



**SECURITIES AND FUTURES COMMISSION** 證券及期貨事務監察委員會

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BY HAND

The Honourable Henry Tang, GBS, JP  
Financial Secretary  
Government Secretariat  
12/F, West Wing  
Central Government Offices  
Lower Albert Road  
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Regulation of Banks' Securities Operations

We discussed at our last meeting the issue of regulation of the securities business of banks. This has been raised in the media as one aspect of the so-called "uneven playing field" between brokers and banks doing securities business. Whilst this business is all subject to the same provisions of the SFO, some brokers have complained that the two regulators implement the rules differently. We discussed therefore whether these activities could be brought under the same regulator, not just a common regulatory regime.

The attached paper looks at some of the practical issues and also the background on how we reached the current situation. The broad conclusion is that given the significant hurdles to be overcome - both practical and political - there would need to be strong reasons for change and a strong will to drive such a change through at this time.

I look forward to the opportunity of discussing this with you.

Yours sincerely,

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# Regulation of Registered Institutions and Relevant Individuals

## INTRODUCTION

1. The purpose of this paper is to provide information on the regulatory structure with regards to securities services undertaken by financial institutions in the banking and securities sectors and the viability of the regulation of the securities business by banks being under the same regulator as brokers.

## BACKGROUND

### *Proposal to abolish banks' exemption*

2. Under the former regime, banks enjoyed exemption from SFC regulation on the basis that they did very little securities business at that time. The Securities Review Committee originally recommended total abolition of the exemption system. Following a review of those provisions and consultation with the industry in 1990, it was concluded that banks should not continue to be exempted from SFC regulation in view of the fact that many of them had since become significant participants in the securities industry.

### *Market views*

3. The Hong Kong Association of Banks ("HKAB") expressed grave concerns about possible duplication or conflict of responsibilities between the SFC and the Hong Kong Monetary Authority ("HKMA"), the cost of licensing bank staff and concomitant administrative costs. They submitted that banks' activities were closely supervised by the HKMA, they conformed to high standards, complied with strict rules and observed capital adequacy requirements that were more stringent than the Financial Resources Rules ("FRR").
4. The stock broking industry took a contrary view. It submitted that an inherent and essential element of a level playing field for all industry participants was exposure to the same standards of regulatory oversight.

### *SFC's review*

5. As a result of the comments from the HKAB and the HKMA, the SFC visited five banks in August 1996 to gain a better understanding of their securities operations. Although some unsatisfactory areas were found, overall the securities operations were well run and capable of generating increasing competition for traditional brokers. The SFC came to the view that, in keeping with the prevailing trend in all developed markets, the prudential supervision of banks should remain with the banking regulators, namely HKMA, notwithstanding that banks could engage in securities dealing and investment advice.

## *The Administration*

6. The Administration considered it necessary to enhance HKMA's regulatory functions in relation to securities business conducted by authorized institutions (including banks) under the Banking Ordinance. Among others, a major provision in the Banking (Amendment) Bill 2000 was to put beyond doubt, the fact that HKMA's regulatory powers covered the whole of authorized institutions' businesses and that it remained the primary regulator of banks. This approach was consistent with the "Core Principles for Effective Banking Supervision" published by the Basle Committee in 1997 – Principle 20, stipulating that an essential element of banking supervision was the ability of the supervisors to supervise the banking group on a consolidated basis.

## PRESENT POSITION

### *Level playing field*

7. Following the commencement of the SFO in 2003, banks (as registered institutions) and their relevant individuals<sup>1</sup> are now formally subject to the various rules, codes of conduct, guidelines and disciplinary powers of the SFC unless there were equally or more stringent requirements under the Banking Ordinance. For instance, FRRs and the Client Money Rules would not apply to banks as there were already more stringent requirements on initial paid-up capital, capital adequacy and liquidity, large exposure, etc. under the Banking Ordinance to ensure banks' prudential safety and protection for clients' interest. (Please see Appendix 1 for the current modus operandi.)
8. In respect of the supervision of the conduct of regulated activities by banks, some maintained the view that there was a risk that the regulatory standards and requirements would not be consistently applied to SFC licensees and registered institutions.

