurance (C of I) briefed members on the Administration's proposal of introducing a new category of "travel insurance agents" to the Insurance Intermediaries Quality Assurance Scheme (IIQAS) to encourage travel agents to register as travel insurance agents so that they could sell and actively promote travel insurance to their clients and be subject to proper regulation. He highlighted the following points:

- (a) Under the Insurance Companies Ordinance (ICO) (Cap. 41), a person "who holds himself out to advise on or arrange contracts of insurance" as an agent of an insurance company had to be appointed by and registered as an agent of that insurance company. The Insurance Agents Registration Board (IARB) was a self-regulatory body set up by the Hong Kong Federation of Insurers (HKFI) for the registration and administration of insurance agents, their responsible officers and technical representatives (collectively referred to as "insurance agents");
- (b) The IIQAS was introduced in 2000 to promote professional conduct and quality of insurance intermediaries (agents and brokers). It was designed primarily for the registration and regulation of people who intended to practise insurance as a full time occupation. Under the IIQAS, a person who wished to be registered with the IARB as an insurance agent and be able to sell general insurance products (including travel insurance) had to be fit and proper and was required to:
 - (i) pass a compulsory examination paper on "Principles and Practice of Insurance" and a separate qualifying examination paper on "General Insurance"; and
 - (ii) fulfil the Continuing Professional Development Programme (CPD) requirements (namely to complete 10 CPD hours of insurance related study each year to maintain and upgrade his/her professional knowledge).
- (c) It was the Government's policy to encourage Hong Kong people to take out travel insurance before they travelled so as to better protect themselves. The tsunami disaster in December 2004 and a number of fatal accidents involving Hong Kong residents travelling abroad had highlighted such a need. The Administration considered it necessary to facilitate travel agents to be registered as "travel insurance agents" so that they could sell travel insurance with proper regulation. This would ensure that travel agents selling travel insurance had attained a basic proficiency in the knowledge about travel insurance and understood the professional conduct and responsibility expected of them. Furthermore, to protect consumers, travel agents who wanted to sell travel insurance would

be required to be registered with the IARB, so that they would be subject to the same self-regulatory system now applicable to all insurance agents;

- (d) Taking the considerations in item (c) above into account, the Administration proposed to introduce a new category of “travel insurance agents” under the IIQAS. The details of the proposal were as follows -
- (i) Any travel agent who wanted to register as a “travel insurance agent” must be fit and proper and had passed a new examination paper (the qualifying examination) which combined the two papers on principles and practice of insurance and general insurance with emphasis on travel insurance. The registration procedures and fees would be the same as those applicable to insurance agents;
 - (ii) A person registered as “travel insurance agent” was only allowed to sell travel insurance for the tour or travel package which he/she was arranging for the client. Other than that, he/she was not allowed to sell other forms of insurance including travel insurance (such as annual travel insurance policy or stand-alone travel insurance); and
 - (iii) The formal requirements of CPD would not be applied to the registered “travel insurance agents”. The Administration would discuss with the HKFI to issue guidelines requiring the insurance companies to provide the necessary training and refreshment courses for the travel insurance agents.
- (e) The Office of the Commissioner of Insurance (OCI) had discussed with the HKFI and the Travel Industry Council of Hong Kong (TIC) and drawn reference to overseas experience before the proposal was formulated. A consultation paper on the proposal was sent to the relevant stakeholders in the travel and insurance industries on 28 April 2005. While the HKFI and the TIC expressed support for the proposal, the HKFI suggested that some forms of CPD requirement could be retained. Meanwhile, the representative bodies of insurance intermediaries were concerned that by creating a separate category of “travel insurance agents”, it would set a precedent for similar relaxation to be given to other types or forms of insurance such as motor insurance or employees’ compensation insurance. They were also worried that the proposal might lead to a relaxation of the existing examination and CPD requirements on insurance intermediaries and thus downgrade the professional image of the insurance profession;

