



**RESPONSES TO THE FOLLOW-UP QUESTIONS
RAISED BY THE SUBCOMMITTEE ON 26 JUNE 2009**

7 July 2009



2. **With reference to the sample checklists used by HKMA to conduct Tier 1 and Tier 2 on-site examinations on regulated activities of RIs (Annex 2A of M2(C)) and the thematic examination on RIs' investment advisory and dealing activities in credit-linked investments (Annex 2B of M2(C)), please advise whether HKMA has provided SFC with a copy of these checklists, and provide a copy of the checklist(s) used by SFC in conducting inspections on Licensed Corporations (LCs).**
 - 2.1. Before the Legislative Council Subcommittee hearing on Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products, HKMA has not provided SFC with a copy of any of the three checklists for comment, i.e. Tier 1 and Tier 2 on-site examinations on regulated activities of RIs (Annex 2A of M2(C)) and the thematic examination on RIs' investment advisory and dealing activities in credit-linked investments (Annex 2B of M2(C)).
 - 2.2. In 2006, SFC conducted a second round of thematic inspection of selling practices of licensed corporations in parallel with HKMA's thematic inspection of selling practices of the RIs. During the co-ordination of this concurrent thematic inspection, HKMA provided its draft examination checklist to SFC for comment.
 - 2.3. SFC has checklists for inspecting licensed corporations when conducting different regulated activities. Please refer to **Appendix A** for a summary of key inspection objectives and steps in relation to an inspection of a licensed corporation advising on securities.



4. The attached written questions raised by the Hon LEUNG Kwok-hung and handed to the Chief Executive Officer of SFC at the hearing on 26 June 2009.

Document 1

Function (Power & Duty) of SFC

- 4.1 I refer to the first set of questions raised by Mr. Leung Kwok-hung at the hearing on 26 June 2009 and will now try to explain the division of responsibilities between the SFC and HKMA in greater detail than in my statement. For each question your question is first set out in full in bold type and my response follows.

Q 1. Have you stated all the important functions of SFC in paragraph 3 of your statement?

- 4.2 In paragraph 3 of my Statement I set out 6 functions of the SFC. This was not intended to be an exhaustive statement of all of the SFC's functions, as I did not think it appropriate to set out all of the important functions of the SFC in the introduction. It would have taken several pages to do so. For those interested in reading about our other functions a footnote to paragraph 3 tells readers that the full text of our functions can be found in the Appendix 2 to the Statement. The footnote reads: "See Appendix 2 for the full text of the SFC's regulatory objectives, functions and powers and general duties."

Q 2. Why you jump from (a) to (e) in para 3 and (b) to (d) are missing? Are they not important?

- 4.3 I did not list all of the SFC's functions. I felt that the focus of the Subcommittee's inquiry was on the statutory duties that the SFC owed to investors. I selected 6 of these. All of the SFC's functions are important.

Q 3. Why the very important function of SFC as provided in s5(1)(b)(ii) is missing, I hope it is not on purpose?

- 4.4 I did not include s.5(1)(b)(ii) of the Securities and Futures Ordinance (the "SFO") on the opening page of my statement because the split of responsibilities between the SFC and the HKMA is a complex issue which I dealt with separately in the Statement.

Q 4. In paragraph 47, you said 'the SFC has no statutory powers to supervise RIs', I think it is a wrong interpretation of s5(1)(b)(ii). My reason is s.5(1)(b)(ii) provides that

The function of the Commission, are so far as reasonably practicable, to supervise, monitor and regulate-

such of the activities carried on by registered institutions as are required to be regulated by the Commission under any of the relevant provisions;



“Such activities” should mean the regulated activities under Schedule 5, SFO. Hence, the law clearly states that your powers and duties are not merely “to regulate”, but also to “to supervise and monitor” the RIs in their regulated activities.

Q 4.1 Do you agree that your interpretation of SFC’s duties and powers as set by SFO is wrong and your written statement is incomplete relating to SFC’s duties and powers of supervising RIs?