### *Current profile*

9. As of 31 December 2005, there were 25,210 SFC licensees (1,287 firms and 23,923 individuals) and 82 registered institutions with a total of 22,502 relevant individuals. These registered institutions engaged in a full range of securities businesses apart from stock broking, such as investment advice and distribution of funds and structured products. (Please see Appendix 2 for the regulated activities carried out by registered institutions.) There were also 45 banks (of which 40 were registered institutions) with a total of 155 subsidiaries operating securities business under the direct supervision of the SFC. These subsidiaries engaged about 5,000 licensed individuals.

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<sup>1</sup> "relevant individual" in relation to a registered institution, means an individual who performs for or on behalf of or by an arrangement with the institution any regulated function in a regulated activity.

## ALTERNATIVE APPROACH

10. This paper examines the implications of whether the regulation of the securities business undertaken by banks could be under the same regulator as brokers. Some brokers maintain that there is an inconsistent implementation of regulatory standards between the HKMA and SFC towards the conduct of regulated activities by banks and licensed corporations respectively. They consider that banks have been favourably treated by HKMA as compared to them by SFC in light of the fact that bank employees have rarely been disciplined by HKMA in carrying on regulated activities.
11. The current regime is a finely balanced craft, borne out of difficult compromises. The SFO has only been in implementation for less than three years and a new memorandum of undertaking was only entered into with HKMA on 12 December 2002 ("MoU"). Accordingly, although securities businesses conducted by SFC licensees and banks are subject to the same rules and regulations promulgated by the SFC, if there exists a regulatory disparity, the problem may lie more in implementation rather than policy. It would be expected that, given time and further experience and cooperation, such differences could be resolved.
12. In addition, the two regulators maintain a close dialogue on issues relating to supervision of banks' regulated activities and consult one another in relation to any complaint received or issue raised by either regulator on regulated activities conducted by banks and on disciplinary actions following thereon, including recommendations on the exercise of disciplinary powers. This consultation will also include any appeals against a decision of the SFC or the HKMA concerning a bank. All these measures serve to minimise the risk of regulatory disparity.
13. Brokers also feel that the regulatory field is tilted against them in that their representatives are subject to a formal licensing regime by the SFC, whereas banks' employees carrying on regulated activities are not.
14. In this respect, HKMA enters the names of these employees on its public register, which is maintained by HKMA on their website. Before such entry, HKMA checks the conduct and fit and proper concerns against SFC's database and requires the banks to certify that these employees have complied with the same competence and continuous professional training requirements as SFC licensed representatives. HKMA also checks these compliance records when they do inspections.
15. There are also other fundamental issues that need to be considered in considering any change from the current structure. We attempt to set these out in paragraphs 16 to 24.

### *Legislation and consultation*

16. Extensive amendments would be required to the SFO, its subsidiary legislation, and the Banking Ordinance to cater for a change to the regulation of banks and their employees in relation to regulated activities.
17. For example, s.5 of the SFO regarding functions and powers of the SFC would require amending in relation to the SFC's powers to regulate registered institutions. Part V of

the SFO as a whole and related subsidiary legislation, in particular s.114 and s.119 of the SFO, would require amendments to bring in line the licensing requirements of registered institutions. S. 194, s. 196 and s.197 would also require amendments to bring disciplinary actions against registered institutions on par with those for licensed persons.

18. As this entails amendments to the SFO as well as the Banking Ordinance, an in-depth and lengthy consultation would be necessary to properly determine the market's reaction. It should be noted that the original consultation on regulation of banks in 1990 met with significant resistance from the HKAB and resulted in a prolonged process before an agreement could be reached with the market. This proposal represents a significant change to the agreement reached during the preparation of the SFO (i.e. that HKMA is the frontline regulator for banks' securities operations). Consequently, strong opposition on the proposal is expected from the banks.
19. The process of ushering the Securities and Futures Bill through the consultation and legislative process was painful to say the least. The industry and the Legislative Council took the opportunity to reopen and attack the Administration and the two regulatory bodies on what had been in the statute book for a long time. In the end, a number of substantial compromises had to be struck. Given that the political environment today is even more difficult than that in the period 1998-2002, we should not underestimate the danger of having to defend, once again, what is in the law.

