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Report of the Panel on Financial Affairs for submission to the Legislative Council

Purpose

This report gives an account of the work of the Panel on Financial Affairs from October 2009 to June 2010. It will be tabled at the meeting of the Legislative Council (LegCo) on 7 July 2010 in accordance with Rule 77(14) of the Rules of Procedure of LegCo.

The Panel

2. The Panel was formed by a resolution passed by the Council on 8 July 1998 and as amended on 20 December 2000, 9 October 2002, 11 July 2007 and 2 July 2008 for the purpose of monitoring and examining government policies and issues of public concern relating to financial and finance matters. The terms of reference of the Panel are set out in **Appendix I**.

3. For the 2009-2010 session, the Panel comprised 20 members¹, with Hon CHAN Kam-lam and Hon Ronny TONG elected as Chairman and Deputy Chairman respectively. The membership list of the Panel is in **Appendix II**.

Major work

4. During the 2009-2010 session, the Panel continued to provide a forum for LegCo Members to exchange views with the Financial Secretary (FS) on matters relating to Hong Kong's macro-economic situation. The Panel also received briefings by the Chief Executive of the Hong Kong Monetary Authority on the work of the Hong Kong Monetary Authority (HKMA). As the outbreak of the global financial crisis in the latter half of 2008 had given rise to concerns about the inadequacies of the existing regulatory systems for the financial markets, in particular

¹ During the period from 21 December 2009 to 27 January 2010, the Panel comprised 21 members.

that for structured financial products, issues relating to regulatory reforms to enhance investor protection received special attention during this session.

Macro economy

5. The Panel is keenly concerned about the challenges facing Hong Kong arising from the debt crisis enveloping some European countries such as Greece and Hungary. Although exports of goods in Hong Kong in the first quarter of 2010 largely returned to levels prior to the outbreak of the global financial crisis and export of services grew in the first quarter of 2010 by 17.9% year-on-year in real terms, the export outlook for Hong Kong may turn more uncertain in the latter part of 2010 given the need for indebted European countries to implement austerity measures on the already fragile nature of the global recovery.

Inflationary pressure and risk of asset-price bubbles

6. The real gross domestic product in Hong Kong resumed a positive year-on-year growth of 2.5% in the fourth quarter of 2009 and grew further by 8.2% in the first quarter of 2010. Private consumption expenditure grew further in the first quarter of 2010 by 6.5% year-on-year in real terms, up from the 4.8% growth in the further quarter of last year. Netting out the effect of the Administration's one-off relief measures, the year-on-year rate of change in underlying Composite Consumer Price Index (CCPI) was 0.8% in the first quarter of 2010 and went up further to 1.3% in April 2010. Panel members expressed concern that inflationary pressure might creep up further as economic recovery proceeded. They were also concerned that the appreciation of the Renminbi (RMB) and upsurge in the prices of foodstuffs and raw materials would increase the financial burden on small and medium-sized enterprises and low-income households. FS advised that recognizing the financial burden on the general public, in particular low-income households, caused by the emerging inflationary pressure and other economic factors, he had delivered a \$20 billion relief package in the 2010-2011 Budget. The Special Loan Guarantee Scheme was also introduced in December 2008 as a time-limited initiative to tackle the credit crunch problem arising from the global financial crisis. A considerable number of enterprises had been granted loans under the Scheme to tide over their liquidity problem, and this had indirectly help secure the jobs of those employed by the enterprises.

7. The Panel noted that as the inflow of funds had increased by \$640 billion since the fourth quarter of 2008, the formation of asset-price bubbles remained a major risk in Hong Kong. Overall domestic flat prices had surpassed the peak in 2008 by around 15%. Members expressed concern about the difficulty faced by the public in buying homes, especially small and medium sized flats. FS advised that the Administration had proposed various measures in the 2010-2011 Budget to ensure a healthy and stable development of the property market by increasing the flat supply through fine-tuning the land supply arrangements, discouraging property speculation, improving transparency in property transactions and transaction prices, and preventing

excessive expansion in mortgage lending. Further measures were rolled out along the same directions in April 2010. According to the latest data from HKMA, the number of residential mortgage applications fell by 7.7% in April. The Administration would continue to closely monitor the situation and introduce further measures when necessary.