- (f) The objective of the proposal was to encourage travel agents to obtain the necessary qualifications for selling travel insurance without compromising the professional standards. Apart from the qualifying examination paper mentioned in item (d)(i) above, the Administration was also considering the feasibility of imposing some form of continuous training on travel insurance agents in consultation with the travel and insurance industries. The Administration would continue to liaise and discuss with the industries to finalize the relevant study notes and examination arrangement;
- (g) The Administration proposed to implement the new arrangement as soon as possible. To implement the proposal, the Code of Practice for the Administration of Insurance Agents would need to be amended by the HKFI with the Insurance Authority's approval but there was no need for any primary or subsidiary legislative amendments. Subject to the finalization of the examination and continuous training arrangements for the travel insurance agents, it was expected that the proposed registration system would be ready for implementation in early 2006; and
- (h) The Administration did not see the need for introducing similar proposals for other types or forms of insurance.

Discussion

Details of the proposal

48. Mr CHAN Kam-lam expressed support in principle for the proposal to introduce a new category of "travel insurance agents". Mr CHAN however considered it not clear as to whether travel agents or their staff were required to be registered as "travel insurance agents" under the proposed new registration system.

49. C of I advised that the Administration put forward the current proposal in order to encourage travel agents to register as travel insurance agents so that they could sell and actively promote travel insurance to their clients and be subject to proper regulation. Any travel agent who wanted to register as a travel insurance agent should register with the IARB. If the travel agent wanted to engage its staff to sell travel insurance, it must ensure that the staff were fit and proper, had passed the qualifying examination and were duly registered with the IARB.

50. The Chairman was concerned how the Administration could ensure that only the qualified staff were deployed by travel agents to sell travel insurance to their clients. C of I advised that the OCI and the IARB would step up publicity of the new registration system and monitor travel agents' compliance with the requirements.

Follow-up actions on complaints and suspected breaches would also be taken as appropriate.

51. Mr James TIEN appreciated the need to encourage and facilitate the public to take out insurance before they travelled. He was however concerned whether the insurance company or the travel agent would be held liable for any mishandling of travel insurance by an employee of the travel agent, and the channel available for the public to lodge their complaints.

52. C of I advised that under the current regulatory regime for insurance agents, an insurance company would be held responsible for the action of its appointed insurance agents in the course of the sale of its insurance products and services. This would apply to the “agent-principal” relationship between a travel agent registered as a travel insurance agent and an insurance company. As with the present regulatory regime, members of the public might lodge their complaints with the IARB or the OCI.

53. Mr CHAN Kam-lam enquired whether the proposal would lower the premium for travel insurance. C of I pointed out that insurance premium was determined by the market. However, given that the proposal would encourage the public to purchase travel insurance, it was expected that the associated business growth and increase market competition might help to lower the premium for travel insurance in the long-run.

Views of the travel and insurance industries on the proposal

54. The Chairman pointed out that the HKFI, the representative body of insurance companies, supported the Administration’s proposal in principle and offered some suggestions for refining the proposal. However, the representative bodies of insurance intermediaries were against the proposal. Referring members to the various submissions provided by the insurance industry, the Chairman highlighted that while the insurance intermediaries had no objection to the proposal of allowing travel agents to sell travel insurance, they were strongly against the proposal of relaxing the existing examination requirements under IIQAS and setting a separate examination paper for travel insurance agents, as such an arrangement might compromise the professional standard of the insurance profession and affect the interests of the public. Given that the examination paper was the focus of contention, the Chairman requested the Administration to elaborate on the scope of the paper to facilitate the consideration of the proposal by the Panel and the insurance and travel industries.

