




**RESPONSES TO THE FOLLOW-UP QUESTIONS
RAISED BY THE SUBCOMMITTEE ON 3 JULY 2009**

7 July 2009



Q.5 The attached written questions raised by Mr LEUNG Kwok-hung and handed to the Chief Executive Officer of SFC at the hearing on 3 July 2009.

**Question from the Hon Leung Kwok Hung
July 3, 2009**

Document 3

Discretionary Power not to be Handed Over to Another Agency Unlawfully.

After all these hearings and with the evidence testified by the SFAT, the MA, DMA and you, I would like to say some of my observations and expect you to answer my questions below.

The present arrangement under the MOU has caused SFC to lose its discretionary power in the supervision of RIs conferred to it by the SFO, MA holds the decision power as to whether to open a file for investigation and as to whether to pass the preliminary investigation result to SFC for further action or to close the file without SFC's approval. In paragraph 1.3 of the written statement from you, it indicates that the present practice has, in substance, made the MA become the true decision-maker in the approval of an application to be a RI. But the law only designates the MA to offer advice to the SFC and the SFC should be the decision-maker, by law, in the registration of RIs. The above practices are examples demonstrating that, in substance, the discretionary powers of the SFC in the supervision, investigation, regulation and registration of RIs are illegally fettered. According to the common law doctrine of non-delegation and unfettering of discretionary power, the above are unlawful.

The common law doctrine, *Carltona* Principle, although provides some flexibility which allows devolution of discretionary power under certain conditions, such as by reason of enhancing administrative efficiency and expeditious decision-making, however, these decisions should not be of adjudicative nature. It also requires that the party that owns the original power from statutes should be accountable for the results so as to avoid buck-passing. The present practice between SFC and MA does not satisfy these requirements.

Comments of the SFC in response:

- 5.1 The introductory comments in this Document 3 proceed from a number of premises which we do not accept.**
- 5.2 Firstly it is stated that "the MOU has caused SFC to lose its discretionary power in the supervision of RIs conferred to it by the SFO". The SFC is not conferred with a power to supervise RIs. That power is conferred on the HKMA under s.180 of the SFO and s.55 of the BO. The MoU has therefore**



not caused the SFC to "lose" any discretionary power in the supervision of RIs.

- 5.3 Secondly, it is stated that "In paragraph 1.3 of the written statement from you, it indicates that the present practice has, in substance, made the MA the true decision-maker in the approval of an application to be a RI." What we said in paragraph 1.3 (page 23 of the written statement) is this :

"The SFC must have regard to the HKMA's advice on the fitness and properness of the bank, and may rely wholly or partly on it in deciding whether or not to register the bank."

- 5.4 This is a statutory requirement in s.119(4) of the SFO. We continued :

"In practice, the SFC invariably relies on the HKMA's advice because this arises out of HKMA's detailed and considered assessment of all of the relevant information, including information that is supplied to it by the SFC, unless the SFC has information or concerns to the contrary."

- 5.5 This does not mean that the HKMA becomes the true decision-maker in the approval of an application to be a RI. The decision is made by the SFC. As we indicate in paragraph 1.3, if the SFC has information or concerns to the contrary, it can decide to reject or approve an application even if the HKMA's advice is to the contrary.

- 5.6 Thirdly, it is stated that "The above practices are examples demonstrating that, **in substance**, the discretionary powers of the SFC in the supervision, investigation, regulation and registration of RIs are illegally fettered." There is no question of the SFC having "illegally" fettered its powers if it relies on HKMA as the SFO permits it to, and envisages that it should, do so. In relation to registration of RIs, s.119(4) expressly states that :

"In deciding whether to register or refuse to register an applicant under subsection (1), the Commission-

- (a) shall have regard to any advice given to it by the Monetary Authority pursuant to subsection (3)(c); and
- (b) may rely wholly or partly on that advice in making that decision."

- 5.7 Indeed in relation to all of its functions in relation to RIs, s.5(3) of the SFO expressly states –

"(3) The Commission, in performing any of its functions in relation to-
(a) any authorized financial institution as a registered institution or as an associated entity of an intermediary; or
(b) any person as an associated entity of an authorized financial institution that is 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."

- 5.8 Furthermore, when exercising almost all of its powers in relation to RIs, the SFC is required first to consult with the HKMA (see s.119(2), (4) and (9), s.182(4), s.198(2) of the SFO and, in relation to any rules and codes, s.398(4) and 399(9) of the SFO). Similarly, when exercising its powers to discipline



relevant individuals and EOs under s.58A(1) and 71C(4) of the BO respectively the HKMA must consult the SFC.

5.9 Given the degree of interaction between the SFC and the HKMA permitted and envisaged in, and sometimes required by, the SFO and the BO, the MoU sets out the principles, bases and mechanism for the implementation of, and enables the SFC and the HKMA to perform, their respective statutory functions under, the regulatory structure established under the SFO and the BO. However, the MoU does not represent a fetter on the powers of the SFC (or the HKMA). It expressly provides at clause 4 that :

- “(a) this MoU ... 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 any third party”.

5.10 As we have explained before, the Carltona principle is not relevant to the present discussion with regard to the MoU and is not relied upon by the SFC.

LKH : I would like you to answer the following questions. Please cite legal authority, such as case law or provisions, to support your answers.

A. *Prima facie, ultra vires*, for the administration to decide the regulatory structure not in accordance with law

5.11 The premise underlying this statement is misconceived. The administration does not decide the regulatory structure. It proposed a regulatory structure in the Securities and Futures Bill and the Banking (Amendment) Bill. The regulatory structure was established under the SFO and the BO, which were both enacted by the Legislative Council. The regulatory structure as set out in the SFO and the BO is being implemented by the SFC and the HKMA. There is no question of *ultra vires* or “not in accordance with law”.

Q.1 In answering my questions in the last hearing, you mentioned that ‘as regard to the 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?

5.12 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.2 Under which section(s) of which ordinance(s), the administration obtains their power in designing the present regulatory structure of the SFC and HKMA?



5.13 The regulatory structure was established under the SFO and the BO, which were enacted by the Legislative Council. See also the answer on the previous page about *ultra vires*.

Q.3 The interference of the administration in deciding the regulatory structure of HKMA and SFC seems to lack the support of law and is *ultra vires* of the administration. Do you agree?

5.14 The premise of this statement is misconceived. The regulatory structure was established under the SFO and the BO, which were enacted by the Legislative Council. There is no interference by the administration.

B. Fettering of discretionary power

I would like to have your explanation on the following, *prima facie, ultra vires* acts.

Ultra vires to turn "may rely" as provided by law into "must rely" in practice

Q.1 According to s5(3)(b)SFO, SFC should have the discretionary power of either "to rely" or "not to rely" on the MA in performing its function. The MOU and the present practices as testified by SFC and HKMA has, in substance, turned it into a "must". It is *ultra vires*. What is your comment?

5.15 We are unclear which "present practices as testified by SFC and HKMA" are referred to.

5.16 The 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. The MoU expressly provides at clause 4 that :

- "(a) this MoU ... 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 any third party".

5.17 If the SFC decides to rely on the HKMA that itself is an exercise of discretion, expressly conferred by s. 5(3)(b) and s. 119(4)(b) of the SFO. It is not and cannot be an *ultra vires* act. There is nothing in the MoU to suggest that the SFC "must rely" on the HKMA concerning any matter. Its discretion under s.5(3)(b) cannot and has not been fettered, as clause 4 makes clear.



- 5.18 Turning to look at what powers the SFC does have in relation to RIs, the “may rely” “must rely” theory and dichotomy you propounded does not accord with what happens in practice. In the area of registration of RIs, s.119(2) requires that the SFC refer an application for registration as an RI to HKMA and s.119(4) requires that the SFC shall have regard to any advice given to the SFC by the HKMA pursuant to subsection (3)(c). However, the decision to authorize registration is ultimately that of the SFC alone.
- 5.19 In the area of making rules and setting regulatory standards through the publication of Codes and Guidelines, the SFC is required to consult with HKMA if the rules of codes or guidelines apply to RIs. However, we will normally consult industry bodies and the public as well, and not rely simply on the HKMA’s views.
- 5.20 In the area of day to day inspection and supervision of RIs, the SFC has no powers or duties as these are conferred on HKMA under s.180 of the SFO (as well as the BO). Section 5(3) of the SFO has no application.
- 5.21 The SFC has powers of investigation under s.182 of the SFO. However, it is only where the SFC has reason to inquire whether an RI is guilty of misconduct or is not fit and proper that it may carry out an investigation and, potentially, take disciplinary action. The SFC is also required to consult with the HKMA before commencing an investigation (see s.182(4) of the SFO).
- 5.22 Clause 8.1 of the MoU makes it clear that the SFC does not simply rely on the HKMA to follow up on a complaint. This clause provides for the SFC referring complaints received to HKMA but recognizes that the SFC may commence an investigation independently –
- “If the SFC considers that the subject of the complaint is relevant to a matter that the SFC can investigate under s.182 of the SFO, the SFC will inform the HKMA of its opinion at the time it passes a copy of the complaint to the HKMA.”
- 5.23 Again, when determining a sanction to be imposed under s.196 or s.197 of the SFO, the SFC is required to consult with the HKMA but is not required to obtain the consent of the HKMA before imposing a sanction.

Power to open a file to investigate shall not be fettered

- Q.2** Instead of submitting the on-site examination report or complaints to SFC for them to decide whether to open a file for investigation, the MA makes decision on whether to open a file for Investigation itself. This is an *ultra vires* act because if MA decides not to open a file, SFC cannot take any action beyond what MA had decided. However, this power is conferred by SFO to the SFC and not to the MA. What is your comment?
- 5.24 The HKMA has the power to conduct inspections and impose sanctions on RIs, EOs and relevant individuals under the BO. It is fully entitled to exercise its discretion whether to inquire into a matter exercising its powers under the BO or s.180 of the SFO or refer a matter to the SFC for investigation under s.182 of the SFO. If the HKMA decides not to open a file to investigate or to refer the matter to the SFC, it is within its discretion to do so. There is no



legal duty on the HKMA that it must refer complaints to the SFC for the latter to investigate under s.182 (even though, as stated at clause 8.2 of the MoU, it will do so on receipt of a complaint relevant to a matter under s.182: see below). On the other hand, once the SFC receives a complaint in relation to a RI (whether directly from a member of the public, or from the HKMA), it has to consult the HKMA first under s.182(4), and is entitled (but not bound) to rely on the views and judgment of HKMA, including whether a complaint should be investigated under s.182 (under s.5(3)(b)). There is no *ultra vires* act by either the HKMA or the SFC. Indeed, unless the information available to the HKMA provides sufficient reason to inquire whether an RI is guilty of misconduct or is not fit and proper it will serve no purpose submitting the on-site examination report or complaints to SFC.

5.25 Furthermore, clause 8.2 of the MoU provides that -

“[w]henever a complaint is considered by the HKMA to be relevant to a matter that the SFC can investigate under s.182 of the SFO, the HKMA *will* refer such complaint to the SFC as soon as reasonably practicable.”

5.26 Clause 8.1 of the MoU also confirms that the SFC will investigate complaints under s.182 if it considers appropriate.

5.27 This is an example of the MoU being an implementation of the regulatory structure under the SFO and the BO enacted by the Legislative Council.

Discretionary power to close an Investigation file shall not be transferred

Q 3. The MOU which empowers the MA to decide if an opened file is to be closed and not to submit to SFC is *ultra vires* because under such arrangement in the MOU, the MA shall, in effect, have the discretionary power as to whether a possible breach of code should be put under further investigation by the SFC or not. However, this power is conferred to the SFC under SFO. So it is a case of *ultra vires*. What is your comment?

5.28 The provisions of the MoU are plainly not intended to operate in the manner suggested. Clause 8.2 of the MoU provides that -

“[w]henever a complaint is considered by the HKMA to be relevant to a matter that the SFC can investigate under s.182 of the SFO, the HKMA *will* refer such complaint to the SFC as soon as reasonably practicable.”

Power to approve the registration of a financial institution shall not be fettered

Q 4. In para 1.3 Q1 of your written statement, it shows that the present practice has, in substance, made the MA become the true decision-maker in the approval of an application to be a RI. It is a case of *ultra vires*.

5.29 Paragraph 1.3 Q1 of my written statement does not state or show that the present practice has, in substance, or otherwise, made the MA the true decision-maker in the approval of an application to be a RI. The decision maker is the SFC. Please see my comments on the introductory comments of this Document above.



Q.4 (cont). You said in para 1.3 that 'undermine the role that HKMA was intended to play in this process'. Please advise:

a. Who intend HKMA to play such role? The MA or the administration?

5.30 The legislation enacted by the Legislative Council intends the HKMA to play a role in the process of registration of RIs. For example, s.119(2) and (3) provide –

"(2) The Commission shall refer to the Monetary Authority any application made to it under subsection (1).

(3) Upon receiving an application for registration for a regulated activity referred to him under subsection (2), the Monetary Authority shall-

(a) consider the application;

(b) consult the Commission upon the merits of the application; and

(c) advise the Commission whether he is satisfied by the applicant that the applicant is a fit and proper person to be registered for that regulated activity."

b. Do you agree that this fettering of SFC's power has amount to ultra vires? If not, why not?

5.31 I do not agree. Following a procedure laid down in the statute cannot be "fettering" a power or in any way *ultra vires*, which means beyond its powers. Where the power is conferred by legislation properly enacted, that is the legal source and basis of the power.

Duty to protect investors shall not be transferred

Q.5 One of your statutory duties is to protect the investors. Do you recognise that SFC has to bear the ultimate responsibility for the failure to deliver the outcome of protecting investors?

5.32 The regulatory objectives and functions of the SFC are set out in sections 4, 5 and 6 of the SFO. These include the following -

"(1) The functions of the Commission are, so far as reasonably practicable-

(i) to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products;"

5.33 We have discharged this function.

Power to initiate an on-site examination shall be under SFO by law and HKMA is only to cooperate with such initiation



- Q.6** Have you ever suggested to the administration before the collapse of Lehman that the present power you have is fettered to such an extent that the effectiveness of delivering the outcome of protecting investors will be hampered? If not, why not?
- 5.34 We have not suggested to the administration before the collapse of Lehman that the present power the SFC has is fettered to such an extent that the effectiveness of delivering the outcome of protecting investors will be hampered because we did not believe this to be the case.
- Q.7** SFC has issued a number of warnings to HKMA before the collapse of Lehman. It indicates that SFC was aware of the risk to the investors. However, SFC has not exercised directly the supervisory power conferred by the law to scrutinize the misconduct of the RIs to prevent harm to investors as it did against the LCs in the same period. It is a, *prima facie*, reckless omission of duty of the SFC. What is your comment to this conclusion?
- 5.35 Before the collapse of Lehman we were not aware that there may be a problem with mis-selling by RIs. We did not have the power to inspect and supervise RIs. The power rests with the HKMA. There was no omission of duty of the SFC, reckless or otherwise.

Buck-passing, ultra vires and loop-hole plugging

- Q.8** Do you agree that the present arrangement is a typical buck-passing practice among the administration, HKMA, and SFC which is purposely designed to avoid legal and administrative accountability for the three parties?
- 5.36 It is unclear what "present arrangement" is referred to. There is no "buck-passing" in any way whatsoever. There is no question of avoiding any form of accountability. The responsibilities of each of the regulators are set out in the SFO and the BO, which were approved by the Legislative Council.
- Q.9** Do you agree that this is a serious loophole in our regulatory system that leads to harm to investors of this unprecedented size and yet no one will be accountable for harm which may be avoided or reduced considerably if due care, diligence, skill and better cooperation are to be exercised by SFC and HKMA?
- 5.37 It is unclear what "serious loophole" is referred to. There is also an assumption in the question that "due care, diligence, skill and better cooperation" could have avoided or reduced considerably the alleged harm to investors, or that the SFC and/or the HKMA have not exercised such "due care, diligence, skill and better cooperation" which is not accepted or established.
- Q.10** What is your suggestion as to how to plug this buck-passing loophole?



5.38 It is unclear what "buck-passing loophole" is referred to. There is no "buck-passing loophole" that we are aware of. The responsibilities of each of the regulators are set out in the SFO and the BO, which were approved by the Legislative Council.

C. The MOU

Q.1 Although Para 4(c) of the MOU claims that no power, duty and obligation have been transferred, this claim cannot conceal the arrangements and practices which are, in substance, amounting to a delegation of power. It turns "may rely" into "must rely" (compare s5(3)(b)SFO and para 5 of MOU). It fetters the supervisory function of SFC under s5(1)(b)(ii). It imposes rigidly fixed roles and responsibilities to the two regulators without citing any legal authority or provisions or ordinances that authorize this division of roles and responsibilities. The MOU and the present practices as testified by SFC and HKMA are, *prima facie, ultra vires*. Do you agree? If not, why not?

5.39 For the reasons and explanations given above we do not agree that the MoU is ultra vires. It is unclear to what "present practices as testified by SFC and HKMA" you refer. Nevertheless we are not aware of any practices conducted by either the SFC or the HKMA which are ultra vires. Further, there is nothing in the MoU (whether in clause 5 or otherwise) which suggests that the SFC "must rely" on the HKMA.