Low-income households

8. Members noted that the number of households with monthly household income below \$4,000 had increased from 92 300 in 1997 to 190 600 in 2010, and the proportion of households with monthly household income below \$8,000 accounted for some 21% of the total number of domestic households. Members expressed concern about the widening disparity between the rich and the poor and the lack of long-term commitment of the Government to address the problems of poverty and social immobility. FS explained that the increase in low-income households was mainly attributable to a rise in economically inactive households and elderly households. The Administration had been adopting a pragmatic approach through the social safety net to help alleviate the difficulties of these households, and had fostered employment and training services to support job seekers.

Investor protection

Action plan on investor protection measures

9. The Panel continued to monitor issues of public concern relating to investor protection under the existing regulatory regime for investment products. On 2 November 2009, the Administration briefed the Panel on the progress of the Action Plan for taking forward in phases the various recommendations in the reports of HKMA and the Securities and Futures Commission (SFC) on the Lehman Brothers Minibonds Incident submitted to the Financial Secretary on 31 December 2008.

10. The Panel noted that a number of improvement measures had been implemented by Registered Institutions² (RIs) under the initial phase of the Action Plan to enhance the sales process of investment products and the business conduct of intermediaries. In this regard, HKMA had issued circulars to RIs to require them to attach “health warnings” to retail derivatives products, to audio-record the sale process of investment products, and to have clear segregation between the general banking business and securities-related activities etc. SFC had launched public consultation on proposals to enhance the regulation of intermediaries selling investment products to the public. The proposals include the requirement of product key facts statements, introduction of cooling-off periods, disclosure of commercial interest involved in the sales process (including commissions and fees), etc. The consultation conclusions were published on 28 May 2010.

² Registered Institutions (RIs) refer to authorised institutions which are registered under the Securities and Futures Ordinance (SFO) to conduct securities intermediary activities. Under the SFO and the Banking Ordinance, HKMA is the front-line supervisor of registered institutions.

11. Panel members pointed out that a fundamental issue revealed in the Lehman Brothers-related Minibonds Incident was that the protection of ordinary retail investors under the current disclosure-based regulatory regime was inadequate. In this regard, members suggested that reference should be made to the practice of advanced economies of prohibiting the offering of investment products with returns disproportionate to the high risk involved to ordinary retail investors. Members also raised concerns about the lack of market transparency of unlisted investment products, and urged the Administration to put in place suitable measures. As regards the present arrangement of having two regulators, namely HKMA and SFC, to regulate the financial services industry, members considered that this arrangement had given rise to coordination and other problems, and requested the Administration to review this aspect of the regulatory regime. Noting that the majority of the complaints relating to the Lehman Brothers Minibonds had been resolved through the settlement arrangement offered by distributing banks, members urged HKMA and SFC to deploy more resources to deal with the complaints relating to the sale of other Lehman-related investment products, in particular, equity-linked notes. Members also urged the regulators to enhance the efficiency and transparency in their investigation work.

Authorization of offering documentation in relation to structured products

12. At present, there are two separate regimes under which SFC authorizes the documents of financial products sold to the Hong Kong public, i.e. the prospectus regime under the Companies Ordinance (Cap. 32) (CO) and the offers of investment regime under the Securities and Futures Ordinance (Cap. 571) (SFO). Whether the public offer of a financial product is regulated under the CO prospectus regime or the SFO regime is determined by the legal form of the product although such structured products may have similar economic risk and return profiles. On 3 May 2010, the Administration briefed the Panel on the legislative proposals for transferring the regulation of public offers of structured products from the CO prospectus regime to the offers of investment regime in the SFO, so that all structured products (regardless of their legal form) will be regulated under the SFO offers of investment regime. SFC would issue a new Code on Unlisted Structured Investment Products to set out the criteria that the SFC would normally consider before exercising its power to authorize the issue of offer documents or advertisements for unlisted structured products commonly seen in the retail market at present.

13. Panel members were concerned how the proposed transfer of the authorization regime from CO to SFO would enhance the protection for investors. They also noted that while the safe harbours (i.e. exemptions from the requirement of SFC authorization of offering documents) under the CO would no longer apply to structured products after the transfer, there were exemptions provided under SFO. They were keen to know the circumstances where such exemptions would apply. The Administration advised that following the proposed transfer, all structured products marketed publicly, including those which were currently not classified as

“securities”, would be subject to the existing regulatory requirements on “securities” as stipulated in the SFO. Public offer of structured products would be regulated by one regulatory regime, i.e. the SFO regime, which allowed more flexibility for the SFC to issue codes and guidelines to set out its regulatory policy on structured products. Under the transfer proposals, Part IV of the SFO would have its own set of exemptions which mainly applied to structured products offered to professional investors and traditional banking products offered by authorized financial institutions such as currency linked instruments and interest rate linked instruments.