55. C of I advised that the IIQAS was designated primarily for the registration and regulation of people who intended to practise insurance as a full time occupation. Given that the selling of travel insurance was not the core business of travel agents, it was neither desirable nor practical to require travel agents to fulfil the same examination requirements intended for full time insurance practitioners, which covered a wide range of insurance subjects not at all relevant to travel insurance. On

the other hand, if travel agents were required to fulfil the IIQAS requirements, they would be able to sell various insurance products to their clients in addition to selling travel insurance. This was not desirable because travel agents might be distracted from the core business of providing travel services and this would create regulatory problems to both the OCI and the Travel Agents Registry. In practice, the travel industry was not keen to sell insurance products other than travel insurance to their clients. In the circumstances, the Administration considered that a more pragmatic approach should be adopted. The proposed examination paper for travel insurance agents would combine the two papers under the IIQAS and cover the essence of the principles and practice of insurance and general insurance with special emphasis on travel insurance, such as accident and liability. This would ensure that travel agents could be well-attuned to the sale of travel insurance, after attaining basic proficiency in the knowledge about travel insurance and understanding of the professional conduct and responsibility expected of them. Hence, the professional standard of the insurance profession would not be lowered or compromised. C of I assured members that the Administration would continue to liaise and discuss with the insurance and travel industries in working out the details of the qualifying examination for travel insurance agents.

56. Responding to Miss Mandy TAM's enquiry, C of I advised that the Administration planned to finalize the details of the qualifying examination within the next two to three months. Arrangements would be made with the Vocational Training Council for conducting the examination. There were currently over 1 700 travel agents employing more than 10 000 staff. It was envisaged that it would take about six to nine months for the staff concerned to complete the necessary training and examination before the implementation of the proposed new registration system.

57. Miss Mandy TAM noted that the representative bodies of insurance intermediaries were also concerned that the Administration's proposal would set a precedent for similar relaxation to be given to other types or forms of insurance, such as motor insurance and employees' compensation insurance. She enquired how the Administration would address this concern.

58. C of I pointed out that travel insurance was different from other types or forms of insurance in that it was linked to the risk of the destinations, duration of the journey and the nature of activities intended to be performed by the traveller during the trip. The travel agent who arranged and organized the trip for the client, given the proper travel insurance training, was in a suitable position to advise the client of his/her travel insurance needs. The same did not apply to motor or employees' compensation insurance. The travel insurance to be arranged by travel insurance agents would be restricted to that trip on a trip basis which was one-off in nature. In contrast, third party liability motor insurance and employees' compensation insurance were compulsory by law and many people had already bought insurance covers for their cars or employees, which were transferable to their new cars or employees. Hence, the Administration did not consider that the special arrangement applicable to travel agents would also be applicable to other trades.

59. Mr Howard YOUNG noted that only about 40% to 50% of Hong Kong people purchased travel insurance before they travelled. The rate was low when compared with other jurisdictions and indicated the need to strengthen promotion work in this area. In this connection, the travel industry welcomed the Administration's proposal to introduce a new category of "travel insurance agents". Given that travel insurance agents were allowed to sell travel insurance only, the qualifying examination should focus on this area. Mr YOUNG also pointed out that a number of travel agents were small in scale and had limited number of staff. Flexible arrangements should be worked out to facilitate the staff of travel agents to receive training to prepare for the qualifying examination and to meet the CPD requirements.

Other options

60. Ms Emily LAU expressed support for the Administration's policy to encourage the public to purchase travel insurance before they travelled. However, noting the grave concern expressed by the insurance intermediaries, Ms LAU had reservation on whether the current proposal was the best option to achieve the policy objective. She urged that the Administration should conduct further consultation to address the concerns raised by the insurance intermediaries.

61. The Chairman, Deputy Chairman and Mr James TIEN enquired whether the Administration had considered other options to encourage members of the public to take out travel insurance before they travelled. The Chairman and Mr TIEN suggested that consideration might be given to enhancing the co-operation between travel agents and the three major insurance companies, such as by allowing staff of the three major insurance companies to station in premises of travel agents for selling travel insurance. Ms Emily LAU supported the suggestion but stressed that participation should not be restricted to the three major insurance companies, or else it would discourage open and fair market competition.