#### *Relationship with HKMA*

20. The current MoU would need to be re-negotiated with the HKMA to determine a mutually agreeable modus operandi to avoid regulatory overlap. This would be essential to deal with issues such as money laundering, which falls within the ambit of HKMA as a prudential matter, but would also require the involvement of the SFC where it involves conduct issues and regulated activity.

#### *Resources*

21. There would be significant implications in terms of resources requirements for the SFC. The licensing department anticipates that it would require an increase to its resources by at least 25 additional staff. Also our inspection regime will need at least 12 additional professional staff in various grades. This estimation has not included other resources required for enforcement, legal services and other related support services, who would also need to take up their share of the function.
22. Furthermore, the existing licensing computer system would require an overhaul to accommodate all the new information accompanying the addition of banks and relevant individuals to the jurisdiction of the SFC.
23. There would also be cost implications for the banks themselves, as they may need to restructure their businesses in line with the changes between the SFC and HKMA. E.g. in setting up separate subsidiaries to delineate securities business from banking business, licensing of individual employees etc.

### *Socio-political factors*

24. On a macro level, there may be some social and political costs to the public. For instance, the proposal may further reinforce the public's existing perception that the SFC is getting too powerful in light of the new SFO, statutory backed listing, sponsors etc. However, this paper is not in a position to examine these issues, which are likely to be topics brought up at the level of the Administration.

### **OTHER IMPLICATIONS**

25. On a final note, whilst there may be merits in creating a single regulator for all securities businesses operated by brokers and banks, one should not overlook the possible ramifications that this proposal might bring to the entire financial services sector that is comprised of not only banks and brokers, but also the insurance industry.
26. Similar disparities exist between insurance intermediaries and stockbrokers. Insurance intermediaries are essentially regulated under the self-regulatory regime established under the Insurance Companies Ordinance. The SFC does not regulate them unless they are also engaged in any of the regulated activities as defined in the SFO. (Approximately only 10% of these intermediaries are licensed by the SFC.) The SFC is only involved in authorising investment-linked assurance schemes and other insurance-related investment products offered by insurance companies.
27. If the argument of having to ensure a level playing field among intermediaries in the financial services is taken to the furthest, it is possible that the industry would argue that even insurance intermediaries selling investment-linked assurance schemes should also be subject to the same regulatory oversight. Quite naturally, this would bring up the question of a super regulator. Again, it is outside the scope of this paper to examine this issue.

## THE SFO REGIME

### *Current regime*

1. The current regulatory framework is the product of extensive negotiation and consultation with the investing public and the industry, which finally obtained the sanction of the Legislative Council. While the SFC sets the standards in respect of the conduct of regulated activities, the HKMA remains the frontline regulator for banks.

### *Registration of banks and their relevant employees*

2. Banks can no longer enjoy exempt person status and instead have to be registered with the SFC in order to carry out regulated activities. It should be noted that banks not only engage in stock broking, but also are major advisors and distributors of structured products and funds. In considering related applications for registration, the same fit and proper criteria and competence requirements apply as for SFC licensed persons. However, before approving a bank to become a registered institution, the SFC has regard to the HKMA's opinion on the merits of the related application.
3. For each regulated activity registered, a bank needs to appoint and maintain at least two "executive officers" whose appointments are consented to by the HKMA to supervise the related regulated activity. This is equivalent to the requirements for "responsible officers" applicable to licensed corporations.
4. Notwithstanding that relevant employees of banks do not need to obtain a certificate of licence from the SFC, they are required to comply with the same competence and continuous professional training requirements as SFC licensed representatives in order to carry out regulated activities on behalf of banks. The HKMA will also conduct regulatory vetting on that individual, including checking with the SFC.
5. Similar to licensed representatives, particulars of all relevant employees of registered institutions are published in the register of "relevant individuals" maintained by the HKMA on its website. Where there are fit and proper concerns about a particular bank employee, the HKMA may refuse to enter that individual's name into the register.

