

**SFC Submission to the LegCo Panel on Financial Affairs**

**Re: Meeting on 3 January 2005**

**Agenda V – Further discussion on proposed amendments to the Securities & Futures Ordinance (“SFO”) – the proposal of splitting the post of the chairman of the SFC into a chairman post and a chief executive officer post**

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1. We are pleased to be given the opportunity to provide our views to the Honourable members on the Administration’s proposal to change the SFC’s governance structure.

**The Administration’s proposal**

2. As set out in the Administration’s paper dated 4 November 2004 (“Administration’s Nov Paper”), the Administration has proposed to improve the SFC’s governance structure such that the Commission is led by a non-executive chairman (“C/SFC”) while the executive arm is headed by a chief executive officer (“CEO”). It is suggested that the role of the C/SFC should be separated from that of the executive arm to further enhance the internal checks and balances of the Commission, with a view to enhancing the independence of the governing body and hence its ability to discharge its supervisory functions over senior management.
3. The proposed responsibilities of the C/SFC are set out in paragraph 8 of the Administration’s Nov Paper. It is proposed that the non-executive C/SFC will not be involved in the day-to-day regulatory work (e.g. reviewing individual listing applications and investigating possible breaches of the SFO, etc). S/he should not influence the decisions of the executive arm on such individual cases. To ensure the independence of the post of C/SFC, it is proposed that during the tenure of the C/SFC’s office, s/he should not:
  - (a) be a director of any listed company in Hong Kong;
  - (b) have any material interest in any principal business activity of or be involved in any material business dealing with a listed company, or any person or institution engaged in activities regulated by the Commission.
4. The proposed responsibilities of the CEO are set out in paragraph 9 of the Administration’s Nov Paper. In summary, it is proposed that the CEO should have executive responsibility for the day-to-day running of the Commission, and that s/he should implement the strategy as agreed by the SFC governing body and facilitate the effective functioning of the governing body.

**The history and current governance structure of the Commission**

5. It may be useful to draw upon the history of the Commission and the thinking behind its current corporate governance structure, which can be traced to the

Ian Hay Davison Report of 1988. At that time, the 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). The relevant parts relating to the governing body of what was to become the SFC are spelt out in paragraphs 9.37 to 9.41 [[Appendix 1](#)]. It essentially envisaged that the board comprised four full-time members, including the Chair and Deputy Chair, and three Non-Executive Directors (“NEDs”). The SFO amended this arrangement to have the NEDs outnumber the Executive Directors (“EDs”).

#### Composition of the SFC

6. The constitution of the SFC Board, including the requirements for the conduct of its proceedings, is contained in Part 1 of Schedule 2 to the SFO. All the Members of the Board are appointed by the HKSAR Chief Executive and the SFO requires that the majority of the Members must be NEDs. The composition of the Board ensures independent supervision of the Commission’s executive functions.
7. The present Board comprises twelve Members: five full-time EDs, including the Chairman, and seven NEDs.

#### How the Commission operates

8. The Board meets regularly every month and holds additional meetings as necessary. All important policies are discussed and approved by the Board. During Board meetings, divisional staff explain policy proposals to the Members and give regular briefings to Members on the progress of their work and important policy and operational issues. The Members have separate access to the senior management and divisional staff for any additional information they may require about any policy proposal. All Members have access to the Commission Secretary who is responsible for ensuring that the procedures for the conduct of Commission meetings are complied with.
9. The Members are also briefed on the financial position of the Commission by way of monthly financial statements giving details of the budget, revenue, expenditure, and forecasts. The Commission’s financial statements are considered by the Audit Committee and approved by the Board before being published in quarterly and annual reports. Each year, after consideration by the Budget Committee and the Board, the revised and proposed budgets are submitted to the Financial Secretary for approval and laid before LegCo.
10. Our NEDs play an important role in ensuring that the Commission is accountable and transparent. An NED chairs the Budget Committee. The membership of both the Remuneration Committee and the Audit Committee is exclusively comprised of NEDs, and the Chairman, the Chief Operating Officer and other EDs only attend upon invitation. The recommendations of these Committees are then tabled for approval by the full Commission. In

addition, on an *ad hoc* basis, the Chairman and the Chief Operating Officer regularly consult the NEDs on important personnel, risk management and governance issues.

### Checks and balances

11. The Commission places great importance on corporate governance and always strives to enhance our accountability to the public and the transparency of our work. We adopt and implement corporate practices commensurate with the best standards applicable to public bodies.
12. All our important policies are discussed and decided upon at the Board level. As mentioned above, the majority of our Members are NEDs who are appointed by the HKSAR Chief Executive.
13. Each year, the Commission appoints an external consultant to conduct an annual internal control review. The internal control review programme is approved by the Audit Committee.
14. The Commission is also subject to various external checks and balances to ensure that it meets its regulatory objectives and performs its functions in a fair and transparent manner:
  - regular review by the Process Review Panel (“PRP”), an independent non-statutory panel established by the Chief Executive in November 2000, to review the Commission’s internal operating procedures, including those for ensuring consistency and fairness (the Commission is the first securities regulator to introduce a PRP);
  - periodic review of the Commission’s procedures and practices by the ICAC;
  - oversight by the media, the Ombudsman, the Administration and LegCo;
  - many of its regulatory decisions are subject to full review by the Securities & Futures Appeals Tribunal which is chaired by a High Court judge
  - judicial review;
  - testing policy initiatives with the Advisory Committee, Public Shareholders’ Group and other consultative committees established by the Commission and having a largely external membership drawn from the market;
  - subject to being directed by the HKSAR Chief Executive in the performance of its functions;
  - required to consult the Financial Secretary before exercising certain powers;
  - the Chairman and any of the other Board Members may be removed at any time by the HKSAR Chief Executive;
  - the Commission answers to world opinion if it regulates the market in a manner inconsistent with its status as an international financial centre.

The existing checks and balances on the Commission have worked well. No decision-makers are unaccountable within the Commission.

15. All the Commission's corporate governance policies and practices are published in our annual reports. We have been recognised three times by the Hong Kong Institute of Certified Public Accountants for the disclosure of our corporate governance policies and practices in our annual reports.

The Commission's views on the Administration's proposal

16. The Commission has consulted all Board Members on the Administration's proposal and set out a summary of the Board's views in our letter to the Administration dated 26 October 2004, a copy of which is attached to the Administration's Nov Paper. In short, the proposal of splitting of the functions of the C/SFC and CEO was agreed in principle, as it was consistent with corporate governance principles. There were, however, differing views on whether the C/SFC should be full-time and executive as now or part-time and non-executive as proposed by the Administration.
17. For ease of reference, we set out below a summary of Board Members' views:
- All Members recognised that the current governance structure of the Commission was working well. In the circumstances, some Members questioned why a change needed to be brought about now and in such a short timeframe.
  - Whilst almost all Members agreed that the concept of a split was uncontroversial, the real practical issue was how the actual functions of the Commission should be split between the C/SFC and the CEO. In practice, given the complexities involved in exercising the regulatory role of the Commission, there would be difficulties in separating operational responsibilities from policy responsibilities since both were intertwined.
  - The majority of Members doubted that the C/SFC could be part-time, given the complexity and range of policy and regulatory issues that the Commission has to handle. In terms of accountability, public image and perception, the C/SFC would still be the public face of the Commission and would be accountable for the Commission's management issues, and its policy and regulatory decisions. This would call for the full-time attention of the C/SFC. In reality, the C/SFC would have to be actively involved in the work of the Commission.
  - Most Members were concerned that it might not be easy to find a suitable candidate who had absolutely no real or perceived conflicts of interest if the C/SFC, as a regulator, were to hold other positions. On the other hand, the demand for a full-time executive C/SFC might limit the pool of potential candidates.

International experience

18. We note that in its Nov Paper, the Administration has usefully set out the organisational set-up of a number of overseas regulators. The LegCo

Secretariat has also been asked to prepare an information note on the situation of the relevant overseas regulators.

19. To further assist the Honourable members, we would like to share our research on the governance structure of some major overseas regulators. The details are in Appendix 2. A few points to note are as follows:
- In summary, the UK Financial Services Authority (“FSA”) and the Monetary Authority of Singapore (“MAS”) have Chairmen with no formal executive responsibility for the day-to-day running of their institutions. However, the US Securities and Exchange Commission, the Australian Securities and Investment Commission, the German Federal Financial Supervisory Authority (“BaFin”), the China Securities Regulatory Commission and the Australian Prudential Regulation Authority (“APRA”) all have executive Chairmen.
  - The FSA’s experience of splitting the Chairman’s post is very recent as this only became effective as from September 2003. It should also be noted that the FSA is a super-regulator (i.e. it regulates the whole financial community in the UK, including banking, securities and insurance businesses) and hence a split role model may be more suited to such a huge organisation, though the jury is still out. Although the FSA Chairman is not labelled as an executive Chairman, he receives substantial remuneration and has to spend most of his time at work answering to the British Parliament, managing the board, establishing policies and priorities and representing the FSA both domestically and internationally. Therefore, the incumbent *de facto* acts as a full time Chairman with executive responsibilities and the position carries an executive salary sufficient to attract someone of the highest calibre.
  - The MAS Chairman used to be the Deputy Prime Minister and is currently the former Prime Minister of Singapore so this is not a suitable analogy.
  - Following the collapse of the HIH Insurance in Australia, a report was issued by the HIH Royal Commission on 3 April 2003. In light of the recommendations made by the Honourable Mr. Justice Owen, Commissioner of the Royal Commission, the governance structure of the APRA was changed. APRA’s non-executive board (the board was led by a non-executive chairman and the only executive member in the board was the CEO) was subsequently replaced with an executive group, which comprises the executive Chairman and two executive commissioners carrying the responsibility, and accounting to the government, for the operation and performance of APRA. Please see the relevant extract from the HIH Royal Commission Report at pages 19 – 24 of Appendix 2.
20. In our view, no one model fits all though it is clear that most securities regulators in the major jurisdictions against which Hong Kong would benchmark itself are chaired by full time executives. Quoting from the Honourable Mr. Justice Owen (paragraph 6.6 of the HIH Royal Commission Report):

*“For me, the key to good corporate governance lies in substance, not form. It is about the way the directors of a company create and develop a model to fit the circumstances of that company and then test it periodically for its practical effectiveness. It is about directors taking control of a regime they have established and for which they are responsible. The concepts do not lend themselves easily to specification in something such as a code of best practice...”*

*Whatever the model, the public must know about it and about how it is operating in practice. Disclosure should be a central feature of any corporate governance regime. .... The annual report and, in these times, the company’s websites are important forums for disclosure.*

*Directors who take the fundamental notions of openness, integrity and accountability seriously and who bear in mind matters of the sort discussed [in this Report] will be well on the way to good corporate governance.”*

21. It should be noted that Hong Kong is one of the top ten largest securities markets in the world in terms of market capitalization. This is amply recognized as the SFC is currently a member of the Technical Committee of IOSCO (the standard setting body of the International Organization of Securities Commissions) and was unanimously elected as its Chair. Hong Kong has held this position twice in its history. Since the key members of the Technical Committee, which regulate the largest and most developed markets in the world, are all executive chairs or Commissioners in their own right, it has to be recognized that Hong Kong is treated as an equal amongst this community.
22. As far as is known, all past Chair of the Technical Committee has been Executive Chairmen.

#### Concluding remarks

23. Based on the recommended best practice in corporate governance of public bodies, the splitting of functions between the C/SFC and CEO was agreed in principle. However, it is important that the ensuing debate and handling of the proposal should not end up undermining the reputation or authority of the Commission nor reducing the chance of Hong Kong assuming its rightful position in the international securities community. Any proposal should not be a reflection on the existing governance of the Commission, which has been working well and is transparent and well respected by the market, both domestically and internationally.

24. The Commission recognizes that the decision regarding the split between the C/SFC and CEO is a policy decision that is a prerogative of the Administration. This paper points out the various issues that the Administration may wish to consider in that important decision.

Securities and Futures Commission  
17 December 2004

## Extract of the Hay Davison Report 1988

Governing body

9.37. Given the breadth of its operations, it would be inappropriate to vest the powers and responsibilities in a single person. He would be both too powerful and undesirably stretched, even with the Exchanges undertaking much of the day-to-day supervision.

9.38. We recommend that the new SC should be governed by a small board, preferably with seven members: a chairman, deputy chairman, two other full-time directors and three non-executive directors.

9.39. While carrying full responsibility for the management of the Commission, the four full-time SC board directors should not be too closely involved in detailed day-to-day business, although of necessity they would be close to major issues. They must be free to see the wood for the trees, to manage the agency and its various departments and to steer a course based on a clear set of policies. The day-to-day work would therefore fall to their supporting staff.

9.40. We see a role for non-executive directors on the board to keep the full-time directors on their toes and to bring an independent eye to the SC's management. They should take a primary interest in the areas of management and organisation, rather than policy and operational supervision and would not therefore need securities market experience or expertise. They should not be actively involved in the securities industry.

9.41. Given the considerable commercial sensitivity of the information in the SC, the non-executive directors should not have an automatic right to see sensitive papers on individual cases.



## **Governance Structure of Overseas Regulatory Authorities**

### **Financial Services Authority, U.K.**

The Financial Services Authority (FSA) has been the single regulator for financial services in the U.K. since 1 December 2001. The FSA is governed by a Board appointed by HM Treasury. The majority of the Board members are non-executive. In addition to the Chairman and Chief Executive, there are currently three Managing Directors and 12 non-executive members of the Board, of whom one, the Deputy Governor (Financial Stability) of the Bank of England, is an ex officio director. One of the non-executive members is Deputy Chairman and “lead” non-executive.

The FSA is accountable to Treasury Ministers and, through them, to Parliament. Under the legislation, the FSA must report on the achievement of its statutory objectives to the Treasury every year. Treasury Ministers must then lay the report before Parliament.

The FSA split the top post when Sir Howard Davies stepped down as the FSA Chairman and Chief Executive in September 2003. Mr. Callum McCarthy was appointed as the FSA’s Chairman and Mr. John Tiner was appointed as the Chief Executive Officer.

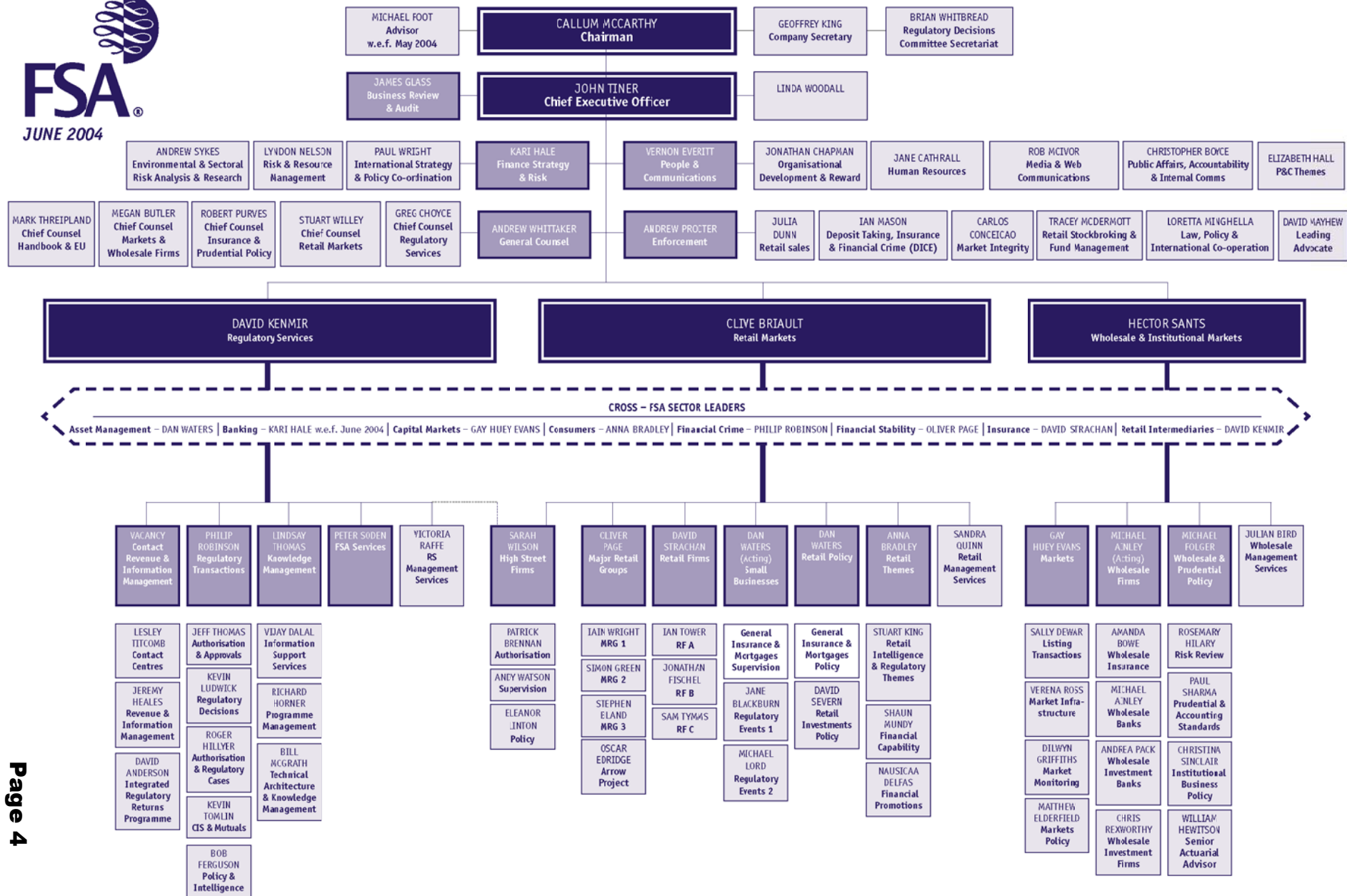
The Chairman has no executive responsibility for the day-to-day running of the FSA. His key responsibilities are to:

- establish and develop an effective Board;
- lead the Board as a team;
- plan and manage the Board’s business;
- establish priorities for the FSA;
- maintain and develop a productive relationship with the FSA Chief Executive, for whose recruitment is responsible;
- with the Chief Executive, lead the communication of FSA policies with a wide range of constituencies;
- represent the FSA on particular national and international financial institutions;
- establish and maintain high level contacts with the most important financial institutions worldwide;
- acts as an accountability focus for the FSA, chairing its annual public meeting, giving evidence to select committees, and writing to the Chancellor of the Exchequer (if needed) on the most significant issues arising under the formal exchange of letters of December 2001;
- represent the FSA in the most senior meetings of the Tripartite Standing Committee, alongside the Chancellor and the Governor of the Bank of England.

The Chief Executive Officer is responsible for implementing the strategy agreed by the Board, in whose formulation he will have played a major part. He has the executive responsibility for the FSA’s business under authority delegated to him by the FSA Board. His key responsibilities are:

- reporting regularly to the Board with appropriate, timely and quality information so that the Board can discharge its responsibilities effectively;
- informing and consulting the Chairman on all matters of significance to the Board so that the Chairman and the Board can properly discharge their responsibilities;
- developing and delivering the strategic objectives agreed with the Board;
- recommending to the Board significant operational changes and major capital expenditures where these are beyond the delegated authority;
- assigning responsibilities clearly to senior management and overseeing the establishment of effective risk management and control systems;
- recruiting, developing and retaining talented people to work at the FSA; and in particular establishing a strong management team which is fairly and fully evaluated;
- communicating throughout the FSA the strategic objectives and the values of the FSA agreed with the Board, and ensuring that these are achieved in practice;
- sharing with the Chairman and with other members of the FSA senior management the responsibility for communicating the FSA's messages externally;
- representing the FSA on selected international financial institutions.
- All FSA staff, other than the Chairman's immediate staff and the Company Secretary, ultimately report to the Chief Executive (see organisation chart).

## Appendix 2



### **U.S. Securities and Exchange Commission**

The Securities and Exchange Commission (SEC) was established by the Congress in 1934 to enforce the securities law. Its primary mission is to protect investors and maintain the integrity of the securities market.

The SEC operates under a Commission of five Commissioners and is headed by the Chairman. The SEC, based in Washington, DC, has four Divisions and 17 Offices . It has 11 regional and district offices throughout the country (see organisation chart).

The US President designates one of the five Commissioners as Chairman, who is the Commission's top executive. The current SEC Chairman is Mr. William H. Donaldson. The other four Commissioners are Ms. Cynthia A. Glassman, Mr. Harvey J. Goldschmid, Mr. Paul S. Atkins and Mr. Roel C. Campos.

The five Commissioners are appointed by the President with the advice and consent of the Senate. Their terms last for five years and are staggered with one Commissioner's term ending on 5 June each year. To ensure that the Commission remains non-partisan, no more than three Commissioners may belong to the same political party. The Commissioners shall not engage in any other business, vocation, or employment other than that of serving as Commissioners.

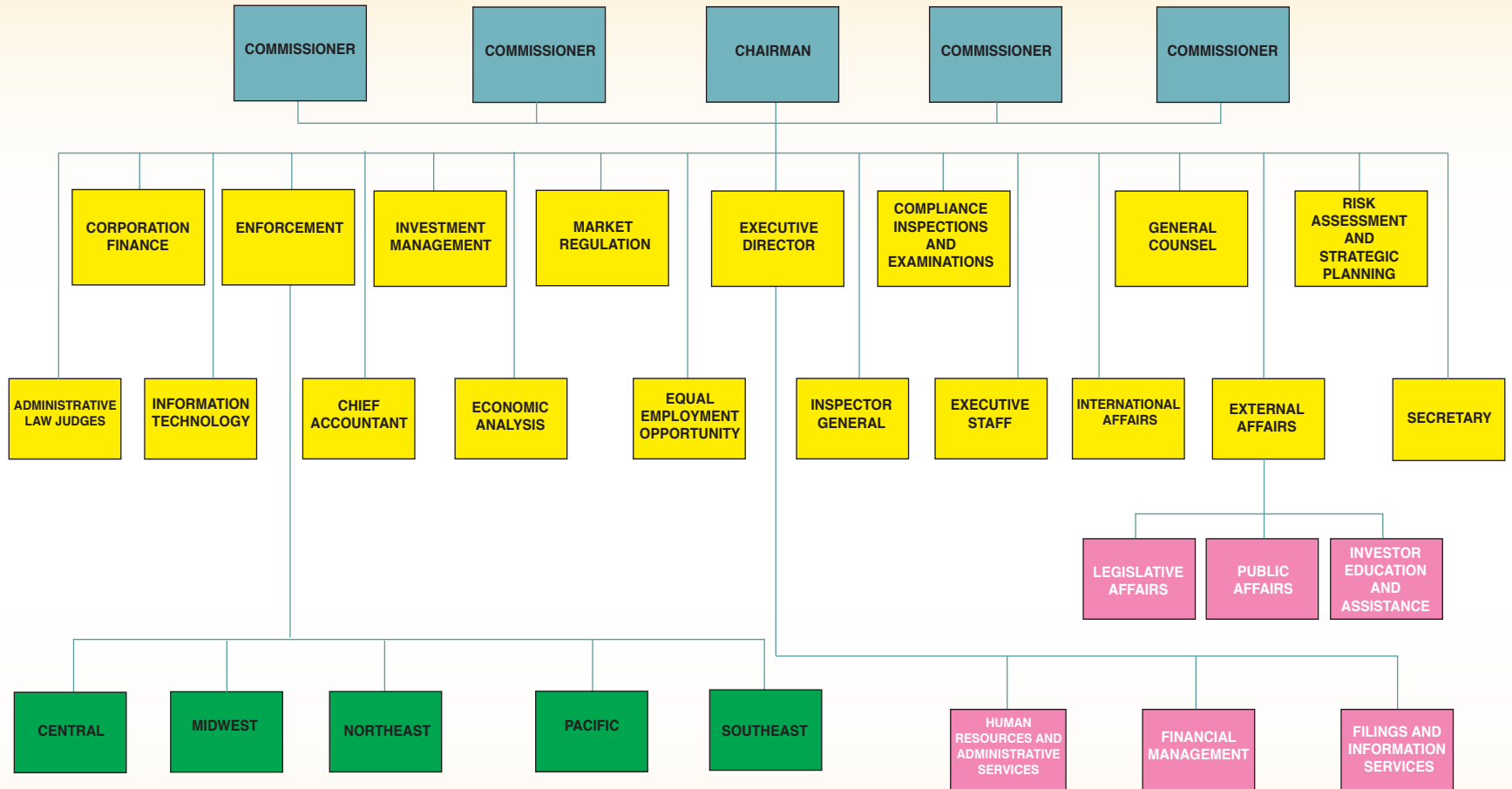
The Chairman is assisted by the Chairman's Office in developing the direction for the agency and implementing new initiatives. It comprises three Managing Executives: the Managing Executive for Policy and Staff; the Managing Executive for External Affairs; and the Managing Executive for Operations and Management.

The Commissioners meet to discuss and resolve a variety of issues that staff brings to their attention. At these meetings the Commissioners:

- interpret federal securities laws;
- amend existing rules;
- propose new rules to address changing market conditions; and
- enforce rules and laws.

These meetings are open to the public and the news media unless the discussion pertains to confidential subjects, such as whether to begin an enforcement investigation.

# U.S. Securities and Exchange Commission



### **Australian Securities and Investments Commission**

The Australian Securities and Investments Commission (ASIC), established in 1989, enforces and regulates company and financial services laws to protect consumers, investors and creditors.

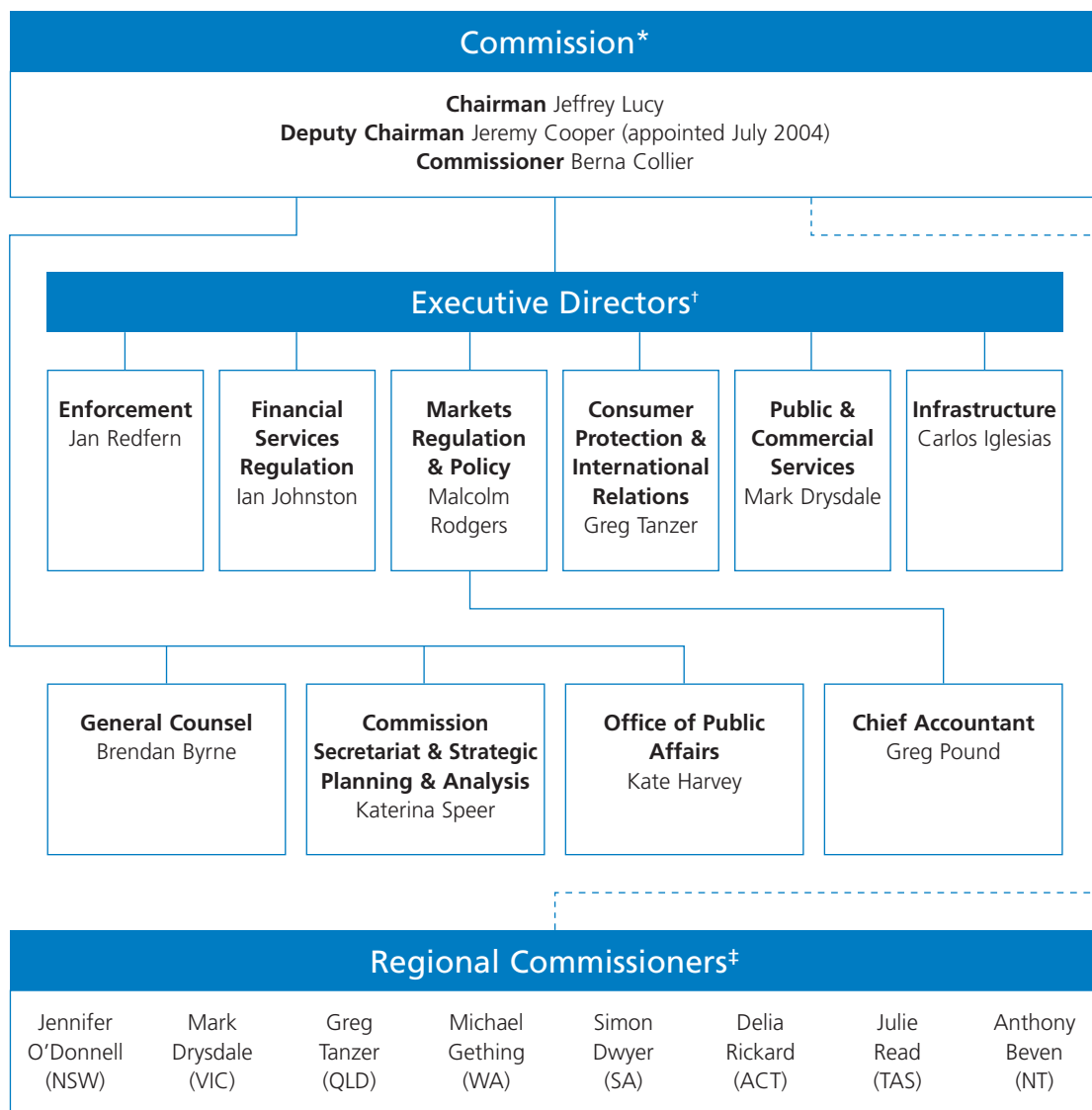
The ASIC operates under the direction of three full-time executive Commissioners appointed by the Governor-General on the nomination of the Treasurer. The ASIC reports to the Commonwealth Parliament, the Treasurer and the Parliamentary Secretary to the Treasurer.

The Governor-General appoints one of the three Commissioners as the Chairman and another as the Deputy Chairman. The current ASIC Chairman is Mr. Jeffrey Lucy and the Deputy Chairman is Mr. Jeremy Cooper. The third Commissioner is Professor Berna Collier. The three Commissioners are full time executives, who direct ASIC's affairs.

Apart from the three Commissioners, ASIC's senior management consists of 7 operating directorates led by Executive Directors (see organisation chart). In addition, Regional Commissioners represent ASIC in each State and Territory.

The Commission holds formal meetings to consider and set goals and strategy, including ASIC's strategic plan and directorate business plans. Meetings also review operational, financial and Audit Committee reports, and key issues affecting human resources, governance and delegations.

ASIC's Executive Committee, the senior management forum of Commissioners and Executive Directors, meet monthly to discuss current and emerging issues, and to plan and make policy across the organisation.



\* Commissioners' biographies, see page 47.

† Executive Directors' details, see relevant directorate chapters.

‡ Regional Commissioners' details, see page 55.

### **Monetary Authority of Singapore**

The Monetary Authority of Singapore (MAS), established on 1 January 1971, administers the various statutes pertaining to money, banking, insurance, securities and the financial sector in general. Following its merger with the Board of Commissioners of Currency on 1 October 2002, the MAS has also assumed the function of currency issuance.

The MAS operates under the direction of its Board of Directors, which is appointed by the President. The Chairman of the Board is appointed by the President on the recommendation of the Cabinet. The current Chairman is Mr. Goh Chok Tong, Senior Minister of the Government.

The Board of Directors is responsible for the policy and general administration of the affairs and business of MAS and informs the Government of the banking and credit policy of MAS. The Board is ultimately accountable to the Parliament of Singapore through the Minister in charge of MAS.

The Board is assisted by the Chairman's Meeting, Monetary and Investment Policy Meeting, Audit Committee and Risk Committee.

The Chairman's Meeting makes decision on major changes to the regulatory framework and supervisory policies. The Meeting also approves major changes to policies and strategies relating to financial centre development, international and regional relations.

For day-to-day administration, the MAS Act vests the Managing Director with power to make decisions and exercise all powers that may be exercised by MAS. The current Managing Director is Mr. Koh Yong Guan, who is also a Board member.



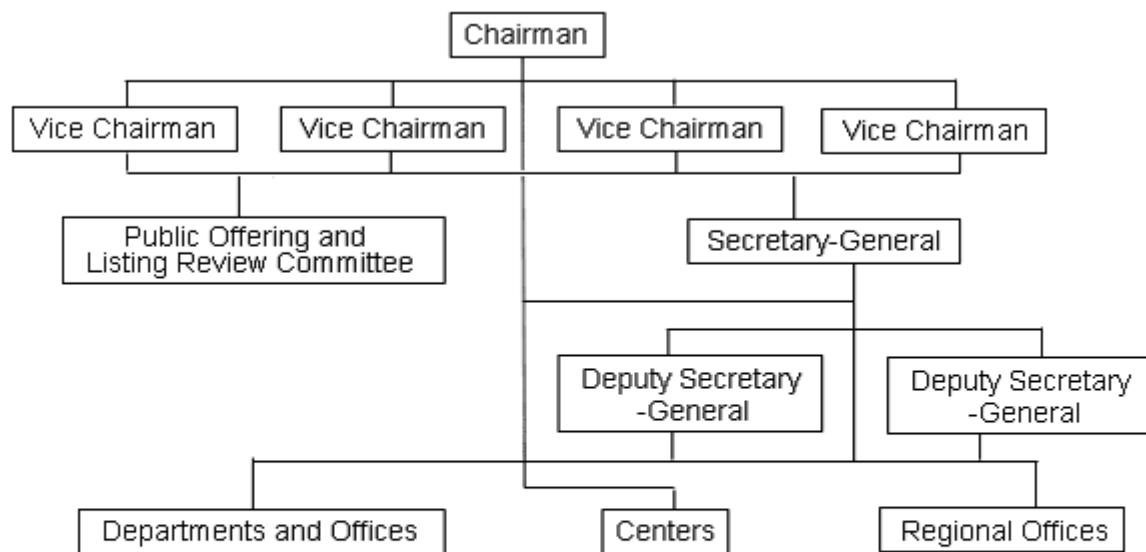
# Organisation Chart

<div> <div>Board of Directors Lee Hsien Loong, Chairman</div> <div> <div>Managing Director's Office Koh Yong Guan, Managing Director</div> <div> <div>General Counsel's Office Ng Heng Fatt</div> <div>Strategic Planning Office Teo Swee Lian</div> <div>Internal Audit Timothy Ng</div> </div> </div> <div>Audit Committee</div> </div>							
Economic Research & Financial Stability Khor Hoe Ee	Monetary Policy & Investment Ong Chong Tee	Development & External Relations Ong Chong Tee	Prudential Supervision John Palmer		Market Conduct Shane Tregillis	Currency & Corporate Resource Foo-Yap Siew Hong	
Macroeconomic Surveillance Wong Fot Chyi	Economic Policy Khor Hoe Ee	External Leo Mun Wai	Banking Supervision Lee Boon Ngia	Insurance Supervision Hauw Soo Hoon	Market & Business Conduct Andrew Khoo	Corporate Services Shih-Teo Siew Poh	Human Resource Tan-Tay Hwee Ling
External Economies Ng Bok Eng	Monetary Policy Edward Robinson	Communications Angelina Fernandez	Division I Aw Kian Huat	Division I Tan Hak Leh	Consumer Issues Merlyn Ee	Logistics, Administration & Event Management Maggie Tan	HR Development Han Twee Heng
Financial Surveillance Wong Fot Chyi	Reserve & Monetary Management Jacqueline Loh	Financial Services Cooperation Leong Sing Cheong	Division II Teo Lay Har	Division II Portia Ho	Financial Advisers & Insurance Intermediaries Richard Teng	Property & Building Services Yap Soon Guan	HR Management Loo Pauy Liean
Information Resource Centre Adeline Koh	External Fund Management Tan Puay Lit	International & Regional Relations Eric Chan	Division III Lee Kee Meng	Division III Leow Yung Khee	Market Conduct Policy Mohammad Nizam Bin Ismail	Security Lee Hoe Hin	Information Technology Huay Khee Chuang
	Foreign Exchange, Liquidity & Gold Michael Tay	Financial Centre Development Ng Nam Sin	Division IV Chua Kim Leng	Prudential Policy Low Kwok Mun	Securities & Futures Supervision Mimi Ho	Currency Ho Kwen Chan	Applications Yuen Keng Yin
	Global Fixed Income Cheryl Tan	Capital Markets Celestine Khoo	Complex Institutions Supervision Teo Swee Lian	Capital Policy Ho Hern Shin	Capital Markets Intermediaries Lam San Ling	Coins & Business Excellence Low Siang Kok	Data Centre Huay Khee Chuang
	Monetary Management Lee Chuan Teck	Investor Services Alison Lim	Division I Lim Phang Hong	Prudential Policy Loo Siew Yee	Corporate Finance Wong Nai Seng	Notes & Services Teo Chuen Seng	IT Infrastructure Liew Lye Ha
		Strategic Development Luz Foo	Division II Wan Aik Chye	Specialist Risk Supervision Enoch Ch'ng	Enforcement Aurill Kam	Finance Tai Boon Leong	IT Security David Ng
		Treasury & Technology Celestine Khoo	Division III Goh Gin Choo	Financial Risk Tham Ming Soong	Markets & Clearing House Mimi Ho	Corporate Risk Carolyn Tan	
				Payments & Infrastructure Terry Goh		Financial & Management Accounting Linda Koh	
				Technology Risk Tony Chew		Foreign Investment Accounting Loh Mun Su	
						Operations & Custody Administration Jean Tsen	

### **China Securities Regulatory Commission**

The China Securities Regulatory Commission (CSRC), established in 1992, is a ministry rank unit directly under the State Council governing the securities and futures markets of China.

The CSRC has one Chairman, four Vice-Chairmen, one secretary-general, and two deputy secretary-generals. It has 13 functional departments or offices, 3 subordinate centres, and one special committee. It also has 10 regional offices set up in key cities around the country and a missionary office in every province, autonomous region, cities directly under the jurisdiction of the State Council, and cities enjoying the provincial-level status in the state economic plan.

**Organizational Structure of the CSRC**

### **Federal Financial Supervisory Authority of Germany**

The Federal Financial Supervisory Authority (known as BaFin for short) was established on 1 May 2002. BaFin is the single regulatory authority responsible for the supervision of credit institutions, financial services institutions, insurance companies and securities trading.

BaFin is answerable directly to the Federal Government and is subject to the legal and functional supervision of the Federal Ministry of Finance.

The Head of BaFin is the President, Jochen Sanio, who is assisted by Karl-Burkhard Caspari as Vice-President. The three Directorates each have their own Head, known as Chief Executive Directors: Helmut Bauer is Head of the Banking Supervision Directorate, Dr. Thomas Steffen is Head of the Insurance Supervision Directorate and Georg Dreyling is Head of the Securities/Asset Management Supervision Directorate, which is based in Frankfurt am Main.

Directly attached to the President's Office is an Anti-Money-Laundering and Financing of Terrorism Group. Also reporting directly to the President are the Press and Publicity/Internal Information Management Office; the President's Private Office; the Internal Audit Office; and the Project Management Office.

Like the cross-sectoral departments, the Central Administration Department (Department Z) reports directly to the Vice-President. Among other things, it deals with BaFin's budget, cost-to-performance accounting, personnel matters and IT matters.

Overall, BaFin is divided into 17 Departments, three Groups, around 130 Sections and four Offices.



Organisationsplan der Bundesanstalt für Finanzdienstleistungsaufsicht  
Stand: 01.11.2004

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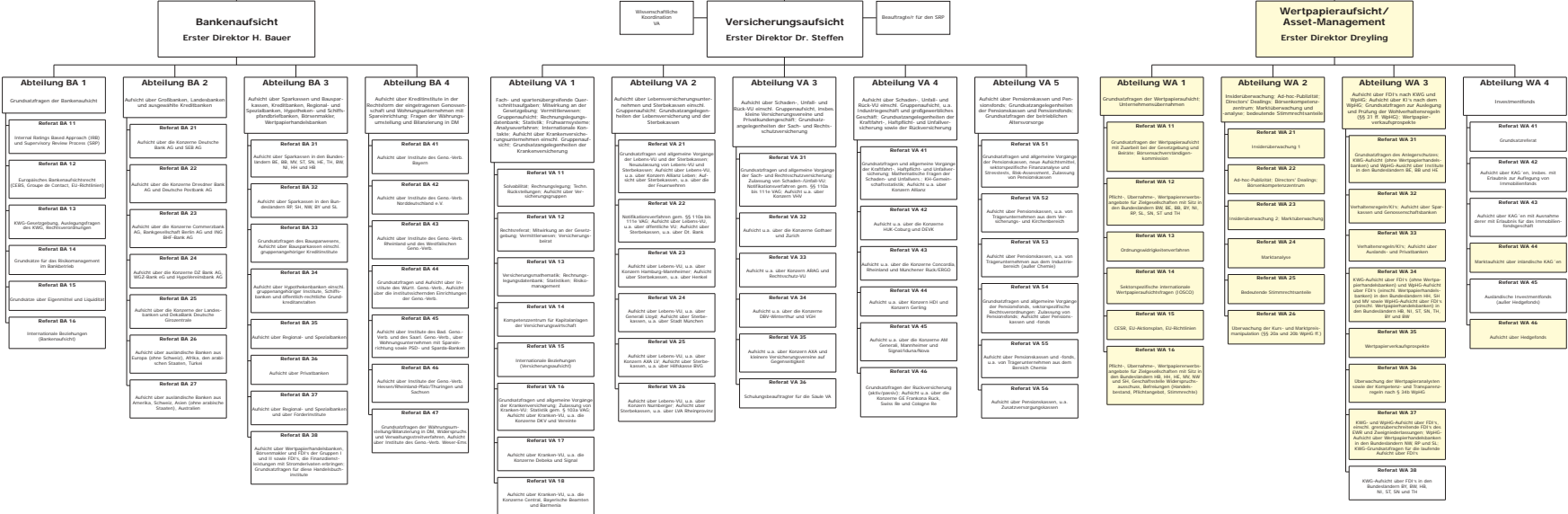
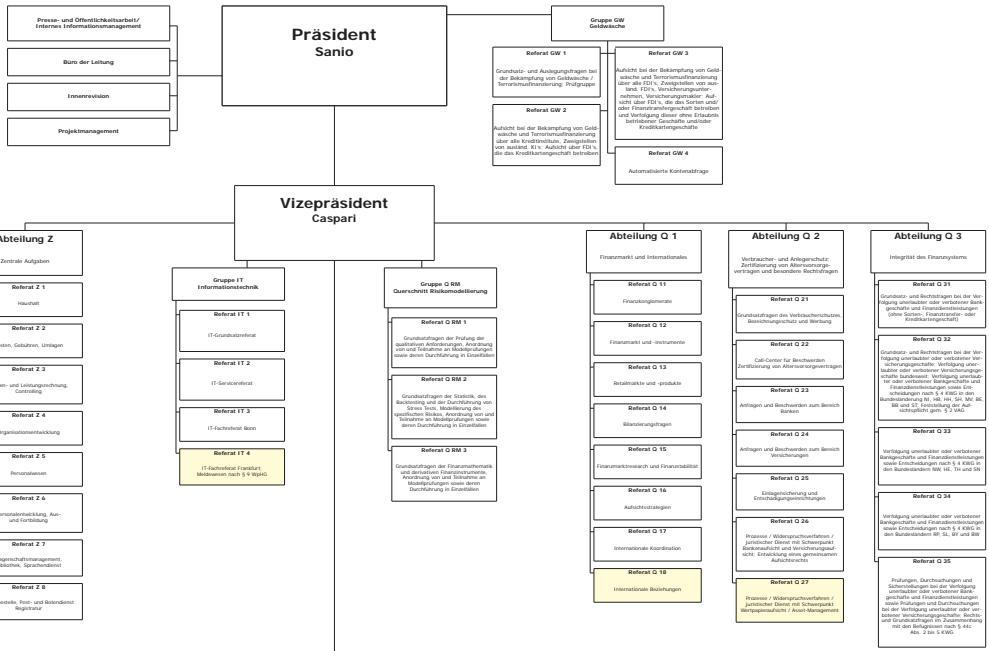
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### **Australian Prudential Regulation Authority**

The Australian Prudential Regulation Authority (APRA), established on 1 July 1998, is the prudential regulator of Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

Before 1 July 2003, APRA was overseen by a Board of largely part-time non-executive members appointed by the Treasurer. Among the nine Board members, eight were non-executive. Six of the Board members, including the Chair and the Chief Executive Officer, were appointed by the Treasurer for terms of up to five years. Two ex officio members were appointed by the Governor of the Reserve Bank of Australia and one by the Chairman of the Australian Securities and Investments Commission.

The Board's primary functions were to:

- determine APRA's policies (including goals, priorities, strategies and administrative policies);
- ensure that APRA performs its functions properly, efficiently and effectively; and
- ensure that APRA's operations are conducted having regard to its purpose as stated in section 8 of the Australian Prudential Regulation Authority Act 1998.

The governance structure of APRA was changed as a result of the recommendation of the Honourable Mr. Justice Owen who was appointed to head the Royal Commission to inquire into the reasons for, and the circumstances surrounding, the failure of HIH Insurance prior to the appointment of the provisional liquidators on 15 March 2001.

In the Royal Commission report issued on 3 April 2003, the Honourable Mr. Justice Owen noted that "APRA's governance structures are not optimal for an organisation for its type. It has a board that is in some respect similar to the boards of commercial entities. I do not think this is necessary. Control—and with it responsibility—should rest with a small full-time executive. This would make APRA more efficient and better able to discharge the responsibilities it has (page 40 of the Chapter entitled "*The Failure of HIH: a critical assessment*" of the HIH Royal Commission Report)."

Mr. Justice Owen was of the view that the imposition of a governance board between the chief executive and the Treasurer had the potential to cloud the line of accountability, especially as it was the board and not the Treasurer that set the duties of the chief executive. As a result of the findings, the Honourable Mr. Justice Owen recommended replacing APRA's non-executive board with an executive group which would carry the responsibility, and account to government, for the operation and performance of APRA.

The new governance structure for APRA came into effect on 1 July 2003 through amendments to the APRA Act. The full-time executive group comprises the Chairman Dr. John Laker, the Deputy Chairman Mr. Ross Jones and the member Mr. Stephen Somogyi. The Executive Group, appointed by the Treasurer, is responsible for determining goals, priorities and strategies.

The Executive Group meets formally on a monthly basis, and more frequently as required, to discuss and resolve the major policy, supervisory and strategic issues facing APRA at the time. It also holds management group meetings with APRA's senior management at least weekly for high-level information sharing and decisions on more routine supervisory and organisational matters.

# BOARD

Jeffrey Carmichael (Chair),  
Graeme Thompson, Rod Atfield, Berna Collier,  
David Knox, John Laker, Ian Macfarlane,  
Don Mercer and Marian Micalizzi.

## Risk Management and Audit Committee

# CEO

Graeme Thompson

Company Secretary  
**Thea Rosenbaum**

Executive General Manager  
Diversified Institutions  
**Tom Karp**

Executive General Manager  
Specialised Institutions  
**Brandon Khoo\***

Executive General Manager  
Policy, Research and  
Consulting  
**Charles Littrell**

Head of Public Affairs  
**Susan Morey**

General Manager  
Branch 1  
**Senthamangalam  
Venkatramani**

General Manager  
Rehabilitation and  
Enforcement  
**Darryl Roberts\*\***

General Manager  
Policy Development  
and Statistics  
**Greg Brunner**

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**Jim Flaye**

General Manager  
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**David Lewis**

General Manager  
Central Region  
**(tba)**

General Manager  
Risk Analysis  
and Research  
**Wayne Byres**

General Manager  
Human Resources  
**Peter Vodicka**

General Manager  
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**Mark Baxter**

General Manager  
Northern Region  
**Puay Sim\*\*\***

General Manager  
Consulting Services  
**Graham Johnson**

Chief Information Officer  
**Colin Cayless**

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and Support  
**Helen Martin**

General Manager  
Risk Assessment and  
Internal Audit  
**Peter O'Callaghan**

General Manager  
Quality Assurance  
and Consistency  
**John Doble**

\*Les Phelps retired on 16 August 2002

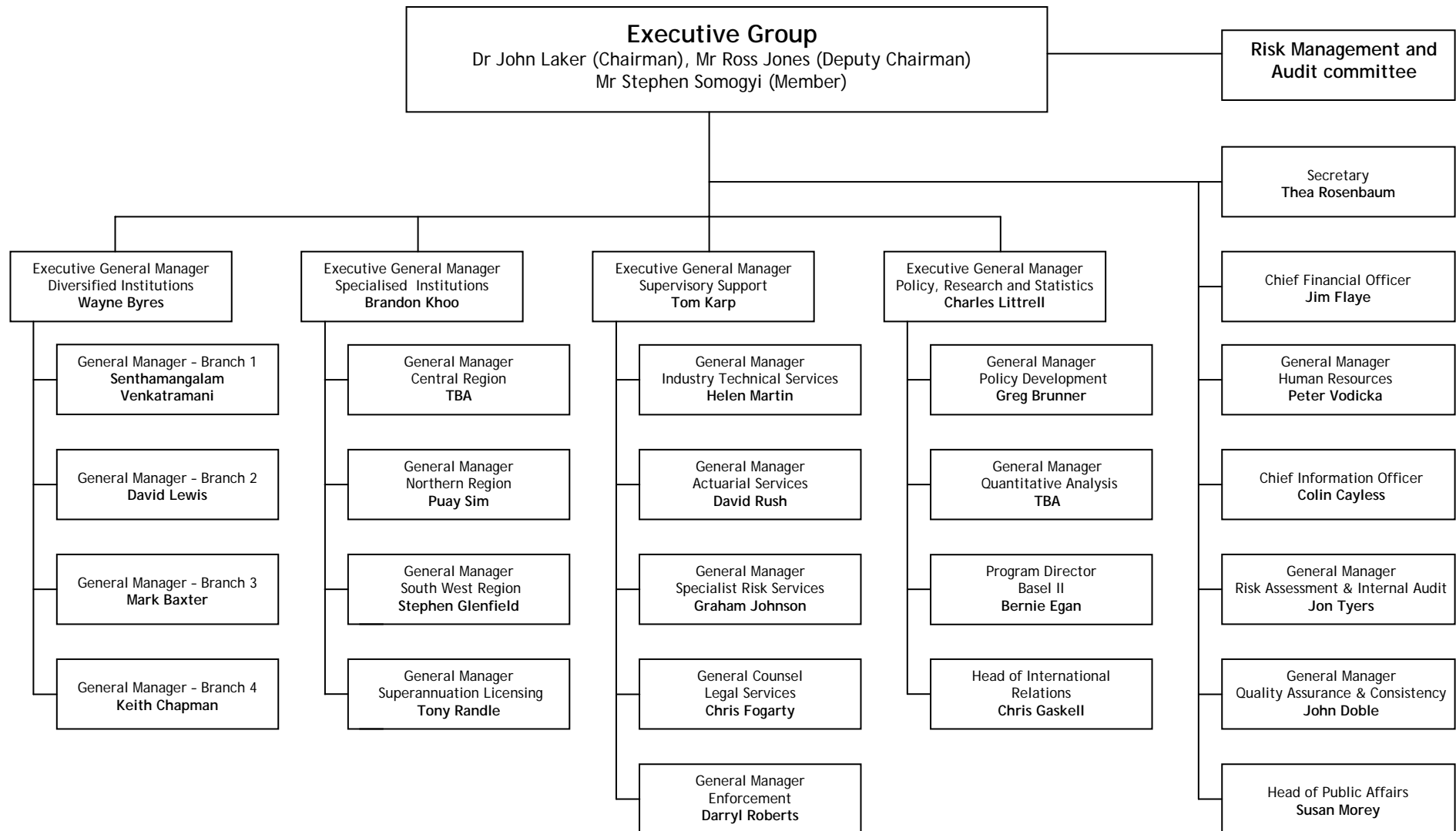
\*\*Bill Gole retired on 4 October 2002

\*\*\*Puay Sim was appointed on 13 September 2002





# ORGANISATION CHART



# **THE FAILURE OF HIH INSURANCE**

## **Volume I**

### **A corporate collapse and its lessons**

**April 2003**

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## **The HIH Royal Commission**

**The Hon Justice Owen  
Commissioner**

4 April 2003

His Excellency the Right Reverend Dr Peter Hollingworth AC OBE  
Governor-General of the Commonwealth of Australia  
Government House  
Dunrossil Drive  
Yarralumla ACT 2600

Your Excellency

In accordance with the Letters Patent issued to me on 29 August 2001, as amended by Letters Patent issued on 6 February 2002, 2 May 2002 and 23 January 2003, I have inquired into and prepared a report on the reasons for and the circumstances surrounding the failure of the HIH insurance group.

I now present to you my report and return the Letters Patent.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Neville Owen', written in a cursive style.

The Hon Justice Owen

*The Landmark, 345 George St, Sydney NSW Postal Address: GPO Box 4014, Sydney NSW 2001  
Telephone: (02) 8270 6216 Facsimile: (02) 9200 5444 Email: justice.owen@hihroyalcom.gov.au*

## Explanatory notes

The report consists of three volumes.

This first volume ‘tells the story’ of the failure of HIH in order to answer the question: why did HIH collapse? It also canvasses changes that are desirable if we are to minimise the risk of another failure of a large insurance company. Discussion of the evidence is kept to a minimum in this volume, but this does not mean that I have proceeded without a close analysis of the evidence on which my findings are based.

Volumes II and III provide a detailed recitation and critical examination of the evidence.

The following notes clarify practices adopted for the preparation of the report.

### References to people

As a general rule, after the first mention people are referred to simply by their family name. This has been done in the interest of efficiency: no disrespect is intended.

### 8.5.1 Governance

Under the *Australian Prudential Regulation Authority Act 1998* APRA is overseen by a board of largely part-time non-executive members appointed by the Treasurer. The board is presently comprised of a number of people with expertise in the various industries regulated by APRA, although they do not formally represent the interests of those industries. Section 19 of the APRA Act requires that the board include a representative from ASIC and two from the Reserve Bank of Australia, one of whom must be either the governor or deputy governor of the RBA. The board's primary functions, as set out in s. 17, are to:

- determine APRA's policies (including goals, priorities, strategies and administrative policies)
- ensure that APRA performs its functions properly, efficiently and effectively
- ensure that APRA's operations are conducted having regard to its purpose as stated in s. 8 of the APRA Act.

Section 36 of the APRA Act states that the chief executive has the duties that the board determines. But the board does not appoint the chief executive; that is a matter for the Treasurer.

The APRA Act provides the board with the power to do anything that is necessary or convenient to be done for or in connection with the performance of its functions (s. 18). The board may also delegate some of its functions to a board member (including the chief executive) or member of the staff (s. 20).

APRA is subject to the *Commonwealth Authorities and Companies Act 1997*. In particular this Act places duties on board members of Commonwealth authorities to:

- exercise powers with the degree of care and diligence that a reasonable person would exercise in that position (s. 22(1)). A person will be taken to have met the requirement under s. 22(1) if in respect of business judgments he or she makes the judgment in good faith for a proper purpose; does not have a material interest in the subject matter of the judgment; informs himself or herself about the subject matter to the extent reasonably appropriate; and rationally believes the judgment is in the best interests of the Commonwealth authority (s. 22(2))
- act in good faith in the best interests of the relevant authority and for a proper purpose (s. 23)
- not improperly use their position to gain an advantage for himself or herself or another person or to cause detriment to the authority or to another person (s. 24)
- not improperly use information obtained in undertaking their role to gain advantage for himself or herself or another person or to cause detriment to the authority or another person (s. 25).

These duties are comparable to those imposed on directors under the Corporations Act.

APRA's governance arrangements largely follow the recommendations of the Wallis report. I note, however, that the Wallis report recommended that APRA's chief executive be directly responsible for enforcement actions and not be required to act in those matters under board direction. The Wallis report also recommended that APRA's chief executive be a statutory officer appointed on the nomination of the Treasurer.

The board as constituted has the powers and responsibilities of a governance board rather than the advisory model that the Wallis report appears to have had in mind. Nevertheless, the appointment of the chief executive, which is one of the key responsibilities of a governing board, is not the responsibility of APRA's board. This places the board in a potentially invidious position.

In principle, governance arrangements should ensure that the allocation of responsibility for a function is clear and coincides with the accountability for the performance of that function. The relevant person or body should be set clear and appropriate objectives and be held responsible for meeting those objectives. In APRA's case there is some dissonance and lack of clarity.

The imposition of a governance board between the chief executive and the Treasurer has the potential to cloud the line of accountability, especially as it is the board and not the Treasurer that sets the duties of the chief executive.

The chief executive is answerable to the board—although it does not appoint him or her—as well as to the Treasurer. At the same time, the board carries responsibility for the performance of APRA but does not appoint the person who runs the organisation on its behalf.

While individuals of the kind who are appointed to APRA's board would no doubt be able to play a valuable advisory role—including acting as a commercial sounding board—there is a question as to the utility of non-executive board input into how a regulatory body such as APRA carries out its statutory role.

My preferred model would vest responsibility for the performance of APRA's functions in a small full-time executive comprising a chief executive and two or three commissioners appointed by the government. This model, akin to the way ASIC is governed, would provide more clarity in and definition of lines of accountability.

The model of a small full-time executive would allow some flexibility in working arrangements with scope for collegial decision making as well as some allocation of functional or sectoral responsibilities among commissioners.

There would no longer be a need for APRA to have a governing board. It would be desirable that APRA's chief executive should be given the power to create an advisory board or boards to provide advice on matters such as prudential standards and other policy or commercial advice.

I am aware of the review currently being conducted by John Uhrig of governance arrangements for Commonwealth statutory authorities and office holders. It will be necessary to consider my views on this subject in the light of the outcome of that review.

#### **Recommendation 18**

I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to replace APRA's non-executive board with an executive group. This group would comprise the chief executive officer and two or three executive commissioners and would carry the responsibility, and account to government, for the operation and performance of APRA.

**Recommendation 19**

I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to provide the chief executive with the power to establish an advisory board.

***RBA and ASIC representation***

The Wallis report recommended that ‘the financial regulatory agencies should have substantial board cross-representation to encourage cooperation and foster a common perspective about the needs and dynamics of the financial system’.<sup>[8]</sup>

In the event, APRA has a representative of ASIC and two representatives of RBA on its board. There is no reciprocal representative of APRA on the other agencies.

While the aim of promoting cooperation and a broader perspective was laudable, the concept of the representation of agencies at board level was, I believe, misconceived. On the basis of this inquiry I have reservations too about its utility in practice. Requiring a person who is responsible for running one regulatory agency to become involved in the governance of another agency can only tend to cloud and complicate his or her focus. In my view the APRA model also places the chief executive of APRA in a difficult position. Not only does the chief executive have to account to a board, as well as the Treasurer, but there is a co-agency executive assessing conduct.

There is also a risk that the participation of RBA and ASIC representatives on the APRA board may impede as much as improve coordination between the agencies at working level. There was some indication in the evidence I heard that staff may have assumed that necessary exchange of information would be occurring at board level obviating the need for communication at a working level.

Effective coordination of activities and exchange of information between relevant agencies should be part of the operational responsibility of those who run the agencies. This should be developed through regular formal and informal mechanisms involving agency staff at various levels. At a broader level, a mechanism such as the Council of Financial Regulators, which has representation from the Treasury as well as the agencies, would seem to me to be a more appropriate forum for the strategic consideration of issues affecting the financial services sector.

**Recommendation 20**

I recommend that the direct involvement of representatives of the Australian Securities and Investments Commission and the Reserve Bank of Australia in the governance of the Australian Prudential Regulation Authority be discontinued. This will require amendment of the *Australian Prudential Regulation Authority Act 1998*.