62. C of I re-iterated that travel insurance was different from other types or forms of insurance as mentioned in paragraph 58 above. The current proposal was an appropriate option, as the staff of a travel agent who arranged and organized the trip for a client was in a suitable position to make travel insurance arrangements to suit the specific needs of the client. If a separate counter was set up in the premises of the travel agent for staff of an insurance company to sell travel insurance, the client might consider it inconvenient and time-consuming for him to turn to a separate person and go to the separate counter for the service.

63. Mr SIN Chung-kai pointed out that it was very convenient for members of the public to purchase travel insurance in Hong Kong. Such service was available in banks and even in Mass Transit Railway stations. The crux of the matter was whether they were willing to purchase travel insurance. While expressing support for the Administration's policy to encourage the public to take out travel insurance before they travelled, Mr SIN Chung-kai stressed the need to ensure that the professional

standard of travel insurance agents should be the same or even higher than those of other insurance agents.

64. C of I assured members that the current proposal would not lower or compromise the professional standard of the insurance profession. He also pointed out that reference had been made to the practices in other jurisdictions. In general, most overseas jurisdictions studied gave travel agents concessionary registration arrangement if they only sold travel insurance incidental to their travel business. For instance, in the United Kingdom (UK), travel agents meeting certain conditions were excluded from the registration requirements entirely. In Singapore, full examination and CPD requirements were waived and travel agents were only required to complete a non-examinable course in travel insurance. Such arrangements had not lowered the professional standard of the insurance profession.

65. In response to Miss Mandy TAM's enquiry, C of I advised that the Administration had been taking concerted efforts with the travel and insurance industries in educating the public of the importance of taking out travel insurance before they travelled. The Administration had also stepped up publicity to disseminate the message before the peak seasons for travel.

Follow-up actions to be taken by the Administration

66. In view of the concerns raised by members at the meeting and by the insurance intermediaries in their submissions, members requested the Administration to give further thought to the proposal and consider how the concerns could be addressed. Members also agreed that the Panel would further discuss the proposal after the Administration had further consulted the insurance and travel industries and provided information on the following items:

- (a) Details of the proposed examination for the new category of "travel insurance agents";
- (b) Training for staff of travel agents for the new category of "travel insurance agents";
- (c) Regulation of travel insurance agents;
- (d) Monitoring measures to ensure that only the registered staff of travel insurance agents were deployed to sell travel insurance to their clients;
- (e) How the grave concern expressed by the insurance intermediaries could be addressed, i.e. concerns about similar relaxation to be given to other types or forms of insurance and that the proposal might compromise the professionalism of the insurance industry; and
- (f) Alternative options considered by the Administration.

(*Post-meeting note:* The Administration's written response to the seven submissions was issued to members and non-Panel Members vide LC Paper No. CB(1)2059/04-05(01) on 14 July 2005.)

VI. Rewrite of the Companies Ordinance

(LC Paper No. CB(1)1919/04-05(11) — Paper provided by the Administration

LC Paper No. CB(1)1919/04-05(12) — Background brief prepared by the Legislative Council Secretariat)

67. The Chairman took over the chair for this item.

Briefing by the Administration

68. Upon the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the Administration's latest thinking on the possible framework for taking forward the rewrite exercise of the Companies Ordinance (CO) (Cap. 32). He highlighted the following points:

