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

SFC
證監會

Responses to the written questions raised by Leung Kwok-hung on 28 January 2010

19 March 2010

1. **Section 5 of the Securities and Futures Ordinance confers on the SFC the power and function to protect investors. For the purpose of exercising this power and function, you have the discretionary power to decide whether to rely on the HKMA to supervise banks or to do it on your own, or even not to do anything about it at all. As long as the SFC is able to protect investors from unreasonable harm, you can do whatever you want, but what is most important is that the SFC bears the ultimate accountability for the regulatory outcome. Do you agree?**

1.1 The question proceeds from a false premise. It is not correct to say that the SFC has "the discretionary power to decide whether to rely on the HKMA to supervise banks or to do it on your own". As previously stated in my written submission to the Subcommittee on 12 August 2009 in response to questions on this same point from Mr. Leung Kwok Hung dated 3 August 2009, SFC is not required to, is not empowered to, and does not supervise banks ("RIs").

1.2 The SFC is required by the regulatory structure to rely on HKMA to supervise RIs. This is because the only section in the SFO which empowers persons to supervise intermediaries is section 180 of the SFO and the SFC does not have power under section 180 to supervise banks[1]. Only HKMA has that power.

1.3 The SFC has powers to commence an investigation under section 182 of the SFO. However, these are very different from the powers to supervise conferred by section 180 which permit an authorized person[2], at any reasonable time, to enter premises and inspect and make copies of documents, and make inquiries of persons, to ascertain whether an intermediary is complying with the provisions of the SFO and subsidiary legislation and codes and guidelines made under the SFO. In order to exercise its powers under section 182 in relation to an RI the SFC must first have reason to inquire whether the RI is guilty of misconduct or is not fit and proper. The SFC is also first required to consult with the HKMA before commencing an investigation in relation to an RI[3].

1.4 At the time of passage of the Securities and Futures Bill the different roles of the SFC and the HKMA in regulating the securities businesses of RIs were explained to and discussed / scrutinised by LegCo. The relevant paragraphs of The Report of the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill dated 5 March 2002 (LC Paper No. CB(1) 1217/01-02) are included in Appendix A to these Responses. In paragraph 55 the Report states (references in the Report to "exempt AIs" are references to banks, now called "RIs") -

> "55. The Bills Committee has carefully examined how far the new regime could help minimize regulatory overlap. In line with international practice, HKMA exercises consolidated supervision of AIs (e.g. returns on the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of the AIs concerned and submitted to HKMA regularly). This reflects the fact that HKMA has an overall supervisory concern over the financial subsidiaries of an AI which have impact upon the financial health of the AI concerned. In essence, it is

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[1] Under section 180 of the SFO the HKMA may inspect and enter premises to ascertain whether an RI is complying with the provisions of the SFO and subsidiary legislation and codes and guidelines made under the SFO

[2] An authorized person is a person authorized for the purposes of section 180 of the SFO by the SFC (in the case of an inspection of a licensed corporation) or the HKMA (in the case of an inspection of an RI).

[3] See section 182(4) of the SFO

not possible to "compartmentalize" supervisory responsibilities in such a way that the regulatory overlap between SFC and HKMA could be eliminated. The Administration considers that the current division of supervisory responsibilities between SFC and HKMA is appropriate in Hong Kong's special circumstances and provides an effective solution to provide the requisite degree of protection for investors yet avoids subjecting AIs simultaneously to two regulatory processes administered by HKMA and SFC on a day-to-day basis. Members are assured that AIs will be subject to the day-today front-line supervision by HKMA, using the regulatory standards set by SFC, e.g. Codes of Conduct for Licensed or Exempt Persons under clause 164 of the SFB. The SFC rules and codes/guidelines will apply directly to "exempt" AIs and their securities staff unless there are equally or more stringent requirements under the BO. For instance, FRRs and the Client Money Rules will not apply to AIs as there are already more stringent requirements on initial paid-up capital, capital adequacy and liquidity, large exposure, etc. under the BO to ensure AIs' prudential safety and protection for clients' interests. The administration of the new regulatory framework will be underpinned by a revised Memorandum of Understanding between SFC and HKMA. To facilitate regulatory co-operation, clause 11 of the BAB and clause 366 of the SFB will relax the official secrecy provisions to enable exchange of regulatory information between the two regulators concerning exempt AIs on a timely basis. The HKMA currently has three specialized securities teams (each with three staff) to perform the day-to-day supervision of the securities business of AIs. These teams are of equal status and structure as those teams dealing with bank organizations. Further internal resources will be deployed if necessary to take up additional tasks arising from the proposed regime. The disciplinary regime applicable to exempt AIs is explained in paragraphs 78 to 81."

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2. **Whether you agree or not, please refer to a speech given by Stephen Ip, Secretary for Financial Services, at the second reading of the Securities and Futures (Bill) in 2002. According to him, for the purpose of investor protection, section 4 was specially added to the Bill to make it clear that investor protection is one of the major objectives of the Securities and Futures Ordinance so as to ensure that if the SFC fails to protect investors properly, members of the public can hold the SFC accountable. Have you read this speech?**

2.1 I have read the speech delivered by Mr. Stephen Ip, the former Secretary for Financial Services ("SFS"), at the second reading of the Securities and Futures Bill in 2002 on 13 March 2002.

2.2 The former SFS did not say "section 4 was specially added to the Bill to make it clear that investor protection is one of the major objectives of the Securities and Futures Ordinance so as to ensure that if the SFC fails to protect investors properly, members of the public can hold the SFC accountable". What the former SFS said in relation to the SFC's regulatory objectives was this –

> "We clearly understand the grave importance of enhancing the accountability and transparency of the SFC. Therefore, apart from retaining all existing accountability arrangements, a number of additional checks and balances have also been introduced in the Bill to avoid the possible abuse of power. There are, for example, inclusion of regulatory objectives of the SFC so that the public and the industry can use them as the criteria for assessing the performance of the SFC as well as setting up of the Securities and Futures Appeals Tribunal to review the decisions of the SFC. To further enhance the accountability of the SFC, I will propose amendments stipulating that the number of non-executive directors should be greater than that of executive directors. Furthermore, the SFC should comply with strict procedural requirements when exercising its statutory powers such as offering regulated persons reasonable opportunities to be heard to safeguard their interests. Besides, the SFC should also consult the public and consider the views gathered in detail before enacting any subsidiary legislation. These will help to ensure that any proposal it made will be practicable and that due consideration has been given to the needs of the public and the industry."[4]

2.3 The amendment actually proposed by the former SFS to clause 4(c) of the Securities and Futures Bill (now section 4(c) of the SFO) was as follows "to ~~secure an appropriate degree of~~provide protection for members of the public investing in or holding financial products. The footnote to the amendment reads –

> "While there is no dispute that investors should also take responsibility in protecting their interests and the regulator should not be expected to provide a risk-proof investment environment, we accept the comment of some Members expressed at the meeting on 8 June 2001 that reference

[4] See page 4339 of the Official Record of Proceedings (English version) on 13 March 2002

to "an appropriate degree" of protection in an "objective" clause might not be positively perceived. The revised clause 4(c) together with clause 5(1)(i) to (l) should put in proper perspective the role of the regulator in investor protection." *[Emphasis added].*

2.4 Furthermore, the regulatory objectives of the SFC cannot be read in isolation. The specific duties of the SFC are set out in section 5 of the SFO and are qualified by the provisions of section 6 of the SFO. The duty of the SFC is not to provide a risk free environment for investors. The duty of the SFC is set out in section 5(1)(i) to (l) of the SFO, to –

> "(i) promote understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products;
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> (j) to encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the Commission under any of the relevant provisions;
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> (k) to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor;
>
> (l) 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;" *[Emphasis added].*

2.5 This duty is qualified by section 6 of the SFO which requires the SFC –

> "(2) In pursuing its regulatory objectives and performing its functions, the Commission shall have regard to -
> (a) the international character of the securities and futures industry and the desirability of maintaining the status of Hong Kong as a competitive international financial centre;
> (b) the desirability of facilitating innovation in connection with financial products and with activities regulated by the Commission under any of the relevant provisions;"

2.6 These statutory scheme was explained by the former SFS at page 4335 of the Official Record of Proceedings (English version) on 13 March 2002 where he said this -

> "The key objective of the Bill is, through the establishment of a streamlined and effective regulatory framework, to maintain fair, transparent and orderly markets; promote public confidence in the markets; secure an appropriate degree of investor protection; minimize market misconduct and facilitate market innovations and competition. In implementing the relevant proposals and drafting the legislation, we have been guided by the following principles: firstly, the new framework should be on par with international standards and compatible with

international practices with necessary adjustments in response to local circumstances and needs; secondly, a proper balance should be struck between the need for investor protection and promotion of market development; thirdly, procedures and processes should be simplified and made user-friendly whenever possible to minimize regulatory burden; fourthly, the exercise of regulatory powers should be subject to adequate checks and balances; and lastly, a smooth transition from the existing to the new regulatory framework should be ensured as far as possible for market participants." *[Emphasis added]*

2.7 SFC has implemented its statutory protection mandate in line with the policy intent. As stated at its Annual Report 2007- 08, "The SFC believes in putting investors first, while aiming to strike a balance between investor protection and the continuing needs of an efficient market. We (SFC) are also mindful of keeping our regulatory framework in step with standards in other major financial centres."

3. It really would be a problem if you never read it, given that this speech was cited by you in your first statement.

3.1 Please refer to 2.1 above.

4. At present, through what channels can members of the public hold the SFC accountable? Do you think it is necessary to establish such accountability procedures and system? How can this be done?

4.1 As an independent statutory body the SFC is bound to operate within the functions under the SFO. Under the SFO the SFC is accountable to the Administration: All the members of the Board are appointed by the Administration for a fixed term. The SFO requires that the majority of the board members must be independent Non-Executive Directors ("NEDs")[5].

4.2 The Commission is committed to open communication with our stakeholders and the public. We publish our Quarterly Reports and Annual Report within 45 days after the end of the relevant period. We report our operations and activities to the public through periodic newsletters, press releases, publications and press conferences.

4.3 Each year the SFC must prepare a report on its activities during the financial year and send a copy of the report to the Financial Secretary who shall cause a copy thereof to be laid on the table of the Legislative Council[6]. Officers of the SFC also regularly attend meetings of the Financial Affairs Panel of the Legislative Council which is tasked with monitoring and examining Government policies and issues of public concern relating to financial and finance matters.

4.4 Since its inception in 1989, the SFC has been subject to various checks and balances designed to ensure fairness and observance of due process. Members of the public can complain to the Ombudsman and the ICAC against the SFC and its staff if they believe that we have been guilty of maladministration in the performance of our functions. Anyone who is dissatisfied with an SFC decision may appeal to the SFAT. Where this remedy is not available, they may take civil action in the Courts against the Commission, by either applying for judicial review of the Commission's decisions or seeking remedies.

4.5 If members of the public are dissatisfied with the way in which SFC staff have carried out or failed to carry out their duties they may make a complaint to the SFC. The Procedures for Handling Complaints against Commission Staff ensures prompt handling of any complaints from members of the public against our staff and facilitates effective follow-up action. We have published the procedures on our website to enhance transparency and provide clear guidance to the public.

4.6 The SFC is also subject to scrutiny by the Process Review Panel (PRP). The PRP, which is an external, independent, non-statutory panel, reviews and advises the SFC on the adequacy of its internal procedures and operational guidelines. To carry out its work, the PRP receives and considers periodic reports from the SFC in respect of the manner in which complaints against the SFC or its staff have been considered and dealt with. In addition, the PRP may call for, and review, the SFC's files to verify that the actions taken and decisions made in relation to any specific case or complaint are consistent with the relevant internal procedures and operational guidelines.

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[5] Please see Schedule 2 to the SFO.

[6] See section 15(3) of the SFO.

5. Under the existing performance measurement system of the SFC, are there any indicators and assessment methods in place to assess the economy, efficiency and effectiveness of the SFC's investor protection measures?

5.1 Please refer to 4.1 to 4.6 above. These systems are supplemented by a number of performance pledges which are published on our website. In fulfilling our regulatory roles, we have pledged to be responsive to the general public, market participants, and intermediaries under our supervision. We have pledged to perform a range of functions within a set number of days and we monitor the performance of these pledges and publish the results annually in our annual report.

5.2 The effectiveness of the SFC's investor protection measures is established by (1) monitoring and analysing the views of investors through surveys of investors; (2) monitoring and analysing the complaints that the SFC receives and (3) onsite inspection of licensed corporations (including thematic inspections).

Surveys of Investors

5.3 The SFC regularly appoints consultants to conduct surveys of investors. For example, the SFC conducted a Retail Investor Survey from September to November in 2005. The purpose of the survey was to estimate the retail participation in different investment products and explore the investment behaviour of retail investors in Hong Kong. Of 5,210 adults interviewed 146 (or 2.8%) said that they invested in structured products during the two years preceding the survey.

5.4 In June 2006, we engaged the Social Sciences Research Centre of the University of Hong Kong (SSRC) to conduct Structured Product Investor Survey ("2006 Survey"). The results of this survey were published in November 2006. Key points identified were that –

a. In the survey, 207 structured product investors were successfully interviewed.

b. When asked about their investment objectives many (42.0%) said that they bought structured products for perceived higher returns, comparing to bank deposits of a similar term.

c. Most investors (84.5%) considered structured products were "medium" "high" and "very high risk". But 13.5% viewed structured products as "low" or "very low risk".

d. Most investors (87.9%) bought their structured products through banks (presumably RIs).

5.5 Whilst the survey revealed that few investors bought their structured products through licensed corporations (brokers – 17.4%, investment advisers – 4.3% and other channels – 1.4%), we continued our efforts to educate investors, whether they intended to buy the products through RIs or licensed corporations.

5.6 On finding that few investors received, read and fully understood the offering

documents we responded immediately with more reminders. On the same day as the publication of the 2006 Survey we issued a Dr Wise article on retail structured notes to remind prospective investors of issues that they should consider before investing in these products and a circular to alert issuers and their selling agents to the results of the survey. We also requested that the issuers and selling agents pay particular attention to ensuring that investors understand the risks of these products.

Public Complaints

5.7 The SFC takes all public complaints seriously. The Complaints Control Committee conducts preliminary review of complaints within the SFC's jurisdiction e.g. mis-selling by SFC licensees, to determine whether the matter justifies further assessment. Any complaints of mis-selling by the banks are passed by the SFC to the HKMA, as the banking regulator.

5.8 The SFC groups complaints by category and monitors trends. Before the failure of Lehman, our concerns over mis-selling were driven by the surveys we commissioned and our own onsite inspections as the incidence of complaints regarding mis-selling were relatively low. Before the failure of Lehman the SFC had only received 1 complaint from the public relating to mis-selling of Minibonds. Complaints relating to mis-selling were also low with only 47 complaints being received in 2007 (i.e. 3.9% of the 1,193 complaints received) and only 59 complaints being received in 2006 (i.e. 5.5 % out of 1,068 complaints received). These figures include all complaints received by the SFC including complaints received relating to banks and insurance intermediaries.

5.9 Between the date of the failure of Lehman on 15 September 2008 and 5 May 2009 the SFC received approximately 7,960 complaints against RIs (banks) selling Minibonds and Lehman related structured products and 115 complaints against licensed corporations (brokers) selling these products. We understand that HKMA has received 21,045 complaints as at 27 May 2009.

5.10 The SFC has commenced investigations into 21 RIs (banks) and 5 licensed corporations (brokers) involved in selling Minibonds and Lehman related products. The low incidence of complaints relating to licensed corporations (about 1% of the total) may reflect the fact that, as indicated by the 2006 Survey, few licensed corporations were involved in the sale of structured products.

Onsite inspection of licensed corporations

5.11 One of our key supervisory tools is to conduct onsite inspection of licensed corporations ("LCs") which involves physically attending their offices and assessing their general compliance with applicable requirements. This involves, inter alia -

(a) Assessing the LC's management, supervision and internal controls and considering whether they are commensurate with its business operation;

(b) Conducting walk-through tests of process/order flows to assess proper functioning and effectiveness of the internal control systems;

(c) Verifying financial positions and client assets held; and

(d) Performing sample testing of transactions so as to detect any non-compliance with the Code of Conduct and other regulatory requirements.

5.12 Over the last 3 years, the SFC has conducted approximately 140 onsite inspections of LCs each year. This work is directed towards investor protection. Not one broker failed in Hong Kong during the severe worldwide financial turmoil which followed the failure of Lehman.

5.13 Onsite inspections include thematic inspections where inspection teams look into topical issues or concerns over particular market practices. The SFC regularly analyses market-wide risks and trends emerging from current business and operating environment and, in about 2004, noted a rising trend for Hong Kong investors to invest in investment products other than the more traditional listed securities.

5.14 As a result, in 2004, we decided to conduct a thematic review into the selling practices amongst some investment advisory firms to assess their compliance with the SFO, and the Code of Conduct.

5.15 The report on the thematic inspection issued by the SFC in February 2005 ("the 2005 Report") sets out the regulatory concerns at the time, by – S20

(a) presenting the findings of our theme inspection on selling practices adopted by investment advisory firms;
(b) discussing some of the issues that arose out of our investigations and which we believe pose serious regulatory concerns; and
(c) clarifying some of the existing requirements.

5.16 The 2005 Report explains that, in Hong Kong, an investment advisory firm may be an LC, an RI or an insurance intermediary. The SFC's inspection and investigation initiatives had, so far, been limited to reviewing the selling practices of LCs which were under the SFC's direct supervision.

5.17 The 2005 Report identified areas of unsatisfactory practice noted during the review and served as a set of benchmarks giving all licensed investment advisers a roadmap on how to ensure they would stay within the regulatory requirements. The 2005 Report was copied to all RIs by a Circular issued by HKMA on 1 March 2005

5.18 The SFC has subsequently conducted a second thematic review of selling practices and published a report in 2007 which revealed similar issues and deficiencies. S27

6. Do you think the Director of Audit should recommend to the SFC a system regarding such indicators and assessment methods?

6.1 Please refer to 5.1 above in which we set out the multiple levels at which our performance is already reviewed in accordance with the provisions of the SFO. In particular, our performance is subject to the supervision of the independent NEDs of the SFC, the various committees with external members and the Administration.

6.2 Nevertheless we would welcome any other suggestions from Honourable Members for improvements in the indicators and assessment methods that we employ as investor protection is our priority.

7. Your reports to this Council (SC(1) – S5(C)) pointed to serious problems with the conduct of issuers and banks. Why did the SFC not take action earlier to deal with them, which have caused harm to so many people?

7.1 The report (SC(1) – S5(C) A Thematic Analysis of the Sale of Minibonds – produced at the hearing on 6 November 2009) did not point to serious problems with the conduct of issuers. The report was concerned with common issues that emerged in the investigation of the sale of Minibonds. The reports did not comment on the conduct of issuers. Issuers are not regulated by the SFC unless they happen to be licensed by the SFC and then the regulation relates to the regulated activities that they conduct. In the case of Minibonds, the issuer was Pacific International Finance Limited which was established in the Cayman Islands as a special purpose vehicle to issue Minibonds. It was not licensed by the SFC.

7.2 The issues identified in the report were identified during the course of our investigations commenced after the failure of Lehman. Prior to the Lehman failure, the SFC did not have detailed information regarding the conduct of banks because the SFC was not and is not the front line regulator of banks. The SFC had no power to supervise banks. The HKMA alone had power to conduct on-going supervision of banks and therefore to identify any mis-selling by banks.

8. Do you think that the number of investors harmed is an important regulatory outcome index, and that it should be incorporated into the Government's system of assessing the performance of the SFC?

8.1 Investment involves risk, and some investors will inevitably suffer losses. The SFC cannot provide a risk free environment where no investors suffer losses. As the former SFS said at the second reading of the Securities and Futures Bill in 2002 on 13 March 2002 (cited in the response to Q.2 above) -

". . . there is no dispute that investors should also take responsibility in protecting their interests and the regulator should not be expected to provide a risk-proof investment environment . . ."

8.2 The success or failure of an investment is not related to the performance by the SFC of its functions – it is related to the performance of the companies, or the products, in which money is invested. It would not be right to conclude that a market downturn was an indication that the SFC was failing in its duties and a market upturn was an indication that the SFC was performing its duties. The fact that an investor loses money does not mean that the SFC has failed in its duties and we therefore consider that it would be wrong to use the number of investors who suffer loss as a performance indicator for the SFC.

8.3 In this context it should be noted that fewer than 1% per cent of the complaints we received in relation to the failure of Lehman related to mis-selling by licensed corporations whilst 99% related to banks mis-selling.

9. **The SFO stipulates that the SFC is responsible for supervising, monitoring and regulating intermediaries, but the SFC has handed over its supervisory work to the HKMA. Do you think the SFC should also be responsible for monitoring the HKMA's work in this regard? Has the SFC done so? How do (you) assess the effectiveness of (your) monitoring in the past?**

9.1 Please refer to the response to Q. 1 above.

9.2 The question proceeds from a misunderstanding of the role of the SFC. The SFC was not responsible for supervising and monitoring banks, and could not therefore "hand over" such a role to the HKMA. Under section 180 of the SFO, and under the Banking Ordinance, the HKMA is responsible for supervising banks.

9.3 The SFC has no power under the SFO to monitor the work of HKMA. The HKMA is a part of the Administration with its own statutory powers. The SFC is accountable to the Administration, not the other way around. This question is therefore a matter for the Administration to consider and comment.

10. According to the opinion expressed in (paragraph) 1.5.2 of Appendix 1 to your Report to the Financial Secretary on Issues raised by the Lehman Minibonds Crisis, the SFC is in favour of the Twin Peaks Approach. But then again, the SFC has signed a MOU to allow the HKMA to supervise banks, turning the regulatory system into one of "subjecting one industry to two supervisory bodies". You have the full discretionary power to cancel the MOU signed with the HKMA so as to give the SFC full authority to supervise banks in order to achieve the implementation of the Twin Peaks Approach. Why did you not do so to establish the Twin Peaks Approach that you esteem greatly?

10.1 The question states that the SFC expressed an opinion in the Report to the Financial Secretary on 31 December 2008 in favour of the Twin Peaks Approach. That is not correct. The SFC did not argue in favour of any particular model. We said that a number of models are worthy of study : S36

> *"21.1 The Group of Thirty Report ...comments that the Institutional Approach adopted by Hong Kong is generally considered suboptimal given the evolution of the markets. The report notes that the Functional Approach, where the supervisor is determined by the business transacted rather than the legal status of the entity, remains common and appears to work well. The Integrated Approach, with one single universal regulator, adopted by the UK FSA, brings with it the need to strike a balance between what may be conflicting objectives. The recent failure of Northern Rock in the UK demonstrates the risks posed when one regulator has two functions.*
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> *21.2 The regulatory approach that has attracted more attention recently is called Twin Peaks with a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision and one that focuses on conduct-of-business. Most recently the USA in the report by the Department of the Treasury "Blueprint for a Modernized Financial Regulatory Structure" proposed as a long-term optimal regulatory structure an objective-based regulatory approach with three entities - a market stability regulator, a prudential financial regulator and a business conduct regulator.*
>
> *21.3 We recommend that the government consider whether the current regulatory structure is best suited to facilitate Hong Kong's further development as an international financial centre. "*

10.2 The local financial system has emerged from this global financial crisis without any systemic problems, thanks to our robust regulatory regime. Nevertheless, the G-20 and international regulatory bodies, having learnt lessons from the crisis, have proposed a series of measures to enhance the regulation of financial institutions and markets. We will continue to work closely with the Administration to facilitate Hong Kong's further development as an international financial centre.

10.3 The question again proceeds from a misunderstanding of the role of the SFC when it states that –

> "the SFC has signed a MOU to allow the HKMA to supervise banks, turning the regulatory system into one of 'subjecting one industry to two supervisory bodies' ".

10.4 The SFC was not responsible for supervising and monitoring banks, and could not therefore "allow" the HKMA to supervise banks. Under section 180 of the SFO, and under the Banking Ordinance, the HKMA is responsible for supervising banks.

10.5 The SFC did not subject the industry to two supervisory bodies. The division of responsibilities was set out in the SFO. The Report of the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill dated 5 March 2002 cited in the response to Q. 1 (above) explains that the division of responsibilities in the SFO was designed to avoid subjecting one industry to two supervisory bodies' -

> "55. The Bills Committee has carefully examined how far the new regime could help minimize regulatory overlap. In line with international practice, HKMA exercises consolidated supervision of AIs (e.g. returns on the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of the AIs concerned and submitted to HKMA regularly). This reflects the fact that HKMA has an overall supervisory concern over the financial subsidiaries of an AI which have impact upon the financial health of the AI concerned. In essence, it is not possible to "compartmentalize" supervisory responsibilities in such a way that the regulatory overlap between SFC and HKMA could be eliminated. The Administration considers that the current division of supervisory responsibilities between SFC and HKMA is appropriate in Hong Kong's special circumstances and provides an effective solution to provide the requisite degree of protection for investors yet avoids subjecting AIs simultaneously to two regulatory processes administered by HKMA and SFC on a day-to-day basis."

10.6 The MOU does not change the regulatory regime established under the SFO and cancelling it would also have no effect on that regime. The Report of the Bills Committee states "The administration of the new regulatory framework will be underpinned by a revised Memorandum of Understanding between SFC and HKMA." The MOU does not "allow the HKMA to supervise banks". Aside from restating the roles and responsibilities conferred on the SFC and the HKMA by law (i.e. under the SFO and the BO), the MOU is mainly concerned with sharing of information between the SFC and the HKMA.

11. Do you consider (the choice between) the Twin Peaks Approach and the dual regulatory approach a major policy of regulating the financial industry? Who should be the one to decide on this policy, John Tsang or KC Chan?

11.1 The choice between the Twin Peaks Approach and any other regulatory approach is clearly a major policy issue in determining how best to regulate the financial services industry, However, this is not an issue for the SFC to decide. This question should more appropriately be put to the Administration. The local financial system has emerged from this global financial crisis without any systemic problems, thanks to our robust regulatory regime. Nevertheless, the G-20 and international regulatory bodies, having learnt lessons from the crisis, have proposed a series of measures to enhance the regulation of financial institutions and markets. Any change proposed to the regulatory approach would require legislative change and would therefore be subject to public discussion/ market consultation before any legislative amendments proposals could be introduced into the LegCo for consideration.

12. According to the definition of "Financial Secretary" under Cap.1 of the Laws of Hong Kong, both John Tsang and KC Chan are considered as the Financial Secretary. Do you think this is very confusing? Why does Hong Kong have two Financial Secretaries? Who do you think is the Financial Secretary referred to in the SFO? Which Financial Secretary should the SFC be accountable to?

12.1 This question was answered by the Administration in the FS's written response attached to his letter to the Subcommittee dated 16.12.2009[7]. A29

[7] Please see paragraphs 5(1-2).1 - 5(1-2).4.

13. The disclosure-based (regime) is a major policy on financial regulation. In light of Mr Brian Ho's answer(s) to my question(s), there is a huge legal loophole in the Third Schedule to the Companies Ordinance relied upon by the SFC. For the purpose of examination by this Subcommittee, I have previously requested the SFC to produce its approval reports for ten prospectuses submitted by issuers of structured products, detailed returns completed by issuers in accordance with the Third Schedule, and the follow-up questions raised by SFC reviewers together with the answers given by applicants. Please select in random at least one set of information in this regard for each of the years between 2003 and 2008 in respect of which the issuers or applicants should include banks such as Lehman, Standard Chartered, DBS and Citibank, and provide such information to this Subcommittee as soon as possible.

13.1 The question asserts that there is a huge legal loophole in the Third Schedule to the Companies Ordinance ("CO") relied upon by the SFC. The question does not explain what this alleged huge loophole is meant to be. However, the use of the same term "loophole" in Question 17 indicates that the perceived "loophole" is the fact that there is no prohibition on the use of special purpose vehicles ("SPVs") as an issuer of debentures.

13.2 We do not accept that the absence of a prohibition on the use of SPVs as an issuer of debentures represents a loophole in the Third Schedule to the CO. Investing in a structured product is very different from investing in shares of a company. When you invest in shares of a company you rely upon the directors of the company to grow the business of the company to generate profits to pay dividends and to increase the value of the shares. With a structured product an investor is not relying on any existing business of the company or any growth in that business. The investor in structured products is relying upon a pre-determined formula or occurrence of events described in the prospectus, to pay the return promised. The investor is not relying on the creditworthiness of an SPV but on the value of the collateral.

13.3 Structured products were issued by SPVs precisely because they were companies without other businesses. This was important because it meant that they had no creditors other than the noteholders. As a result it is less likely that an SPV would go into default due to the failure of another line of business or that there would be competing claims from creditors. In technical terms, an SPV is structured to be "bankruptcy remote" under English law. The inevitable consequence of having no other business was that the SPV had no track record or business performance.

13.4 As regards the adequacy of the disclosure required we would point out that paragraph 3 of the Third Schedule to the CO sets out a general disclosure requirement that a prospectus should contain sufficient information to enable a reasonable person to form a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus. This obligation is very broad.

13.5 In addition, reliance on the disclosure in a prospectus or offering document is also supported by statutory liability for untrue statements under the CO[8].

13.6 As regards the documents requested, we have explained previously that the SFC did not authorise any prospectus for LB-related unlisted retail structured

[8] See sections 40, 40A, 342E and 342F of the CO.

products issued/arranged by Standard Chartered Bank (Hong Kong) Limited or Citibank (Hong Kong) Limited during the period between 2003 and 2008. They did issue certain LB-related unlisted retail structured products by way of private placement. However, the documents were not required to be authorized by the SFC under the CO (because they were exempted from being prospectuses by the provisions of the 17th Schedule to the CO). The documents were also not required to be authorized by the SFC under the SFO (because section 103(2)(ga) of the SFO also exempts documents from authorization under the SFO, documents which are exempted from being prospectuses by the provisions of the 17th Schedule to the CO).

13.7 Minbonds and Constellation notes are the main LB-related structured products arranged by Lehman and DBS respectively during the above period. Copies of examples of the comments raised by the SFC on the draft prospectuses of certain series of Minibonds and Constellation notes and the Companies Ordinance Compliance Checklist were provided to the Subcommittee in Appendices E and A to the Written Statement of Mr Brian Ho dated 7 July 2009 respectively. Reports relating to the authorization of the draft prospectuses of these products would typically set out a summary of the key features of the relevant product and the details of any waivers sought.

13.8 The prospectuses of all series of Minibonds and Constellation notes are available on the SFC's website.

14. In my opinion, the purpose of the SFC's 2009 consultation paper on amendments to (the provisions governing) prospectuses of structured products is to allow issuers to provide less information so that they can be issued more easily, rather than protecting non-professional investors. Do you agree?

14.1 We do not agree. The purpose of the SFC's "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance" issued in October 2009 ("the October Consultation") is to invite the public to comment on proposals to transfer the regulation of public offers of structured products in the form of debentures from the CO prospectus regime to Part IV of the SFO so that structured products, irrespective of their legal form, will be regulated under the SFO. Under the SFO, the SFC would be able to publish codes and guidelines setting out its regulatory policy on such products. Separately, in September 2009, the SFC issued a separate consultation in its "Consultation Paper on Proposals to Enhance Protection for the Investing Public ("the September Consultation") which included a new Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and a new Code for Unlisted Structured Products.

14.2 The proposals in the October Consultation do not allow issuers to provide less information so that structured products can be issued more easily. Instead, the October consultation sought to lay down the legal framework whereby the regulation of structured products in the form of debentures will be rationalised with that of structured products in other forms such that their offering documents are all subject to one single SFO regime.

15. How can such amendments protect non-professional investors? Please state in detail.

15.1 As explained in the response to Q14 above, the October Consultation lays down the legal framework so that the regulation of public offers of structured products will be subject to one single SFO regime under which the SFC would publish codes and guidelines setting out its regulatory policy on such products. Publicly offered unlisted structured products and their related offering documents and advertisements will be authorised under the SFO and a new Code for Unlisted Structured Products which was the subject of a separate consultation paper issued in the September Consultation.

15.2 The September Consultation in turn proposed the issue of a Products Handbook which contains a revised Code on Unit Trusts and Mutual Funds, a revised Code on Investment-Linked Assurance Schemes, and a new Code on Unlisted Structured Products, to be made under section 399 of the SFO. The Handbook contains overarching principles as well as detailed provisions aimed at further enhancing disclosure and improving product transparency. These proposals will enhance investor protection.

16. Regarding the aforesaid consultation, how does the SFC ensure that the feedback from non-professional investors and that from issuers of structured products will be treated equally?

16.1 The SFC will consider all responses received and its recommendations will balance these responses as well as our regulatory objectives. Responses received will be published on the SFC's website (unless respondents have requested otherwise) and the SFC's recommendations (on the legislative amendments to implement the proposals in the October Consultation) will be published in the form of a conclusions paper. The Government will consider these recommendations and will draft the necessary legislative amendments which will be published as a Bill in the Government Gazette. The Bill will be tabled before LegCo and debated. We believe this process ensures that the interests of all parties are balanced.

17. **Mr Brian Ho in his answer 4.1 to my question 4 in (SC(1)-S47) said, "Under the CO, there is no prohibition on the use of special purpose vehicles ("SPVs") as an issuer of debentures." This only dealt with a part of the question, which was about the exploitation of the legal loophole in the case of structured products. In fact, the SFC should have amended the unsuitable legislation or codes without delay in 2006 instead of merely checking if they were lawful. This loophole was also revealed in the 2006 consultation paper, but the SFC still allowed the issuance (of such products), which were sold to non-professional investors. Do you agree that the SFC has violated the aforesaid section 4 of the SFO and the legislative intent of the legislation?**

17.1 Please see our response to Q 13 in which we explain that the absence of a prohibition on the use of SPVs as an issuer of debentures did not represent a loophole. For this reason it was not mentioned or identified in the 2006 Consultation Conclusions Paper as being a "loophole" or issue to be addressed. In the work since then of formulating detailed proposals to implement each of the initiatives, soft-consulting different stakeholders on different sets of detailed proposals, reviewing comments from soft consultations and revising the detailed proposals to address stakeholder comments, it has never been suggested that the use of SPVs was a "loophole". A substantial amount of soft consulting was needed on the detailed logistics and technical aspects of certain proposals to reduce any process risk associated with implementation of these proposals but, again, it was never suggested to us that the use of SPVs was a "loophole" which needed to be closed. That remains the position today. Based on the complaints the SFC received, the main issue relating to Lehman-related structured financial products such as Minibonds is that of mis-selling. S17

17.2 The SFC has not violated section 4 of the SFO and the legislative intent of the legislation. At all times, the SFC and its staff have discharged the Commission's objectives, functions, powers and duties in a diligent and responsible manner.

18. The IMF conducted a detailed analysis of Hong Kong's regulatory system between 2002 and 2003 and published a report (namely IMF Country Report No. 03/191, which can be found on the IMF's website.) As stated in paragraph 130 of the report, "*There are a significant number of decisions on which the SFC must consult or seek the consent of various bodies. Some of these requirements are inconsistent with the independent functioning of the SFC, and impair its ability to act quickly in an emergency situation.*" The IMF therefore made the following recommendation: "*(...) the SFC to consult on or seek the consent of other parties to what are essentially regulatory decisions should be reviewed. ... The new SFO [only] partly deals with this problem.*"

The various bodies mentioned by the IMF should include the HKMA. Why did you not urge the Government to amend the legislation?

18.1 The IMF's report is a public document. After considering the comments made by the IMF, the Administration provided a response. The Administration therefore was aware of the comments.

18.2 Under the regulatory system which came into effect in 2003 the SFC is responsible for (1) registration of RIs[9]; (2) issuing subsidiary legislation and codes of conduct which RIs must comply with[10]; (3) investigation[11]; and (4) discipline of RIs[12]. Whereas, the HKMA is responsible for (5) maintaining a register of relevant individuals (employees of RIs who are engaged in a regulated activity)[13] and (6) supervision of RIs[14]. Given this division of responsibilities relating to RIs it is clearly essential that the SFC consult with the HKMA[15] in carrying out its duties in regulating RIs, just as HKMA is also required to consult with the SFC[16].

18.3 At the time of passage of the Securities and Futures Bill the different roles of the SFC and the HKMA in regulating the securities businesses of RIs were explained to and discussed / scrutinised by LegCo. The relevant paragraphs of The Report of the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill dated 5 March 2002 (LC Paper No. CB(1) 1217/01-02) are included in Appendix A to these Responses. In paragraph 55 the Report states (references in the Report to "exempt AIs" are references to banks, now called "RIs") –

> "55. The Bills Committee has carefully examined how far the new regime could help minimize regulatory overlap. In line with international practice, HKMA exercises consolidated supervision of AIs (e.g. returns on the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of the AIs concerned and submitted to HKMA

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[9] Under sections 119 and 129 of the SFO. However, the SFC is required by section 119(2) to refer any application for registration to the HKMA and to have regard to its advice in deciding whether to register an applicant.

[10] Principally under Parts VI and VII of the SFO

[11] Under section 182 of the SFO

[12] Under sections 196 and 197 of the SFO

[13] Under section 20 of the Banking Ordinance (Cap 155) ("BO")

[14] Under section 180 of the SFO the HKMA may inspect and enter premises to ascertain whether an RI is complying with the provisions of the SFO and subsidiary legislation and codes and guidelines made under the SFO

[15] Under sections 119, 134, 159, 160, 179, 182, 198, 214, 396 and 399 of the SFO

[16] Under sections 58A and 71C of the BO

regularly). This reflects the fact that HKMA has an overall supervisory concern over the financial subsidiaries of an AI which have impact upon the financial health of the AI concerned. In essence, it is not possible to "compartmentalize" supervisory responsibilities in such a way that the regulatory overlap between SFC and HKMA could be eliminated. The Administration considers that the current division of supervisory responsibilities between SFC and HKMA is appropriate in Hong Kong's special circumstances and provides an effective solution to provide the requisite degree of protection for investors yet avoids subjecting AIs simultaneously to two regulatory processes administered by HKMA and SFC on a day-to-day basis. Members are assured that AIs will be subject to the day-to-day front-line supervision by HKMA, using the regulatory standards set by SFC, e.g. Codes of Conduct for Licensed or Exempt Persons under clause 164 of the SFB. The SFC rules and codes/guidelines will apply directly to "exempt" AIs and their securities staff unless there are equally or more stringent requirements under the BO. For instance, FRRs and the Client Money Rules will not apply to AIs as there are already more stringent requirements on initial paid-up capital, capital adequacy and liquidity, large exposure, etc. under the BO to ensure AIs' prudential safety and protection for clients' interests. The administration of the new regulatory framework will be underpinned by a revised Memorandum of Understanding between SFC and HKMA. To facilitate regulatory co-operation, clause 11 of the BAB and clause 366 of the SFB will relax the official secrecy provisions to enable exchange of regulatory information between the two regulators concerning exempt AIs on a timely basis. The HKMA currently has three specialized securities teams (each with three staff) to perform the day-to-day supervision of the securities business of AIs. These teams are of equal status and structure as those teams dealing with bank organizations. Further internal resources will be deployed if necessary to take up additional tasks arising from the proposed regime. The disciplinary regime applicable to exempt AIs is explained in paragraphs 78 to 81."

19. Why was it that the SFC not only refrained from fighting for legislative amendments but actually signed the MOU to farm out its work to the HKMA, leading to further decentralisation of the SFC's regulatory work?

19.1 The SFC did not sign the MOU to farm out its work to the HKMA. The responsibilities of the HKMA referred to in the MOU are already statutory responsibilities of the HKMA under the SFO and the BO. An MOU is necessary to set out the manner the SFC and the HKMA co-operate with each other and perform their respective functions under the SFO. S1-Appendix 10

19.2 If the SFC wished to transfer responsibilities to the HKMA this would require a Transfer of Functions Order. However, the SFO does not provide for the SFC transferring its functions to the HKMA. The functions performed by the HKMA in relation to the securities businesses of banks are already their functions under the SFO and the BO and they do not need to be transferred to the HKMA by the SFC.

20. In fact, the IMF had warned the SAR Government at an early stage that there was something wrong with the existing regulatory governance, and that improvement should be made so that (the regulatory governance arrangements) could be placed on a more formal and publicly accountable basis. The IMF also forewarned that any failures of large financial institutions would lead to serious problems given the current unclear delineation of regulatory responsibilities. Why did you still sign the MOU, which has contributed to the shirking of responsibilities in the current Lehman fiasco for which no one can be clearly held accountable?

20.1 It appears that the IMF's comments have been misunderstood in formulating this question. Lehman Brothers Holdings Inc. which filed for bankruptcy protection in September 2008 was regulated by US regulators, not the HKMA or the SFC. Neither HKMA nor the SFC was shirking their responsibilities in signing the MOU **S1-Appendix 10**

21. Is it true that you deliberately did that so that you could hardly be held accountable?

21.1 No. Please see answers to Qs 18 to 20.

22. **Please refer to the following opinion expressed in IMF Country Report 03/191:**

"98. The regulatory governance arrangements are moving in the right direction; however they could be placed on a more formal and publicly accountable basis. The regulatory and financial stability framework comprises of a complex web of institutional arrangements and is strongly reliant on personal relationships and understanding at the level of the agency heads and government. **[Comment: This is obviously an example of the rule of man instead of a good system.]** ***... While there has been no bank closures in the last 10 years, there does not appear to be a clear division of responsibility between the regulatory authorities in the case of a threatened insolvency of an LCFI.*** **[Comment: This is obviously a warning in advance and the Lehman fiasco is evidence. The persons in charge of regulation and policies can hardly pass the buck.]"**

Do you agree with my comments in the two brackets [...] above?

22.1 The comments set out in the question are not correct as they misinterpret paragraph 98 of the IMF Country Report 03/191. The concern is about a failure of a bank in Hong Kong. The Report states : "*While there has been no bank closures in the last 10 years . . .*". The warning has no application to Lehman which was a US investment bank, regulated by the US Securities and Exchange Commission and which failed unexpectedly over the course of a single weekend. There was no "threatened insolvency" which the policy advocated by the IMF could address.

APPENDIX A

The Report of the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill dated 5 March 2002 *(extracts)*
LC Paper No. CB(1) 1217/01-02

"(D) Regulation of Market Intermediaries

A single licensing system

46. The Bills Committee notes that the SFB introduces a single licensing system for market intermediaries to replace the existing multi-registration system. Under the proposal, an intermediary will only need one single licence to engage in all types of regulated activities, except for the provision of securities margin financing service, which is subject to sole-business requirement. Members welcome this new regulatory initiative as it, together with other SFC initiatives, will help to reduce administrative costs and burden on SFC in the long run, as well as cutting down the compliance costs for intermediaries and permitting them to structure their activities within one licence, thereby allowing them greater flexibility in capital and resources deployment. Clients will also have the benefit of a one stop service from their intermediaries. Corporations that carry on any of the nine regulated activities defined in Schedule 6, and representatives working on their behalf are required to be licensed. Clause 118 provides that an AI is required to apply to SFC for exemption for carrying out regulated activities. FS is empowered to amend Schedule 6 by way of subsidiary legislation to cater for future development.

47. All corporations or individuals admitted to the regulatory regime must meet the "fit and proper" criteria (clause 128). These include the applicant's financial status, qualifications, experience, ability, reputation, character, reliability and financial integrity, etc. For a corporate applicant, its internal control procedures and risk management systems are also considered. To enhance investor protection, a "management responsibility" concept has been introduced. Each licensed corporation or exempt AI must have for each regulated activity at least two "responsible officers" (ROs) approved respectively by SFC under clause 125 of the SFB or HKMA under clause 9 of the BAB. In the case of a licensed corporation, all executive directors must be approved by SFC as ROs. ROs are persons responsible for directly supervising the conduct of the regulated activities of the licensed corporation or exempt AI.

Level playing field between licensed persons and exempt persons

48. Some members express serious concern about the proposed arrangements for AIs under the new regulatory framework. They consider that to level the playing field for all market intermediaries, an AI should no longer be entitled to exempt status in respect of its conduct of regulated activities, and that the supervision of regulated activities should be carried out by SFC alone. The Bills Committee takes note of the concerns expressed by some deputations, including HKSbA and the Institute of Securities Dealers Limited (ISDL), that under the proposal, intermediaries will be subject to two regulatory regimes and that there is a risk that the regulatory standards and requirements will not be consistently applied to SFC licensees and exempt AIs. There is also concern that AIs would take advantage of their exempt

status which would result in unfair competition in the securities and futures market. For example, exempt AIs are not required to comply with the stringent Financial Resources Rules (FRRs) (clause 141) made by SFC prescribing requirements on the maintenance of financial resources by a licensed corporation and the Client Money Rules (clause 145) in dealing with client money. The deputations hold the view that as securities business is no longer incidental to banking services and some banks have already registered with SFC their subsidiaries operating securities business in order to gain direct access to the stock exchange, there is no justification for continuing the granting of exempt status to AIs. Furthermore, it would not be difficult for a bank to set up a separate entity with separate designated capital to conduct the regulated activities and be regulated by SFC as any other licensed corporations. For the purpose of providing a level playing field and for better utilization of resources and clear division of responsibility, there should be a single regulator for securities business and a separate regulator for banking activities.

Dual regulator approach versus single regulator approach

49. In this respect, the Bills Committee has made reference to the overseas duty visit delegation which finds that the increasing engagement in multibusiness by financial institutions is also a common feature in the US and the UK. But the two jurisdictions have adopted regulatory structures for their market intermediaries different from that proposed for Hong Kong. In the UK, FSM Act has established FSA as the single regulator for the entire financial services industry. The problem of inconsistency in regulatory approach therefore does not exist. As for the US, due to historical reasons, separate financial regulators are maintained for different trades. The Gramm-Leach-Bliley Act of 1999 enables the creation of a financial holding company (FHC) whose functional subsidiaries are permitted to engage in specified financial activities such as banking, insurance and securities dealing. While SEC will continue to regulate the securities activities of a FHC, the banking regulators will look at the banking activities and the Federal Reserve Board will become the "umbrella regulator" of a FHC to regulate it on a consolidated basis.

50. The delegation is of the view that in essence, both the UK and the US have adopted "the same regulator for the same regulated activities" approach. They recognize that the focus of a bank regulator should be on prudential supervision to ensure that the supervised institutions have adequate capital and liquidity to discharge their liabilities and to avoid systemic risks, while supervision of securities business should focus on conduct regulation where attention is more directed to the day-to-day operations of the institutions and the compliance with standards and codes. It has been the common view of the regulators and market practitioners in the UK and the US that it will be more competent for those in the trade to regulate the conduct of the trade. The Bills Committee notes the delegation's view that although the supervision of AIs by HKMA does cover prudential and conduct supervision, the emphasis is on prudential supervision. HKMA has to rely on AIs themselves to carry out conduct supervision of staff. In contrast, SFC has maintained prudential supervision as the starting point, and invested much resources in conduct supervision at both corporate and individual levels. The delegation therefore considers that there is no compelling argument for AIs to remain exempted from SFC's regulatory regime.

51. The Administration nevertheless points out that the exemption in the Gramm-Leach-Bliley Act has, in fact, permitted banks to continue providing securities services in the form of trust and fiduciary activities or as an accommodation to certain

customers. These activities are not subject to SEC's regulation. The US model is therefore not really a "same regulator for the same regulated activities" approach.

Level playing field under the new regulatory regime

52. Regarding members' concern about the exempt status of AIs, the Administration accepts that "exempt person" is a misnomer and does not reflect the proposed regulatory framework under the SFB and the BAB. AIs engaging in regulated activities are subject to a whole range of regulatory requirements and disciplinary sanctions. Despite that under the SFB, there is a new requirement that SFC shall consult HKMA in deciding whether or not to grant the exempt status (clause 118), SFC may impose conditions on the operation of regulated activities by an AI and can revoke its exempt status. The consultation requirement is appropriate as HKMA has detailed knowledge about the AI from its capacity as the banking regulator under the arrangement. To address members' concern, the Administration will move CSAs to replace the term "exempt person" with "registered institution", "exempt" with "registered", and "exemption" with "registration" throughout the Bills. Moreover, to rationalize the respective roles of SFC and HKMA in the registration of AIs for carrying on a regulated activity, CSA will be moved to clause 118 of the SFB to stipulate that SFC "shall have regard" to and "may rely wholly or partly" on the advice by HKMA in making the decision on whether to "register" the AI.

Regulation of securities business of "exempt"[(5)] AIs

53. The rectification of the misnomer on the "exempt status" of AIs still has not addressed the fundamental question of what would be the best way in regulating the AI's securities business. Some members of the Bills Committee and a number of deputations have put forward the suggestion that AIs should be required to conduct their securities business through a subsidiary. The Administration has pointed out that this arrangement would not serve the best interests of investors and does not address the supervisory overlap between HKMA and SFC. While some AIs perceive that there are commercial and management benefits in setting up a separate entity specializing in the securities business, others may choose to enter into strategic alliance with independent exchange participants in handling customer orders. The decision on whether to set up their own subsidiaries for such purpose is a business decision for individual AIs.

54. In this respect, the Hong Kong Association of Banks (HKAB) and some academics are of the view that in their capacity as "agents", AIs provide additional convenience to investors. There are a significant number of investors who maintain securities trading accounts with AIs. Investors should be allowed to choose whether to conduct their securities trading through an AI or with a broker. Given the increasing sophistication of financial markets nowadays, banking and securities business are becoming increasingly intertwined. It is difficult, if at all possible, to impose any artificial barrier between the two types of services. The Administration concurs with this view and considers that the involvement of AIs is beneficial to the overall development of the securities and futures market. To compel AIs to set up subsidiaries for their securities business would not serve the best interests of investors. At present, AIs are not required to set up subsidiaries for their insurance or MPF businesses, and HKMA remains the front-line regulator for the operations of AIs

(5) For the purpose of this report, the "exempt AI" mentioned in the ensuing paragraphs are those AIs granted with "exempt status" under the Blue Bills but renamed as "registered institution" at Committee Stage.

in these areas of activities. This arrangement is in line with the regulatory framework proposed in the SFB.

55. The Bills Committee has carefully examined how far the new regime could help minimize regulatory overlap. In line with international practice, HKMA exercises consolidated supervision of AIs (e.g. returns on the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of the AIs concerned and submitted to HKMA regularly). This reflects the fact that HKMA has an overall supervisory concern over the financial subsidiaries of an AI which have impact upon the financial health of the AI concerned. In essence, it is not possible to "compartmentalize" supervisory responsibilities in such a way that the regulatory overlap between SFC and HKMA could be eliminated. The Administration considers that the current division of supervisory responsibilities between SFC and HKMA is appropriate in Hong Kong's special circumstances and provides an effective solution to provide the requisite degree of protection for investors yet avoids subjecting AIs simultaneously to two regulatory processes administered by HKMA and SFC on a day-to-day basis. Members are assured that AIs will be subject to the day-to-day front-line supervision by HKMA, using the regulatory standards set by SFC, e.g. Codes of Conduct for Licensed or Exempt Persons under clause 164 of the SFB. The SFC rules and codes/guidelines will apply directly to "exempt" AIs and their securities staff unless there are equally or more stringent requirements under the BO. For instance, FRRs and the Client Money Rules will not apply to AIs as there are already more stringent requirements on initial paid-up capital, capital adequacy and liquidity, large exposure, etc. under the BO to ensure AIs' prudential safety and protection for clients' interests. The administration of the new regulatory framework will be underpinned by a revised Memorandum of Understanding between SFC and HKMA. To facilitate regulatory co-operation, clause 11 of the BAB and clause 366 of the SFB will relax the official secrecy provisions to enable exchange of regulatory information between the two regulators concerning exempt AIs on a timely basis. The HKMA currently has three specialized securities teams (each with three staff) to perform the day-today supervision of the securities business of AIs. These teams are of equal status and structure as those teams dealing with bank organizations. Further internal resources will be deployed if necessary to take up additional tasks arising from the proposed regime. The disciplinary regime applicable to exempt AIs is explained in paragraphs 78 to 81.

56. Regarding the brokerage industry's concern that employees who conduct regulated activities for exempt AIs are not required to be licensed by SFC, the Administration explains that under the BAB, HKMA will maintain a register of individuals who perform for or on behalf of an exempt AI any regulated function in a regulated activity. The HKMA will adopt the same fit and proper criteria promulgated by SFC in respect of its licensees for admitting AIs' representatives to the register including the examination and continuous professional training requirements. The primary responsibility for ensuring observation of the criteria rests with the management of the AI. The AI will be required to demonstrate that suitable arrangements have been put in place to ensure its representatives receive appropriate training in line with such criteria, the compliance with which will be inspected by HKMA during on-site examinations. The HKMA will conduct appropriate background checks, in particular with SFC. If such checks reveal anything negative against a representative, or he/she is not fit and proper, HKMA will use its powers under the BO to require the AI concerned to take appropriate action, such as to remove the representative concerned from the performance of "regulated activities".

57. To address members' concern that only qualified personnel will be engaged by AIs for the conduct of regulated activities, the Administration will move CSA to impose a statutory obligation on a "registered institution" to ensure its securities staff are "fit and proper" (revised clause 118(8) of the SFB). This requirement will become a statutory condition for the registration of "registered institutions", a breach of which constitutes misconduct for the purpose of the disciplinary regime. In addition, amendment will be made to the BAB to require HKMA to maintain the public register of securities staff engaged by AIs in a manner consistent with that of the register of licensed representatives kept by SFC (revised clause 4 of the BAB)."

Disciplinary power

76. Part IX of the SFB consolidates, revises and expands the existing disciplinary framework to enable SFC to take disciplinary actions against licensed persons and exempt AIs for misconduct(6) or for conduct that reflects on their fitness and properness. Disciplinary sanctions available under the existing legislation are private or public reprimand, suspension and revocation of licence. Members note that clause 187 has introduced the following three new types of intermediate disciplinary sanctions:

(a) partial suspension or revocation of licence which aims at providing SFC with the flexibility to tailor the scope of suspension and revocation to affect only a certain part of the business activities of a licensed corporation;

(b) disciplinary fines under which SFC can impose fines on an intermediary which has profited from its improper conduct the amount not exceeding the greater of $10 million or three times the profit secured or increased or loss avoided as a result of the relevant misconduct; and

(c) prohibition order where SFC is empowered to prohibit a licensed corporation or a licensed representative from applying to be licensed, and a person from applying to be approved as a responsible officer of a licensed corporation for a specified period.

77. According to the Administration, the BO and the BAB supplement the disciplinary framework for exempt AIs. Clause 5 of the BAB empowers HKMA as the frontline regulator to reprimand an exempt AI for its misconduct. The HKMA may also withdraw the consent to the appointment of an executive officer of an exempt AI if it is no longer satisfied that he/she is a fit and proper[17] person, or has sufficient authority within the AI to be an executive officer under clause 9 of the BAB. Furthermore, HKMA, can remove the name of an employee of the AI from the public register if he/she is considered not fit and proper or not in compliance with the requirements imposed on him/her under the Codes of Conduct made by SFC under relevant provisions of the SFB.

Disciplinary sanctions and appeal mechanism for licensed persons and exempt persons

[17] Misconduct as defined in clause 186 of the SFB means: a contravention of any of the relevant provisions (defined in section 1 of Schedule 1), or any of the terms and conditions of a licence or an exemption which, in the opinion of SFC, is or is likely to be prejudicial to the interest of the investing public or to the public interest. For the BAB, "misconduct" is similarly defined under clause 5.

78. Some deputations are concerned about the differences in the disciplinary sanctions and appeal mechanism for persons regulated by SFC and exempt AIs and their securities staff. They note that while SFC's licensees are subject to all types of disciplinary sanctions prescribed under the SFB, the only sanction applicable to exempt AIs under the Bill is the revocation of exempt status. The three new types of disciplinary sanctions i.e. partial suspension or revocation of licence, disciplinary fines and prohibition order do not apply to exempt AIs. There is concern as to how consistency in the quality of services provided by SFC licensees and exempt AIs for the purposes of providing a level playing field and enhancing investor protection can be ensured. As regards appeals against decisions of SFC, some members are concerned that exempt AIs and SFC licensees are subject to two different appeal mechanisms. While the SFB provides for decisions made by SFC in respect of licensees to be appealable to SFAT; under the BAB, an aggrieved AI could only appeal to CE in Council the operation of which is less transparent than that of SFAT.

79. To address the above concerns, the Administration proposes a revision of the disciplinary sanctions applicable to exempt AIs. Under these revised proposals, exempt AIs and their securities staff will be subject to the same range of sanctions as SFC licensees, namely revocation, suspension, prohibition orders, public and private reprimands and fines. The specific provisions are set out as follows:

(a) For individual front-line representatives of exempt AIs who have committed an act of misconduct or are considered not fit and proper, HKMA will be empowered to take their names off the register, after consultation with SFC. This includes removal from the register for a specified period of time and effectively amounts to revocation and suspension of the representatives from conducting regulated activities on behalf of the exempt AI (revised clause 5 of the BAB);

(b) The SFC will be empowered, after consultation with HKMA, to suspend or revoke the exemption of an exempt AI on grounds of misconduct or fit and proper considerations (new clause 189A of the SFB); and as the authority for granting consent to executive officers, HKMA will be empowered, after consultation with SFC to suspend or withdraw the consent granted to the appointment of executive officers of exempt AIs (revised clause 9 of the BAB);

(c) The sanction of reprimand will be extended to individual staff of exempt AIs, including the executive officers, senior staff involved in the management of the regulated activities, and front-line staff engaged in such activities. This power will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB);

(d) Prohibition orders will be introduced as an additional sanction for exempt AIs and their securities staff, which means that AIs may be prohibited from applying for exempt status while individuals may be prohibited from engaging in the regulated activities. This power will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB); and (e) Exempt AIs and their staff involved in the regulated activities will be subject to a pecuniary fine as a possible sanction under the SFB. The power to order a payment of fine will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB).

80. In the light of the revised sanctions, the Administration also proposes to standardize the appeal channels by routing all appeals against decisions in respect of the regulated activities of exempt AIs and their relevant staff to SFAT. Appealable decisions made by SFC and HKMA in respect of AIs will be included in Schedule 7 to

the SFB. The SFAT, being the single appellate body, will ensure consistency in the nature and degree of disciplinary sanctions applied by the regulators in similar circumstances.

81. Members generally welcome the Administration's proposal to revise the disciplinary sanctions applicable to exempt AIs and to standardize the appeal channels for exempt AIs and SFC licensees. They believe that this will partly address the concern of market intermediaries about the need to maintain a level playing field in the securities and futures market."