Q 4.2 Are you prepared to adjust what you have testified with respect to this matter or to revise it?

4.5 Paragraph 47 of the statement is one of a series of paragraphs in which we make it clear that the HKMA is the frontline supervisor of RIs. It should therefore be read in the context of the preceding paragraphs.

4.6 Section 5(1)(b)(ii) also cannot be read separately from section 5(1)(b)(i) as the contrast between the words used in each subparagraph is important. The fact that RIs are specifically excluded from subparagraph (i), and dealt with separately in subparagraph (ii), suggests that the legislature intended that RIs are to be treated differently from the entities mentioned in subparagraph (i). The entire paragraph reads -

“(b) to supervise, monitor and regulate-

(i) the activities carried on by recognized exchange companies, recognized clearing houses, recognized exchange controllers or recognized investor compensation companies, or by persons carrying on activities regulated by the Commission under any of the relevant provisions, other than registered institutions; and

(ii) such of the activities carried on by registered institutions as are required to be regulated by the Commission under any of the relevant provisions;”

4.7 Hence under s. 5(1)(b)(i) the SFC is required to supervise, monitor and regulate the activities carried on by various recognized bodies or persons carrying on regulated activities (e.g. licensed corporations) under any of the provisions of the SFO or the Companies Ordinance (“CO”), other than RIs.

4.8 In contrast s. 5(1)(b)(ii) provides that in relation to RIs the SFC are only required to supervise, monitor and regulate if the SFC is required to do so under any provision of the SFO or the CO. One must therefore look at the remaining provisions of the SFO and the CO to find activities carried on by RIs that are required to be regulated by the SFC.

4.9 Under the SFO, the SFC is responsible for –

- (a) deciding whether to grant approval for registration of the securities business of RIs, (s.119 of the SFO);
- (b) maintaining a register of RIs and publishing their names (s.136 and 137 of the SFO);
- (c) making rules and setting regulatory standards (which RIs are required to observe), (ss.148, 151, 152, 168, 169, of the SFO); and



- (d) conducting investigations and taking disciplinary action, including revocation of registration of an RI (ss.182, 196 and 197 of the SFO).
- 4.10 In each case (except maintaining a register of RIs and publishing their names) the SFC is required first to consult with the HKMA (see s.119 (2), (4) and (9), s.182(4), 198(2) and, in relation to any rules and codes, s.398(4) and 399(9)). In their broadest sense the functions enumerated at (a) to (d) above could be viewed as functions to “supervise, monitor and regulate” RIs – however, the day-to-day supervision of RIs is dealt with separately in Part VIII.
- 4.11 Part VIII of the SFO, “SUPERVISION AND INVESTIGATIONS” contains an express power to supervise RIs (see s.180 entitled “**Supervision of intermediaries and their associated entities**”).
- 4.12 Under s.180 an “authorized person” is (inter alia) entitled to enter an intermediary’s premises, inspect and make copies of papers and make inquiries of the intermediary and others for the purpose of ascertaining whether an intermediary is complying or has complied with its obligations as an intermediary (e.g. to see whether it is complying with its obligations under the Code of Conduct and the Internal Control Guidelines).
- 4.13 Section 180(11) provides-
- “The relevant authority may authorize in writing any person as an authorized person for the purposes of this section.”
- 4.14 Section 180(17) provides that –
- ““relevant authority” (有關當局) means-
- (a) where-
- (i) the intermediary in question as referred to in subsection (1) is a registered institution; or
- (ii) the associated entity in question as referred to in that subsection is the associated entity of a registered institution,
- the Monetary Authority; or
- (b) in any other case, the Commission.”
- 4.15 Accordingly, while the SFC can appoint an “authorized person” to inspect a licensed corporation, only the HKMA can appoint an “authorized person” to inspect an RI. This means, in normal parlance, that the HKMA alone is responsible for the day-to-day supervision of the carrying on of regulated activities by RIs, including on-site inspections.
- 4.16 The SFO cannot be read without regard to the provisions of the Banking Ordinance (Cap 155) (“BO”) as these prescribe the main regulatory regime for banks. We refer to a LegCo Paper dated December 2001 which explains that the amendments to the BO (proposed at the same time as the Securities and Futures Bill was passing through LegCo – the two Bills were linked) provided HKMA with a legal basis to supervise the securities business of banks. At the foot of page 1 paragraph 4 reads -