Disclosure of price sensitive information by listed corporations

14. The Administration commenced a three-month public consultation in March 2010 on the proposed statutory codification of certain requirements to disclose price sensitive information (PSI) by listed corporations, and briefed the Panel on the proposal on 3 May 2010. The Panel noted that under the proposal, a listed corporation would have the statutory obligation to disclose to the public as soon as practicable any “inside information” that had come to the knowledge of the listed corporation. Directors and officers would be obliged to take all reasonable measures from time to time to ensure that proper safeguards existed to prevent the corporation from breaching the statutory disclosure requirements. To cater for legitimate circumstances where non-disclosure or delay in disclosure would be permitted, the Administration proposed safe harbours for specified circumstances. SFC would be the enforcement authority and the Market Misconduct Tribunal might impose civil sanctions such as regulatory fines on the listed corporation and/or its directors and/or officers breaching the disclosure requirements.

15. While members were in support of the proposal, they urged the Administration to exercise extra care in drawing up the definition of PSI and the safe harbours in the legislation with reference to the relevant statutes of comparable jurisdictions. Panel members were concerned that the proposed maximum regulatory fine of \$8 million might be too low to have an effective deterrent effect. As the proposed legislation did not cover professional advisers to listed corporations such as lawyers and accountants, but these persons might leak or take advantage in certain ways of the PSI obtained in the course of providing services to listed corporations, members requested the Administration to examine whether the proposed legislation should be extended to cover these persons. There was also a view that apart from codifying the PSI disclosure requirements, the Administration should also seek to give statutory backing to the Listing Rules on publication of annual and periodic reports to bolster investor confidence in Hong Kong's securities market.

Investor Education Council and Financial Dispute Resolution Centre

16. The Administration commenced a three-month public consultation in February 2010 on the proposed establishment of an Investor Education Council (IEC) and a Financial Dispute Resolution Centre (FDRC), and briefed the Panel on the proposals on 1 March 2010. The Panel noted that the proposed IEC would be a

company wholly owned and fully funded by SFC, and would implement its strategy primarily through regular, mass media campaigns, building sustainable and tailored outreach programmes for different sectors of the community, and a dedicated website with comprehensive and impartial investor education information. The proposed FDRC would administer a financial dispute resolution scheme by way of primarily mediation and, failing which and if the claimant so wished, arbitration. Financial institutions (i.e. banks, brokers, fund houses, etc.) regulated or licensed by HKMA or SFC would be required to join the scheme as members. FDRC might require scheme members to enter into mediation and arbitration at times of a monetary dispute if the claimant so wished, and the dispute could not be resolved directly between the parties. An arbitration award was final and binding on both parties. If the proposals received public support, the Administration would introduce legislative amendments to pave way for the establishment of the IEC and FDRC.

17. Some members were concerned that with the establishment of the proposed IEC, banks and other intermediaries might shirk their responsibility for providing proper investment advice to their customers. There was a view that unless the IEC provided specific advice on individual financial products rather than generic advice, its establishment would not be of much help to investors, since the nature of risk of individual financial products and the way they were structured could vary a lot.

18. As for the proposed FDRC, some members expressed whether the proposed FDRC could address a major inadequacy of the existing regulatory regime, i.e. the absence of an appropriate authority to order compensation payable by financial institutions to the investors concerned. In this regard, some members enquired whether the Administration would consider setting up a financial services ombudsman with the authority to impose penalties and order compensation. The Administration explained that the proposed FDRC would be similar in nature as a financial ombudsman scheme in other countries. In essence, a financial ombudsman scheme obligated financial institutions to mediation and, failing which, adjudication. The powers of these overseas ombudsmen were no different from those of the proposed FDRC, in that they only had the power to collect information but did not have the power to conduct investigation. There were also views that the proposed maximum claimable amount of HK\$500,000 was too low, there should be proper mechanisms to prevent abuse of the dispute resolution scheme, and the fee structure should not be too lopsided in favour of claimants.

Listing by introduction

19. The shares of Asian Citrus Holdings Limited, which was previously listed in London's Alternative Investment Market and PLUS was listed on the Stock Exchange of Hong Kong by way of introduction on 26 November 2009. There was wide public concern on the unusual price volatility of the shares on the first day of listing, and the Panel held a special meeting on 21 December 2009 to discuss issues relating to the incident. The Panel noted that after the incident, Hong Kong Exchanges and Clearing Limited (HKEx) had reviewed the trading of the shares on the incident day

and had passed the information to SFC for appropriate action. SFC was following up the incident by making enquiries and collecting information about the incident. After the incident, SFC had discussed with HKEx measures to enhance the current arrangements of information disclosure, and HKEx made an announcement on 4 December 2009 about a new information disclosure arrangement to be applied to listing by introduction.

20. Panel members expressed concern whether adequate information had been made available to investors, as it was observed that on the first day of listing of Asian Citrus, HKEx only followed its normal practice of extracting the net tangible asset value (NTAV) per share set out in the list document as at 30 June 2009 for display on the Teletext trading screen, and did not annotate in the Teletext that the NTAV dated 30 June 2009 was the value before the "10 for 1" stock split on 2 November 2009. HKEx explained that it was not its practice to interpret or alter the data in the listing document without receiving such a request from the sponsor of the company concerned. The stock split information was posted on the HKExNews website on 23 November 2009. The Panel urged both HKEx and SFC to investigate the incident and handle the matter seriously in order to protect investors' interests and maintain the reputation of Hong Kong as an international financial centre.

Dissemination of Hang Seng family of indexes

21. In view of market concern about the temporary suspension of dissemination of Hang Seng family of indexes for about 30 minutes on 22 January 2010, the Panel invited the Administration, SFC, HKEx and the Hang Seng Indexes Company Limited (HSIL) to brief the Panel on the investigation and remedial actions taken after the incident at the meeting on 1 March 2010. Panel members raised questions about the root cause of the incident, remedial measures to rectify the systems, and measures to prevent occurrence of similar incidents.

22. The Panel noted the explanation given by HSIL that the incident on 22 January 2010 was caused by a rare incoming message sequence which the system application, using a parallel handling process, had not previously encountered or foreseen. After matching with the HKEx's transaction data, HSIL found that the "out-of-sequence" event occurred on 22 January 2010 was not caused by erroneous data being fed into the system, intrusion by hackers or other malicious human acts. After the incident, HSIL had undertaken a comprehensive review of the system and had taken immediate remedial actions to improve the system to prevent recurrences of the incident. A working group had been set up within HSIL to regularly review and improve the installations and procedures so as to ensure the reliability and accuracy of the system. At a member's suggestion, HSIL indicated that it would consider further improving the RTI system so that it could continue to function despite the occurrence of an "out-of-sequence" event, and keep on updating the price table of the Hang Seng family of indexes at 15-second intervals.

Monetary affairs

Banking stability

23. The Panel noted that as a result of the global financial crisis, governments in the US and Europe had introduced a number of reform measures to tighten the control of the banking sector. Members asked about the possible impact of such enhanced regulatory measures on the local banking sector, especially the medium and smaller sized banks. HKMA advised that the financial and banking sectors of Hong Kong had remained sound and robust in face of the challenges of the global financial crisis, with the capital adequacy ratio of banks maintained at a high level of above 16%. HKMA had participated in the international deliberation of the reform measures and formulation of some of these measures. According to HKMA's work report in May 2010, it had revised its guidance on liquidity risk management standards to implement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision. Moreover, following consultation with the industry associations, HKMA issued the "Guideline on a Sound Remuneration System" in March 2010 to provide AIs with guidance for the development and operation of their remuneration systems in a manner consistent with effective risk management.

24. As formation of asset-price bubbles remained a major risk under the current accommodative monetary environment, members were concerned about the measures to guard against imprudent lending in the banking sector. The Panel noted that on 23 October 2009, HKMA issued guidelines to Authorized Institutions (AIs) on lowering the loan-to-value (LTV) ratio of luxury properties to 60%, and reminded AIs to be prudent in valuation of properties, including small and medium sized properties, and in assessing the borrowers' repayment ability and not to exceed the specified LTV ratios in granting mortgage loans.

25. Being concerned about the impact of the scheduled lifting of the full deposit guarantee by the end of 2010 on the stability of the banking system, Panel members urged HKMA to take appropriate measures to ensure the stability of AIs, taking into account the risks which might arise from liquidity problems of some European countries. HKMA advised that the relevant authorities in Hong Kong, Singapore and Malaysia would co-ordinate over the exit arrangements for the full deposit guarantee, as they introduced similar arrangements and would withdraw the guarantee in their respective jurisdictions on the same date. Co-ordination among the three parties would ensure that there would not be a large outflow of capital from one place to another. Meanwhile, the Hong Kong Deposit Protection Board (HKDPB) had proposed to implement enhancements to the Deposit Protection Scheme (DPS) when the full deposit guarantee expired. HKMA also regularly performed supervisory stress tests on selected AIs aimed at assessing their resilience to potential risks and vulnerabilities.

The Exchange Fund

26. The Panel continued to monitor the investment and management of the Exchange Fund, and noted that the investment income of the Exchange Fund for 2009 (excluding valuation changes in the Strategic Portfolio) amounted to \$106.7 billion. Most of the asset classes of the Exchange Fund recorded investment gains in the year. The Accumulated Surplus increased by \$72.8 billion in 2009, and the investment income of the Exchange Fund for the first quarter of 2010 amounted to HK\$10.8 billion. The fixed rate for calculating the payment to the fiscal reserves for 2009 was 6.8%, and based on this fixed rate, the Exchange Fund paid \$33.5 billion to the fiscal reserves for 2009.

27. Noting that the ExF contained a substantial allocation to US dollar-denominated assets, members expressed concern whether HKMA would adjust the investment strategy for ExF to enhance its investment return. HKMA advised that the primary investment objectives of the Exchange Fund were to ensure capital preservation and adequate liquidity to provide backing for the Hong Kong dollar. Subject to the fulfilment of these objectives, HKMA also aimed to preserve the long-term purchasing power of the Fund. To this end, HKMA managed the Fund prudently and pursues, in a cautious manner, opportunities for diversification of investments for better risk management and yield enhancement purposes. In its work report to the Panel in May 2010, HKMA advised that it had been exploring the feasibility of diversifying into other asset classes, including private equity, emerging-market bonds and equities, and investments in Mainland China. It had started investing a small portion of the Fund's assets in yield enhancement assets and would proceed cautiously and incrementally.

Enhancements to the Deposit Protection Scheme

28. On 1 February 2010, HKDPB briefed the Panel on the outcome of the two-phase review of the DPS and the legislative proposals to take forward the proposed enhancements to the Scheme. The Panel noted that in both phases of public consultation, there was broad support from the public and the industry for the recommendations of HKDPB, which covered the protection limit, compensation calculation basis, product coverage, types of institutions covered, funding arrangements, procedures for determining compensation for depositors, and disclosure requirements on scheme members.

29. As the temporary full deposit guarantee would expire at the end of 2010, members urged the Administration to ensure timely implementation of the proposed enhancements to DPS. The Panel generally supported the various enhancement proposals, particularly those on raising the protection limit from \$100,000 to \$500,000, extending the coverage of the Scheme to include secured deposits, and strengthening the representation requirements on Scheme members to notify their customers of their protected and non-protected deposits. Some Panel members raised concerns about the management of the DPS Fund and urged HKDPB to explore ways to enhance its

investment returns. The relevant amendment Bill was introduced into LegCo in April 2010.

The roles and operation of the Hong Kong Mortgage Corporation Limited

30. The Panel discussed the roles and operation of the Hong Kong Mortgage Corporation Limited (HKMC) on 2 November 2009. Noting that the core objectives of HKMC were to enhance banking stability through providing liquidity to banks, promote home ownership in Hong Kong and facilitate the development of the debt markets, some members queried whether HKMC's engagement in investments in mortgage loan business outside Hong Kong, such as Malaysia, Korea and Shenzhen, had gone beyond its core missions. HKMC explained that its overseas activities, which were often undertaken in collaboration with the relevant central banks, were intended to strengthen HKMC's financial position and hence its ability in achieving its core missions in Hong Kong. HKMC's business diversification beyond Hong Kong had been pursued following a strategic business development review conducted in 2006 by a management consultant, the recommendations of which had been endorsed by HKMC's Board of Directors. In 2006, FS had authorized under section 3(2) of the Exchange Fund Ordinance (Cap. 66) that capital injection to HKMC could be used for investment purposes.

31. