

**立法會**  
**Legislative Council**

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**Panel on Financial Affairs**

**Minutes of special meeting  
held on Friday, 29 September 2006 at 9:00 am  
in the Chamber of the Legislative Council Building**

- Members present** : Hon Bernard CHAN, GBS, JP (Chairman)  
Hon James TIEN Pei-chun, GBS, JP  
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP  
Hon James TO Kun-sun  
Hon CHAN Kam-lam, SBS, JP  
Hon SIN Chung-kai, 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 TAM Heung-man
- Members absent** : Hon Ronny TONG Ka-wah, SC (Deputy Chairman)  
Hon LEE Cheuk-yan  
Dr Hon David LI Kwok-po, GBS, JP  
Hon Emily LAU Wai-hing, JP  
Hon Albert Jinghan CHENG
- Public officers attending** : Mr Frederick MA, JP  
Secretary for Financial Services and the Treasury
- Mrs Sarah KWOK  
Deputy Secretary for Financial Services and the Treasury  
(Financial Services)

- Attendance by invitation** : Securities and Futures Commission  
Mr Martin WHEATLEY  
Chief Executive Officer  
  
Mr Stephen PO  
Senior Director (Intermediaries and Investment Products)
- Clerk in attendance** : Miss Salumi CHAN  
Chief Council Secretary (1)5
- Staff in attendance** : Ms Rosalind MA  
Senior Council Secretary (1)8  
  
Ms May LEUNG  
Legislative Assistant (1)8
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Action

**I. Regulation of securities firms**

- (LC Paper No. CB(1)2158/05-06(01) — Letter dated 23 August 2006 from Hon SIN Chung-kai  
LC Paper No. CB(1)2248/05-06(01) — Paper provided by the Securities and Futures Commission  
LC Paper No. CB(1)2277/05-06(01) — Joint submission dated 27 September 2006 from 118 cash clients of Wing Yip Company Limited  
LC Paper No. CB(1)2277/05-06(02) — Submission dated 27 September 2006 from a cash client of Wing Yip Company Limited)

Purpose of the meeting

The Chairman advised that given the three recent cases of broker misconduct, concerns had been raised by members on whether the current regulatory regime was adequate in protecting the interests of small investors. This special meeting was held for the Panel to discuss with the Administration and the Securities and Futures Commission (SFC) on issues relating to the regulation of securities firms.

Briefing by the Administration and SFC

2. At the invitation of the Chairman, the Secretary for Financial Services and the Treasury (SFST) gave a brief introduction on the Administration's view on regulation of securities firms. SFST pointed out that the three recent cases of broker

misconduct were identified by SFC in its inspection of the brokers concerned. He believed that these three cases were individual incidents and that the majority of the securities firms complied with the rules, codes and guidelines governing their business operations under the current regulatory framework. Noting the concern of the affected clients of the three securities firms about the work progress of the administrators, the Administration had conveyed to SFC the need for the administrators to return the assets to the clients expeditiously. The Administration also called on SFC to step up investor education, including promoting the use of the Investor Participant Accounts (IP Accounts) in the Central Clearing and Settlement System (CCASS) to reduce the risk of investors' securities being misappropriated by broker firms. The Administration was given to know that SFC was working in collaboration with the Hong Kong Exchanges and Clearing Limited (HKEx) on enhancements to IP Accounts to facilitate use by investors.

3. At the invitation of the Chairman, Mr Martin WHEATLEY, the Chief Executive Officer of SFC gave a power-point presentation on the regulatory framework to safeguard the assets of clients of securities firms. His presentation was summarized as follows:

(a) Overview of the brokerage industry

As at 30 June 2006, SFC regulated 430 stock exchange participant brokers, which could be grouped into three broad categories, namely Categories A, B and C. The majority of the brokers fell within Category C (365 firms as at 30 June 2006). The number of brokers operating in Hong Kong was large compared with other major markets. Whilst the market share held by Category C brokers had decreased as compared with that in 2003, the aggregate net profits of Category C brokers in the first half of 2006 increased by five times as compared with the first half of 2005 given the significant increase in the average daily turnover.

(b) Framework to safeguard client assets

- On safekeeping of client securities, most client securities were deposited with CCASS in brokers' omnibus accounts with brokers issuing monthly statements to clients. There were options for clients to have more control on the safekeeping of their securities, including opening Stock Segregated Accounts (SSAs) and IP Accounts. In terms of clients' control of securities movements, the best solution was to open IP Accounts in clients' own names, as investors' instructions would be required for every withdrawal or deposit.
- On brokers' responsibilities under the Securities and Futures Ordinance (Cap. 571) (SFO), there were strict rules/guidelines requiring brokers to segregate securities of cash clients; segregate client money; issue timely contract notes and account statements to their clients; and appoint auditors to annually audit their financial positions and review regulatory compliance.

- On SFC oversight, SFC adopted a risk-based approach in the supervision of securities firms. For example, SFC performed off-site reviews of information submitted by brokers and their auditors, conducted onsite inspections, and took appropriate action in relation to any broker misconduct. Where appropriate, SFC would refer cases to the Police.
- As for the protection offered by the Investor Compensation Fund (ICF), the maximum compensation amount was increased to \$150,000 per investor in April 2003. With this level of compensation, it was estimated that the losses of about 70% of the investors could be fully compensated. The Fund was used as a last resort to safeguard investor losses due to fraud and firm collapse. As at end of August 2006, the net asset value of ICF was about \$1.7 billion.

(c) Lessons learnt from recent incidents of broker misappropriation of client assets

All the three recent cases of broker misconduct (i.e. Whole Win Securities Limited, Tiffit Securities (Hong Kong) Limited and Wing Yip Company Limited) had the following common features and deficiencies:

- The root of the problem was a serious integrity issue where the senior management of the firms (usually the principal owner/shareholder) abused the trust placed in them by their clients and failed to discharge their duty of care in safekeeping their clients' assets.
- The three firms were relatively small businesses without proper segregation of duties or checks and balances.
- Majority of the firms' clients did not maintain an IP Account or a SSA on CCASS.
- Recent auditor reports did not reveal any apparent issues with the three firms.

(d) Three-prong action plan

SFC had devised the following three-prong action plan to help identify brokers with potential integrity concerns and deter misconduct:

- To continue with the rigorous supervision of brokers, keeping a close eye on their financial positions and following up on any anomalies or suspicious behaviour.
- To step up investor education to encourage the use of IP Accounts and checking of their statements.
- To have greater collaboration with auditors in using circularization more effectively to detect fraud. SFC had entered into a dialogue with the Hong Kong Institute of Certified Public Accountants (HKICPA) in this respect and the latter had recently announced that they supported the idea of more effective circularization.

4. Mr Martin WHEATLEY also advised that for the strategy in the longer term, SFC would conduct a review of the existing asset custody arrangements. Moreover, SFC would consider ways to strengthen the existing supervision of brokers, such as reviewing the governance standards and internal control requirements for brokers to handle client assets; working with HKEx to explore further enhancement of IP Accounts; and considering tougher disciplinary sanctions and penalties imposed on firms for certain types of misconduct and deficiencies. In conclusion, Mr WHEATLEY pointed out that even the most stringent regulations could not prevent deliberate fraud, especially by the principal owners/shareholders of firms. It would be important for regulators, auditors, intermediaries and investors to work together to minimize fraud and misconduct.

*(Post-meeting note: The power-point presentation material provided by SFC was circulated to members vide LC Paper No. CB(1)2290/05-06(01) on 29 September 2006.)*

### Discussion

#### *Returning assets to clients*

5. Mr CHAN Kam-lam noted that the clients affected by the three recent cases of broker misconduct had expressed concern about the time taken by the administrators to verify their claims and return their assets. Mr CHAN appreciated their concern and pointed out that given the volatility of the stock market, the affected clients might suffer further losses if they could not get back their stocks. He urged the Administration to liaise with the administrators for expediting their work process and giving priority to assets which had not been subject to misappropriation by the brokers concerned. In this connection, the Chairman drew members' attention to the two written submissions received by the Panel, one from 118 cash clients of Wing Yip Company Limited and another from one cash client of the same company (LC Paper Nos. CB(1)2277/05-06(01) and (02)).

6. In response, SFST said that the Administration was aware of the concerns of the clients affected by the three recent cases of broker misconduct and had conveyed their concerns to SFC. Mr Martin WHEATLEY explained that in all the three cases, SFC had acted immediately upon uncovering the misconduct to stop further dissipation of client assets, by issuing restriction notices and applying for the appointment of administrators. The administrators had to verify clients' claims and recommend to the court as to how the assets should be returned to the clients before obtaining a direction from the court to return client assets. Mr WHEATLEY stressed that for all the three cases, SFC had requested the administrators to take prompt actions and ensured that they were making good progress. Some cases were more complex, involving falsified or incomplete records, and would need more time for the administrators to ascertain the client losses. He advised that in one of the cases, the administrators had already arranged for the return of securities to the unaffected

clients. Nevertheless, time would be required for identifying assets that were not affected and confirming with clients their records against the records of the securities firms.

7. Mr CHIM Pui-chung also expressed concern about losses suffered by the affected clients. In this connection, Mr CHIM was of the view that the costs for appointment of the administrators should be borne by SFC as the regulator, and not by the clients who might have to bear losses as a result of the broker misconduct.

8. Mr Martin WHEATLEY said that the costs of administrators would be charged to the assets of the securities firms concerned but where assets were not available or inadequate to cover the costs, the court would order the costs to be charged to the trust assets held by the firms on behalf of the clients. Clients might register their claims against ICF, which offered a maximum payment of \$150,000 per client on default of a broker firm. Responding to Mr CHIM Pui-chung's concern about controlling the costs of administrators, Mr WHEATLEY assured members that SFC was fully aware of clients' concern and was doing its best to manage the costs of administrators to the benefit of the clients. In this connection, SFC had put in place fixed price contracts for specific work related to the return of client assets.

9. Referring to the written submissions from the cash clients of Wing Yip Company Limited, Mr SIN Chung-kai suggested that improvements be made in the coordination work and the process involved in the return of client assets, such as by designating a coordinator to facilitate better communication between the parties concerned and to hold regular meetings with the clients to keep them informed of the latest progress. Mr CHIM Pui-chung expressed similar concern. Mr CHIM urged SFC to review the current mechanism for the purpose of enhancing the protection of the interests of small investors and to consider setting up a dedicated working group for this purpose.

10. Mr Martin WHEATLEY pointed out that SFC shared the clients' concern and endeavoured to ensure that there were minimum delay and costs in the investigation process. SFC had been in close contact with the administrators and had urged the administrators to return the assets to clients as quickly as possible and keep them informed of the progress. Mr WHEATLEY also pointed out that SFC had a team of officers responsible for advising clients of their rights and matters relating to the operation of ICF. Relevant information was also available on the website of ICF. By way of illustration, Mr WHEATLEY explained that SFC had, after issuing a restriction notice on Wing Yip Company Limited on 7 August 2006, issued press announcements on 8 August 2006, 10 August 2006 and 5 September 2006 to update the clients and the public of the progress of its inquiry, the appointment of administrators and a notice inviting qualifying clients of the company to lodge their applications for compensation against ICF. The administrators had also issued press releases from time to time to keep the clients informed. He stressed that SFC spared no efforts in improving the degree of coordination in the investigation process and ensuring that the administrators maintained good communication with clients

throughout the process. Nevertheless, distribution of client assets could be arranged only upon approval of the court and it took time for the legal proceedings to complete. Responding to Mr SIN Chung-kai's further enquiry about the feasibility of returning securities to cash clients ahead of margin clients, Mr WHEATLEY said that this arrangement was workable only for those securities firms which had complied with the rule of segregation of client assets.

11. To facilitate the Panel's examination on the effectiveness of the current mechanism, Mr SIN Chung-kai requested the Administration to liaise with SFC and provide the Panel with the following information:

- (a) Number of meetings between SFC staff and/or staff of the Financial Services and the Treasury Bureau (FSTB) with the clients of the three securities firms (Whole Win Securities Limited, Tiffit Securities (Hong Kong) Limited and Wing Yip Company Limited) since the issuance of restrictions notices to the firms; and
- (b) Information on investor compensation in respect of cases of securities firms failure in the past two years (including the three recent cases mentioned in item (a) above), including a breakdown of the cases by the number of clients affected; and amount of compensation paid to the affected clients through ICF.

*(Post-meeting note: The written response from the Administration and SFC on paragraph 11 above was circulated to members vide LC Paper No. CB(1)203/06-07(01) on 1 November 2006.)*

#### *IP Accounts and SSAs*

12. Noting that IP Accounts were not popular amongst investors, Mr CHAN Kam-lam urged the Administration, in collaboration with SFC and HKEx, to promote the use of IP Accounts by enhancing the user-friendliness of the accounts and waiving the charges involved. Moreover, in order to inspire confidence of local and overseas investors in the quality of the securities market in Hong Kong, Mr CHAN considered that the Administration should work out a timetable and roadmap for improving the operation of IP Accounts. Miss TAM Heung-man also sought information on the measures to be adopted by the Administration to promote the use of IP Accounts.

13. Mr CHIM Pui-chung shared Mr CHAN Kam-lam's view that the charges for using IP Accounts should be waived. He considered that if HKEx was reluctant to provide the relevant services free of charge, the Administration and SFC should review the current arrangement under which HKEx was responsible for the administration of IP Accounts and explore the feasibility of other options, such as the option of allowing open competition for account administration.

14. SFST appreciated members' concern and pointed out that the Administration was in support of the promotion of IP Accounts for better protection of investors' interests. He pointed out that in his monthly articles published in newspapers, he had repeatedly encouraged investors to use IP Accounts. The Administration noted that SFC was liaising with HKEx with a view to making the service of IP Accounts more attractive to investors, such as improving the user-friendliness and reducing or waiving some of the charges. SFST however pointed out that decision on changes to the design and charges of IP Accounts would be made by the Board of Directors of HKEx.

15. Mr SIN Chung-kai opined that as IP Accounts had not been popular among investors despite previous promotional efforts, the Administration and SFC should explore alternative means for enhancing investor protection, such as examining whether improvements could be made to SSAs. Mr CHAN Kam-lam also pointed out that the Administration should invite HKEx to examine how services of SSAs could be enhanced, such as by waiving the charges on these accounts.

16. SFST pointed out that the level of protection provided by IP Accounts and SSAs were not the same. While clients with IP Accounts had full control of the movements of stocks in their account, SSAs only provided clients with a CCASS statement after every stock movement and a monthly statement, with the control of stock movement still maintained by brokers. While SFC and HKEx were working together for measures to improve the user-friendliness of IP Accounts, it should be noted that a proper balance had to be struck between convenience and risk management.

17. Mr Martin WHEATLEY responded that under the current regime, most client securities were deposited with CCASS in brokers' omnibus accounts. This arrangement provided brokers and clients with convenience as brokers had full control of the movements in the omnibus account and could act on behalf of their clients without getting their prior explicit instructions on every transaction. On the other hand, the use of IP Accounts by clients would provide better protection of their assets as they had full control of the accounts and their instructions were required for every withdrawal or deposit. The choice of using IP Accounts therefore involved a trade-off between convenience and security. SFC was working closely with HKEx to make improvements to IP Accounts and SSAs and progress were being made in this respect.

18. Mr James TIEN doubted whether and how clients who were cash account holders could prevent brokers from repledging the securities in their accounts if they had signed an agreement for margin trading. In response, Mr Martin WHEATLEY said that in order to enhance the protection for investors, SFC had taken the initiative to amend the client securities rules by imposing a repledging limit on firms licensed for dealing in securities or securities margin financing, under which a limit of 180% would come into effect on 1 October 2006 and further reduced to 140% after a period of 12 months. Mr WHEATLEY said that cash clients who wished to engage in



margin trading might either transfer their cash accounts to margin accounts, in which case they would have to bear the risk of their securities being repledged for margin financing, or they might choose to open a separate account for margin trading. He agreed with Mr James TIEN that investor education should be strengthened to alert investors of the impact of signing an agreement for margin trading on the assets in their accounts.

19. Noting from paragraph 7 of the paper provided by SFC that the misconduct involved in the three recent cases was very well hidden, Mr James TO enquired whether the misappropriation of client securities in these cases could have been effectively prevented or uncovered at any earlier stage had all the clients of the three securities firms concerned been using IP Accounts.

20. In reply, Mr Martin WHEATLEY advised that for cash clients, the brokers were not allowed to repledge their securities. For margin clients, the brokers could repledge but could not steal their securities.

#### *Supervision of brokers*

21. Given that the use of IP Accounts could not remove the risk for misappropriation of margin clients' securities, Mr James TO was concerned whether and how the effective protection of investors' assets could be achieved. In this connection, Mr TO enquired whether more rigorous supervision by SFC, such as increased supervision of budget and increased frequency of onsite inspections, would be effective for uncovering any irregularities and/or misconduct at an early stage. Referring to paragraph 6 of the paper provided by SFC, Mr TO also requested SFC to review the relevant files and records to ascertain whether the same "unusual patterns" or irregularities had been identified in its previous onsite inspections or previous examination of financial returns submitted by the three securities firms concerned.

22. Mr Martin WHEATLEY explained that SFC had all along adopted a risk-based approach in the supervision of the large number (430 in total) of stock exchange participant brokers under its regulation. In addition to scrutinizing the monthly financial returns submitted by securities firms, SFC also closely monitored those firms the operation of which had aroused certain regulatory concerns and/or against which disciplinary actions had been taken. In cases where the integrity of the management of the firms was in doubt, SFC would take immediate restrictive action to protect the interests of the firms' clients. Mr WHEATLEY pointed out that under the existing licensing regime, licensed securities firms were subject to detailed rules, codes and guidelines for their business operations and majority of the firms complied with the relevant requirements. As to the three recent cases, the misconduct were uncovered by SFC through onsite inspections after unusual patterns in the financial returns submitted by the brokers had been identified. However, not even the best laws could prevent deliberate fraud, and neither the IP Accounts nor increased resources for more frequent inspections and supervision could fully address fraud and lack of integrity of individual brokers. If more resources would be allowed for SFC to

step up the level of supervision, this would inevitably impose greater constraints on the business operations of securities firms. A balance would have to be struck between investor protection and interference to business operation of securities firms.

23. Mr James TO remained concerned whether the misconduct involved in the three recent cases could have been uncovered at an earlier stage. He requested FSTB and SFC to look into the details of the three cases in this respect. SFST advised that FSTB would not intervene into the daily operation of SFC, which was an independent regulator. Nevertheless, he believed that the non-executive directors (NED) of the Board of SFC would oversee the work of SFC. The new Chairman to be appointed to SFC in accordance with the Securities and Futures (Amendment) Ordinance 2006 enacted in June 2006 would provide additional checks and balances.

PRP

24. On checks and balances of SFC's work, Mr Martin WHEATLEY advised that the internal operational procedures of SFC were subject to review by the Process Review Panel for SFC (PRP). PRP would publish the findings of its review in its annual report. Noting the advice of Mr WHEATLEY and the request of Mr James TO, the Chairman directed the Clerk to write to PRP on behalf of the Panel, inviting PRP to review the three cases mentioned in paragraph 3(c) above, including the following aspects:

- (a) whether the same "unusual patterns" or misconduct mentioned in paragraph 6 of the paper provided by SFC had been identified in SFC's previous onsite inspections or previous examination of financial returns submitted by the three securities firms concerned;
- (b) whether the actions taken and decisions made in relation to the three cases mentioned above were consistent with the relevant internal procedures and operational guidelines; and
- (c) if the answer(s) to item (a) and/or item (b) above were in the affirmative, whether the SFC's internal procedures and operational guidelines were adequate in ensuring the effective performance of SFC's regulatory functions.

*(Post-meeting note: The written response from PRP was issued to members vide LC Paper No. CB(1)306/06-07(02) on 17 November 2006. With the concurrence of the Chairman, the Panel wrote to PRP again on 24 November 2006, inviting PRP to review the three cases of broker misconduct in due course. Further response from PRP would be kept in view.)*

25. In view of the three recent cases of broker misconduct, Miss TAM Heung-man was concerned whether there were adequate checks and balances in the governance structure and internal control mechanism of small sized securities firms to safeguard against fraud. In this connection, Miss TAM enquired whether SFC

would consider strengthening the licensing requirements for securities firms, such as the capital requirement.

26. SFST responded that SFC as the regulator of the securities industry was responsible for the licensing of securities intermediaries. While SFC would take into consideration the level of capital requirement in the licensing of securities intermediaries, higher level of capital requirement alone was no guarantee for the integrity of management of the firms. Mr Martin WHEATLEY pointed out that instead of the level of capital requirement, segregation of operations would be important to the governance of securities firms. Hence, one of the issues to be addressed in SFC's review in the medium term was how to achieve better segregation of duties for small sized firms, particularly for firms with owner-run operations.

27. Mr CHAN Kam-lam opined that the misconduct and fraud involved in the three recent cases would have adverse impact on the prestige of Hong Kong as an international financial centre. He urged the Administration to protect the interests of small investors through strengthening the supervision of securities firms and assisting the brokerage industry to upgrade their service quality.

28. SFST said that the Administration was supportive to the on-going enhancement of service quality in the brokerage industry. He pointed out that the industry associations had devoted a lot of efforts in this respect, such as assisting brokers to acquire knowledge of different financial products in the market. SFST also stressed that the Administration appreciated the contribution of securities firms of different scales. He believed that small sized securities firms could always enhance their market competitiveness through providing tailor-made and quality services to meet the specific needs of their clients.

#### *Collaboration with the audit profession*

29. Referring to paragraph 9(d) of the paper provided by SFC, Mr James TO noted that none of the auditors of the three securities firms concerned had reported any non-compliance with the rules on client securities and client money. In this connection, Mr TO was concerned about the adequacy and comprehensiveness of the auditing work for securities firms. He enquired whether SFC would review the subject in the light of the three cases.

30. Miss TAM Heung-man considered that the use of circularization in the annual audit or a representative sampling of clients for circularization on a regular basis would facilitate the uncovering of fraud or misconduct in a more effective and timely manner. She opined that SFC should consider working out the guidelines on compulsory annual circularization on a big sample basis with the auditing profession to better safeguard the assets of investors.

31. Mr Martin WHEATLEY said that for auditors to confirm the accounting and trade documentation of securities firms, they had to check the firms' records with the

clients. SFC therefore took the view that circularization should form an important part of annual audit as effective circularization could uncover problems. The sample size of clients involved in the circularization should be large enough to provide a representative and meaningful picture. In two of the three recent cases of broker misconduct, circularization had not been conducted as effectively as it should have been, which was a lesson learnt from these cases. Mr WHEATLEY also said that as he had pointed out earlier at the meeting, SFC had entered into a dialogue with HKICPA on incorporating more effective circularization into the guidelines for annual audit.

*Difficulties faced by the brokerage industry*

32. Mr CHIM Pui-chung expressed grave concern about the difficulties faced by securities brokers due to the expansion of securities business by banks. He pointed out that while some banks had attempted to promote their securities services through adopting "zero commission", their clients were subject to other fees and charges for their securities transactions. In this connection, Mr CHIM reiterated the concern of the brokerage industry about the current arrangement under which the securities businesses of banks and securities firms were regulated by different regulators, namely by the Hong Kong Monetary Authority (HKMA) and SFC respectively. He called on the Administration not to turn a blind eye on the difficulties faced by securities brokers.

33. In reply, SFST said that the current regulatory arrangement for the securities industry was endorsed by the Legislative Council in the enactment of SFO in 2002. He pointed out that HKMA and SFC had maintained consistency and applied same standards in their regulation of the securities business of banks and securities firms through their Memorandum of Understanding. The Administration had discussed with the two regulators about the concern of the brokerage industry and were advised by both that changes to the current regulatory arrangement were not necessary. On the concern about brokerage commission, SFST advised that HKEx had announced its decision to liberalize the minimum brokerage commission rule in 2000 when HKEx was listed. He believed that securities investors would obtain detailed information for selection of their service providers in a wise manner, after comparing the services offered and the level of fees to be paid.

**II. Any other business**

34. There being no other business, the meeting ended at 10:40 am.

Legislative Council Secretariat  
6 December 2006