"4. Despite the fact that their authorization under the BO relates specifically to banking business or the business of taking deposits, AIs obviously carry out a wide range of other business activities. Such business activities may have an impact, for good or ill, on the liabilities side of AIs' balance sheets and are thus of direct interest to the banking supervisor. It is for this reason that section 7 of and the Seventh Schedule to the BO seek to provide a legal basis for the MA to supervise all business activities conducted by AIs generally, not only their banking or deposit-taking business."

4.17 Para 11 explains -

". . . AIs are involved in other areas of business in addition to taking deposits and extending loans (such as issuance of credit cards, purchase and sale of foreign currencies, equities trading for customers, marketing of investment products, insurance agency activities and MPF-related services)."

4.18 The HKMA has specific powers under s.55 of the BO entitled "**Examination and investigation of authorized institutions, etc.** to supervise RIs (which are all authorized institutions). Section 55 provides, so far as is relevant -

" . . . the Monetary Authority may at any time, with or without prior notice to the authorized institution, examine the books, accounts and transactions of any authorized institution . . ."

4.19 In the debate on the second reading of the Securities and Futures Bill and Banking (Amendment) Bill 2000 on 13 March 2002, the Administration explained the legislative intent and the principles behind the separation of the roles of the SFC and HKMA under the SFO and the BO -

"Madam President, we fully appreciate the views of those in the securities sector on the conduct of securities business by banks. In response, we have proposed specific amendments to establish a more level playing field. In brief, under the revised regulatory mode, the SFC is responsible for setting regulatory standards, deciding whether to grant approval for registration of the securities business of banks, revoking the relevant registration, making investigations and taking disciplinary actions. The HKMA is the front-line regulator of banks and responsible for routine inspection and supervision. When performing these functions, the HKMA should follow the regulatory standards set by the SFC under the relevant legislation. Our principle of setting regulatory standards is that unless the Banking Ordinance contains equivalent or even stricter requirements, the same requirements should be applied both to brokerage houses and the securities divisions of banks. For example, since the Banking Ordinance contains stricter requirements on capital adequacy ratio, liquidity ratio and risk weight, and so on, the financial resources rules under the Bill need not be applied to the securities business of banks in order to avoid regulatory overlap. We believe that protection for investors will not be enhanced if banks are compelled to comply with two similar sets of requirements. On the contrary, this will increase operation cost of banks and ultimately affect the overall interests of the public.

For the disciplinary regime, we have reached a consensus with the Bills Committee and the industry and have proposed amendments to the effect that the disciplinary sanctions and appeal mechanism applicable to brokerage houses and their employees should equally be applied to the securities divisions of banks and the relevant personnel. The disciplinary sanctions include revocation or suspension of registration, pecuniary penalty, reprimand and prohibition from continuing securities business, and



so on. All appeals will be dealt with centrally by the newly established Securities and Futures Appeals Tribunal.”
(p. 4339)

- 4.20 During the same debate on the Banking (Amendment) Bill the Administration explained that complementary amendments were being made to the Banking Ordinance to enhance the HKMA's supervision of the securities business of RIs –

“During the deliberations of the Bills Committee, Members were most concerned about whether the regulation of AIs by the HKMA on the one hand and the regulation of stockbrokers by the SFC on the other would bring about any differential treatment and unfair competition. They were also worried about whether the new regulatory regime could ensure sufficient protection of the interests of investors and members of the public.

We appreciate Members' concerns. We consider that there are several important principles behind the making of this new regulatory regime. We must provide adequate protection to investors and create a level playing field for registered institutions and licensees of the SFC; at the same time, we must minimize duplicate regulation, so as to reduce unnecessary expenses.

I wish to emphasize that the HKMA is already exercising very prudent supervision on the overall business of AIs. In the case of securities business, for example, the HKMA requires, by means of administrative measures, AIs engaging in securities business to comply with the regulations and guidelines of the SFC. The Bill proposes to enhance the HKMA's supervision of the securities business of AIs on the basis of the existing framework, so as to bring about improvements both in terms of legal framework and enforcement. We propose to spell out the HKMA's statutory functions in respect of regulating the securities business of AIs under the new regulatory regime, so that the HKMA can effect supervision on the day-to-day securities business of AIs by virtue of the relevant provisions of the Securities and Futures Ordinance. This will ensure that these institutions will always comply with the provisions of the Securities and Futures Ordinance and other relevant regulations and guidelines. That way, the effectiveness of regulation and protection of investors' interests can be enhanced.

We propose to introduce a new registration system under the new regime. AIs wishing to engage in regulated activities must register with the SFC to become registered institutions. Later on, when I move the Committee stage amendments, I shall further explain the arrangements under this registration system. In effecting day-to-day regulation of the business of registered institutions, the HKMA will also adopt the same standards applied by the SFC in respect of its licensees. The HKMA will maintain close contact and cooperation with the SFC and discuss with it the common practical problems encountered in the course of supervision, so as to ensure effective supervision, avoid any grey areas and achieve the same standards applied by the SFC in respect of its licensees. Besides, we also propose that the HKMA should be required to maintain a register of persons employed by registered institutions to engage in "regulated activities", which is identical to the register kept by the SFC. It is also proposed that there should be an electronic version of such a register, so that the public can access it on the Internet. That way, transparency can be enhanced.

To sum up, we believe that the Bill as amended will be able to provide an effective and fair regulatory regime for the securities business of registered institutions and enhance the protection for investors and members of the public. To tie in with the amendments



in respect of the Securities and Futures Ordinance, I shall move several Committee stage amendments which have been discussed and endorsed by the Bills Committee.” (p. 4427)

4.21 This division of roles is manifested in s.5(3) of the SFO, which I referred to at paragraph 42 of the Statement, which shows that -

“The Commission, in performing any of its functions in relation to-

(a) any authorized financial institution as a registered institution . . .

may rely, in whole or in part, on the supervision of such authorized financial institution or person (as the case may be) by the Monetary Authority.”

Q 5. *It follows that the supervising, monitoring, and regulating of the EOs of the RIs is also part of your function in the course of supervising, monitoring and regulating the RIs because any systemic problems such as misconduct, failure to comply with the fit and proper requirement of the EOs may lead to disciplinary action against the RIs. Do you agree?*

4.22 I do not agree that this follows. Firstly, the premise is not correct. The SFC does not have the necessary power to supervise the day-to-day operations of RIs. Secondly, the SFC cannot supervise, monitor and regulate EOs of RIs as it has no power to do so. Under the SFO, the SFC is responsible for setting regulatory standards, conducting investigations and taking disciplinary action (in each case after consultation with the HKMA). However, while it registers financial institutions as RIs under s 119 of the SFO after consulting the HKMA, it does not have the power to consent to, or have any role regarding, an individual becoming an EO or to withdraw such consent. The powers to consent to someone becoming, and to regulate, EOs of RIs have been given to HKMA under s. 71C of the BO.



Question from the Hon Leung Kwok Hung
June 26, 2009

Document 2

Discretionary Power Not to be Handed Over to Another Agency¹

Q 1. Does the division of responsibilities between HKMA and SFC as set out in the MOU form part of the structure of the regulatory structure? If not, why not?

4.23 The regulatory structure is established under the SFO and the BO. The division of responsibilities between HKMA and SFC as set out in the MOU is a reflection and implementation of the regulatory structure established under the SFO and the BO.

Q 2. In answering my questions in the last hearing, you mention that ‘regarding to regulatory structure, it should be addressed to the administration’. That means the regulatory structure set in the MOU is a decision of the administration and not a decision made just between SFC and HKMA. Is it right?

4.24 The division of responsibilities between HKMA and SFC as set out in the MOU is a reflection and implementation of the regulatory structure established under the SFO and the BO. This division of responsibilities was approved by the Legislative Council. The MOU did not require the approval of the FS or the SFST.

Q 3. Where does the administration get such power of deciding the regulatory structure as set in the MOU? Under which section(s) of which ordinance(s)?

4.25 The division of responsibilities between HKMA and SFC as set out in the MOU is a reflection and implementation of the regulatory structure established under the SFO and the BO. The statutory authority authorizing the SFC to enter into an MOU is contained in s.5(1)(h) of the SFO.

Q 4. If no legal base for such a decision, the decision of the administration is amounted to *ultra vires*!!!

¹ *Bernard v National Dock Labour Board* [1953] 2 QB 18 applies to show the illegality of MOU; *Carltona* Principle does not apply to prove legality MOU.

Denning LJ in *Bernard* and the common law ruled that disciplinary power conferred to a person by statute cannot be delegated if such power is adjudicative in nature unless such practice or delegation is provided by statute. The present practice has caused SFC to lose its discretionary power in supervision of RIs conferred to it by the SFO. SFC has to wait for MA's decision as to whether to open a file for investigation and as to whether to pass the investigation result to SFC for further action or to close the file without notifying SFC. This practice has pre-empted the supervisory action of SFC and, in substance, removed the discretionary power of SFC in the supervision and investigation of RIs. This shedding of the discretionary power of SFC with an adjudicative nature is against common law. The *Carltona* Principle only allows devolution of discretionary power under certain conditions, such as administrative practice for efficiency enhancement and expeditious decision-making and it requires that the person whom the discretionary power is conferred by the statute should ultimately be accountable and responsible for such devolution arrangement. However, the present practice is not of this nature.



4.26 The legal basis for the division of responsibility is the enactment of the SFO and the BO by the Legislative Council.

Q 5. If without the MOU, according to s5(3)(b)SFO, SFC should have the discretionary power to either “to rely” or “not to rely” on the MA in performing its function. But according to the written and oral evidence this committee collected from you (see Answer Q1, para 1.1, 1.2, & 1.6) and from the MA as well as the arrangement set out in MOU, this discretionary power is completely removed by the MOU or by the wrong interpretation of the law by SFC and MA. It is further evidenced by the transfer of discretionary power of opening files for investigation and of when and how often to conduct on-site supervisory examination of RIs. Though SFC and MA both claim in the MOU and their testimony to this committee that there is in form no delegation of power but in substance it has a delegation of discretionary power and a shed of discretionary power from the person whom the power is conferred. It is an outright *ultra vires*.

4.27 MoU does not detract from or restrict the exercise by the SFC of its discretionary powers. It exists to enable both the SFC and the HKMA to perform their respective statutory functions under the regulatory structure established under the SFO and the BO. Part III of the MoU states -

“III PRINCIPLES

3. The parties will exercise their best endeavours to meet the terms of this MoU. Also, each party will make reasonable efforts to ensure that the other is provided with all relevant information so that the parties may effectively perform their respective statutory functions.
4. In addition, the parties recognise the following overriding principles:
 - (a) this MoU, of which Annex A and Annex B are an integral part, does not modify or supersede any law or regulation;
 - (b) this MoU does not detract from the statutory functions of the parties;
 - (c) this MoU does not amount to a delegation of any of the powers, duties and obligations of the parties;
 - (d) this MoU does not create any rights, obligations or liabilities, enforceable by the parties or by third parties; and
 - (e) this MoU does not affect any arrangements under any other MoU that either party has entered into or may enter into with any other party,and this MoU will be construed accordingly.”