### *Regulatory and supervisory process*

6. The HKMA is the frontline regulator in supervising regulated activities conducted by banks and it adopts the same supervisory standards of the SFC applicable to licensed persons.
7. The HKMA is intended to perform, in a manner comparable to that adopted by the SFC in relation to licensed corporations, on-site inspections of banks and, where appropriate, their associated entities and related corporations, to ascertain their compliance with applicable legal and regulatory requirements. It also conducts off-site reviews, including analysis of information submitted by banks as well as other data collected on an ad hoc basis.

8. The SFC and the HKMA maintain a close dialogue and meet regularly to discuss issues, complaints and investigations relating to the banks' regulated activities. In interpreting the rules, codes, guidelines and other guidance made or published by the SFC, the HKMA will, where appropriate, consult the SFC and draw reference from the SFC's experience in applying such requirements.

***Complaints handling and investigations***

9. Investigation into a particular situation concerning banks may be triggered by complaints received by the SFC or the HKMA, findings from bank examinations conducted by the HKMA, or other investigations conducted by the SFC on licensed persons that are related to banks. Hence, either the SFC or the HKMA can start a case and thereafter there may be transferral of cases between the SFC and the HKMA, or sharing of investigation results and findings in deciding whether or not to take disciplinary action.

***Disciplinary actions and appeals***

10. Under Part IX of the SFO, the SFC may exercise any of the following powers where a bank (being a registered institution) or its relevant individuals or any person involved in the management of its regulated activities, is guilty of misconduct or considered not to be fit and proper:

| Disciplinary actions  | Applicable to           |                      |
|---|-------------------------|----------------------|
|   | Registered institutions | Relevant individuals |
| Revocation or suspension of registration for all or part of the regulated activities  | √                       |                      |
| Public or private reprimand   | √                       | √                    |
| Prohibition from applying for licence or registration   | √                       | √                    |
| Prohibition from applying for approval as an executive officer of a registered institution or a responsible officer of a licensed corporation |                         | √                    |
| Prohibition from having his name entered in the HKMA register   |                         | √                    |
| Ordering the paying of a pecuniary penalty  | √                       | √                    |

11. Under the Banking Ordinance, the HKMA is empowered to impose the following disciplinary actions on a relevant individual who is guilty of misconduct or considered not to be fit and proper, or on an executive officer who is no longer considered to have sufficient authority within a registered institution to act in such capacity:
- removal or suspension of all or part of the relevant individual's information contained in the HKMA register. This in effect prohibits the individual from engaging in any regulated function of any regulated activity of the registered institution, either permanently or temporarily; and
  - in the case of an executive officer, withdrawal or suspension of the consent given by the HKMA.



12. The HKMA is also seeking legislative amendment to confer on it an explicit power to publish details of its disciplinary actions against securities staff of registered institutions.
13. Each party may make recommendations to the other in respect of the other's exercise of its disciplinary powers. They may also liaise with each other during the course of an appeal against a decision of the SFC or the HKMA concerning a registered institution.

*Memorandum of understanding*

14. The SFC and the HKMA signed a new MoU on 12 December 2002 to prepare for the regulatory regime under the SFO (previous MoU was signed in October 1995).
15. The purpose of the new MoU is to strengthen co-operation between the two regulators with a view to eliminating regulatory overlap and to ensure that a consistent regulatory approach is adopted over all intermediaries regardless of which regulatory authority is the primary regulator. This is to ensure that the principle of a level regulatory field for all participants of the securities and futures industry is being upheld. A copy of the MoU is posted on the websites of both the SFC and the HKMA.

**REGULATED ACTIVITIES OF REGISTERED INSTITUTIONS**

(As at 31 December 2005)

| <b>Regulated Activity</b>            | <b>No of Registered Institutions</b> |
|--------------------------------------|--------------------------------------|
| Dealing in securities                | 80                                   |
| Advising on securities               | 66                                   |
| Advising on futures contracts        | 2                                    |
| Advising on corporate finance        | 33                                   |
| Providing automated trading services | 3                                    |
| Asset management                     | 33                                   |