- (a) The CO was of great importance to Hong Kong's economic well being and prosperity. It provided the legal framework enabling businessmen to form and operate companies which created wealth and employment for the community. It also had a regulatory function which set out the parameters within which these companies must operate in order to safeguard the interests of those parties who had dealings with them, such as shareholders;
- (b) The CO was last substantially reviewed in 1984 and broadly in line with the major UK company law reforms taken place in 1948 and 1976. However, the CO no longer suited present day circumstances and, in fact, imposed a burden on large, medium and small-sized enterprises. While actions had been taken to amend the CO from time to time, it had reached a stage where a rewrite of the Ordinance was considered necessary;
- (c) There would be significant economic benefits to Hong Kong from rewriting the CO. The new CO would provide Hong Kong with a legal infrastructure which met its needs and was commensurate with its status as a major international business and financial centre. With streamlined and modernized regulation, Hong Kong company law would meet more fully the needs of, and help save compliance costs incurred by, more than half a million companies, both local and overseas, registered in Hong Kong. For instance, the wider use of electronic communications and the simplification of procedures for the conduct of company businesses as a

result of the UK company law reform was estimated to bring about economic benefits amounting to over \$3.5 billion. It was estimated that implementation of similar changes in Hong Kong would result in substantial savings for companies registered in Hong Kong;

- (d) Over the past decade, many major common law jurisdictions including the UK, Australia, New Zealand, and Singapore had either completed or embarked upon major company law reform programmes. It was important that Hong Kong should not lag behind these jurisdictions. The rewrite of the CO would provide an opportunity for Hong Kong to leverage from company law developments taking place around the world;
- (e) In July 2004, the Administration briefed the Panel on its preliminary proposal to rewrite the CO. The proposal generally received positive comments from Members. Since then, the Administration had given further thought to the proposal. Given that the CO was one of the longest and most complex pieces of primary legislation in Hong Kong, it was expected that the rewrite exercise would necessitate extensive legal research for the purpose of preparing draft drafting instructions, consulting stakeholders and the public on policy and legal matters, and subsequently drafting a new Companies Bill. To ensure that the Bill was a quality piece of work and available within a reasonable timeframe, it was essential that a robust framework be established, staff of the right calibre be recruited and adequate resources be allocated;
- (f) The Administration had made reference to experience of the Company Law Reform of the UK. The Department of Trade and Industry (DTI) in the UK had deployed a dedicated team of staff to undertake the review of the Companies Act. The DTI's companies bill team had been established in July 2001 to take forward the work of turning the recommendations of the independent company law review into legislation. During the heaviest middle phase of the project, the team comprised a total of approximately 22 staff of whom 12 were policy staff and 10 were lawyers. The ranks of the vast majority of these staff were pitched at senior directorate, deputy or assistant directorate levels. In addition, the DTI team was supported by two parliamentary counsels who drafted the legislation;
- (g) The Administration was discussing with the relevant bureaux and departments the total number of dedicated staff, both directorate and non-directorate, required for taking forward the rewrite. Meanwhile, the Administration was also critically examining the workload of the existing staff in the coming years with a view to meeting the staffing requirements through internal redeployment as far as possible. It looked apparent that some additional posts would inevitably be needed for the rewrite, probably including a handful of directorate posts. Furthermore, it was

also necessary to engage external consultant(s) to advise on the rewrite exercise, mainly in the review and rewrite of the relevant provisions on subjects in which the Administration had limited experience and expertise;

- (h) The total financial cost of the creation of additional posts in the Administration and the engagement of external consultant(s) was intended to be met by the Companies Registry Trading Fund. The tentative timeframe for the rewrite exercise covered a period of five years from end of 2005 to the third quarter of 2010. It was estimated that the annual recurrent expenditure for the exercise would be over \$20 million; and
- (i) The Administration welcomed Members' views on the possible framework of the rewrite exercise. It would proceed with finalizing the staffing requirements proposal, and then consult the Panel again before seeking the Finance Committee's necessary approval.

Discussion

Company law reforms in other jurisdictions

69. Miss Mandy TAM indicated support for the proposal to rewrite the CO. Pointing out that the company law reform in the UK was still in progress, Miss TAM enquired how far new developments in the UK reform would affect the rewrite exercise.

70. In response, SFST stressed the importance to ensure that the new CO would meet the needs of modern day users and be on a par with international best practices so that Hong Kong would commensurate with its status as an international financial centre. He emphasized that the Administration would closely monitor developments in other common law jurisdictions and, where appropriate, incorporate their good corporate practices in the new CO.

71. The Registrar of Companies (R of C) supplemented that one of the objectives of the rewrite exercise was to restructure and modernize the CO to meet the needs of companies operating in the 21st century. While the new CO would provide a basic legal framework for operation and regulation of companies, schedules and subsidiary legislation would be used, where appropriate, to specify detailed and technical requirements. This would facilitate regular updating of the law to respond to rapid developments in the business environment. As regards latest developments in the UK company law reform, R of C advised that, on 17 March 2005, the DTI had issued a White Paper on Company Law Reform for public consultation. The White Paper set out the final proposals for the Company Law Reform Bill and included about half the draft clauses of the Bill. The rest of the draft clauses was expected to be released in August 2005. He added that, as the major company law reform programmes in the

UK and other major common law jurisdictions were in their final stages, it should be possible for Hong Kong to, where appropriate, use these as benchmarks with a fair degree of certainty that there would not be major changes for a considerable time to come.

72. Mr CHAN Kam-lam expressed support for the rewrite of the CO. Pointing out that the UK was a member of the European Union (EU), Mr CHAN enquired how far company law developments in the EU had affected the UK company law reform which in turn would have impact on the rewrite of the CO. Given the increasing economic integration between Hong Kong and the Mainland, Mr CHAN considered that reference should also be made to the company law of the Mainland in rewriting the CO.

73. R of C said that as a member of the EU, the UK was required to comply with the EU directives concerning company law, such as those related to capital maintenance. However, Hong Kong was not obliged to follow EU directives and could make reference to comparable provisions in other common law jurisdictions, such as Australia and Singapore, which had more flexible and liberal regulatory requirements in the area of capital maintenance. As regards company laws developments in the Mainland, R of C pointed out that, compared with the CO in Hong Kong which was common law based, Mainland company law was civil law based and generally had been drafted using the corporate law in Germany as a model. While Mainland company law basically laid down the basic principles for the operation and regulation of companies, the CO in Hong Kong contained the detailed requirements and provisions catering for various scenarios. Given the differences in the legal systems between Hong Kong and the Mainland, Mainland company law might not have direct relevance for Hong Kong.

Admin

74. In view of the complexity of the issues involved in the rewrite exercise, Mr CHAN Kam-lam suggested that the Administration should identify major areas for reform and develop proposals for public consultation in stages. The outcome of the consultations could provide good bases for formulating the White Bill which would be subject to further consultation. Mr Ronny TONG shared his view.

Timeframe for the rewrite exercise

75. Mr Ronny TONG and Ms Emily LAU expressed support for the proposal to rewrite the CO. While Ms LAU hoped that the Administration would commence the rewrite exercise as soon as possible, she was concerned that as the White Paper in the UK had just been issued in March 2005, the outcome of the UK company law reform might have impact on the rewrite exercise of the CO.

76. SFST assured members that the Administration would continue to closely monitor the developments in the UK. R of C added that reviewing and up-dating the CO had been undertaken on an on-going basis. Furthermore, Hong Kong was ahead of the UK in introducing statutory provisions on derivative actions and overhauling

the registration system for foreign companies. Apart from implementing the recommendations contained in the Standing Committee on Company Law Reform (SCCLR)'s reports in previous companies amendment ordinances, the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group had commenced a detailed review of the accounting and auditing provisions in the CO in March 2002. Proposals and recommendations of the review were expected to be released for public consultation in 2006.

Admin 77. Given the complexity of the issues involved in the new CO, Mr Ronny TONG and Ms Emily LAU stressed the need to allow sufficient time for scrutiny of the New Companies Bill by the LegCo. They suggested that the Administration should endeavour to introduce the Bill into LegCo in the 2008-09 session so that scrutiny of the Bill could be completed within the LegCo term of 2008 to 2012.

Resources requirements for the rewrite exercise

78. Ms Emily LAU expressed concern about the resource requirements for the rewrite exercise. Given that many major common law jurisdictions were undertaking company law reforms, Ms LAU urged the Administration to make reference to their developments and adopt practices where appropriate so as to enhance the cost-effectiveness of the rewrite exercise.

79. R of C stressed that, while review and reform of company laws in other jurisdictions would serve as good reference for the rewrite exercise, given the economic, social and political differences between these jurisdictions and Hong Kong, extensive research and analysis of the policy and legal background to the company laws of other jurisdictions would be needed to see whether or not they could be adopted by the new Companies Bill.

Admin 80. Ms Emily LAU considered that the estimated non-recurrent cost of \$19 to \$22 million for engaging external consultants and the annual recurrent cost of over \$20 million for the rewrite exercise were on the high side. She further expressed concern about the need to create additional posts to take forward the exercise, in particular the creation of new directorate posts. She urged the Administration to critically review the need for creation of new directorate posts in finalizing the staffing requirements proposal for the exercise.

81. SFST stressed that the Administration was mindful of the need to undertake the rewrite exercise in a cost-effective manner and would endeavour to control the staff costs for the exercise. He re-iterated that the Administration was examining the feasibility of deploying existing staff to meet part of the staffing requirements of the rewrite exercise.

82. Ms Emily LAU referred to the comprehensive review of the CO led by Mr Ermanno Pascutto completed in 1997, which had incurred a huge consultancy fee of \$15 million but contained recommendations of little use for Hong Kong. Ms LAU

stressed the importance for the Administration to engage consultants with suitable experience and expertise to undertake the rewrite exercise.

83. R of C pointed out that the proposed rewrite exercise was completely different from the consultancy completed in 1997 in terms of purpose and scope. While the consultancy completed in 1997 aimed at reviewing the principles and policies in the CO, the rewrite would be a much more comprehensive exercise covering the review, restructuring and rewrite of existing provisions in the CO. Hence, it was not appropriate to make a direct comparison between the two exercises.

Consultation with relevant stakeholders

Admin

84. Mr Ronny TONG enquired about the role of the SCCLR in the rewrite exercise. He further suggested that the Administration should involve the active participation of relevant stakeholders including the SCCLR in the rewrite exercise.

85. R of C advised that the SCCLR was expected to play a key role in the rewrite exercise. The Administration's preliminary thinking was, in the case of those aspects of the CO which had already been reviewed and reformed in the context of companies (amendment) ordinances in recent years, only minor adjustments would be made during the rewrite. The rewrite would focus on areas which had been basically untouched by previous company reviews. The results of the research undertaken by the Companies Bill Team and the consultants on these items, as well as the proposals/recommendations arising from this would be forwarded to the SCCLR for advice in preparing the new Companies Bill. In the case of those proposals/recommendations which had far-reaching and profound implications and were of public concern, consultation with relevant stakeholders and the public would be conducted. R of C supplemented that the Company Law Reform Division of the Companies Registry provided support to the SCCLR in undertaking the necessary research and preparation of discussion papers for meetings.

Way forward

Admin

86. SFST assured members that the Administration would take into account Members' views expressed at the meeting in working out the details of the rewrite exercise. The Administration would consult the Panel on the staffing requirements proposal in the 2005-06 session.

VII. Any other business

Concluding remarks

87. As the meeting was the last regular meeting of the Panel in the 2004-05 session, the Chairman took the opportunity to thank members, the Administration,

and the LegCo Secretariat for their support and contribution to the work of the Panel during the session.

88. There being no other business, the meeting ended at 1:00 pm.

Council Business Division 1
Legislative Council Secretariat
4 October 2005