Comments of the SFC on the footnote

- 4.28 The comments made in the footnote here are based on incorrect premises, namely that there is delegation of any adjudicative (or indeed any other) power by the SFC to the HKMA, or that the SFC has any discretionary power in the supervision of RIs. As explained in the answers in Document 1, the SFC's powers, in so far as RIs are concerned, are limited to deciding whether to grant approval for registration of the securities business of RIs, maintaining a register of RIs and publishing their names, making rules and setting regulatory standards (which RIs are required to observe), and conducting investigations and taking disciplinary action, including revocation of registration of an RI. In each case (except maintaining a register of RIs and publishing their names) the SFO expressly requires the SFC to consult with the HKMA (see s.119(4), s.182(4), 198(2) and, in relation to any rules and codes, s.398(4) and 399(9)).
- 4.29 Further, the points made in the footnote ignores s 5(3)(b) of the SFO. While the SFC does not strictly have the legal *duty* to rely on the supervision of RIs by the HKMA under s 5(3)(b) of the SFO when performing any of its functions, under that provision any such reliance by the SFC is expressly permitted and indeed such reliance is wholly consistent with the policy of having the dual regulatory regime laid down by the SFO and the BO, as the extracts from the debate on the second reading of the Securities and Futures Bill and Banking (Amendment) Bill 2000 on 13 March 2002 set out in the answers in Document 1 show. The very enactment of s 5(3)(b), as well as all provisions requiring consultation with the HKMA whenever the RIs are involved, show a clear legislative intent that the SFC observe this dual regulatory regime policy and to rely on the HKMA in all matters concerning RIs.
- 4.30 The *Carltona* principle has been restated by Mr Justice Ribeiro PJ in *HKSAR v Lee Ming Tee* (2001) 4 HKCFAR 133 at 153 as follows: "Under what has become known as the *Carltona* principle, the courts have recognised that: '... the duties imposed on ministers and the powers given to ministers are normally exercised under the authority of the ministers by responsible officials of the department. Public business could not be carried on if that were not the case. (*Carltona Ltd v Commissioner of Works* [1943] 2 All ER 560 at p. 563)". The principle is not relevant to the present discussion with regard to MOU and is not relied upon by the SFC.



Appendix A

Summary of key inspection objectives and steps in relation to an inspection of a licensed corporation ("LC") advising on securities

1. The objective of an onsite-inspection of a LC advising on securities is to assess the LC's compliance with applicable regulatory requirements, including Code of Conduct of Conduct for Persons Licensed by or Registered with the SFC, Management, Supervision and Internal Control Guidelines For Persons Licensed by or Registered with the SFC and the Questions and Answers on suitability obligations, in relation to LC's investment advisory activities.
2. The onsite-inspection covers various review areas, with particular focus on (i) general assessment of control environment and compliance with applicable regulatory requirements in relation to investment advisory activities and (ii) specific review of sampled transactions. Inspection steps generally include interviews with senior management and sales staffs of the LC, assessment of adequacy of management supervision, sample review of documents, assessment of reasonableness of sampled transactions and follow up on outlier transactions.
3. General assessment
 - a. To assess the adequacy of management supervision over the LC's operations and investment advisory process.
 - b. To review LC's control environment and assess compliance with applicable regulatory requirement in relation to
 - "know-your-client" process (including how well such procedures facilitate the LC in providing suitable investment advice);
 - product due diligence; and
 - client agreements.
 - c. To review
 - the competency level of the LC's sales staff and whether the LC and its sales staff comply with the licensing requirements; and
 - LC's recruitment and training policy.
4. Specific review of sampled transactions
 - a. To assess suitability of investment recommendations made in sampled transactions. Sample review of transactions covers possible mis-selling scenarios, such as high commission rebate, long lock-in periods and complex product structures. (Suitability involves LC's matching the risk return profile of each recommended product with each client's personal circumstances. LC should assess whether the characteristics and risk exposures of each recommended product are actually suitable for the client taking into account client's circumstances.)
 - b. To assess whether the LC has
 - acted in the best interests of the clients, particularly when actual or potential conflicts of interest exist; and
 - explained the nature of the products and the basis of the recommendations to the clients.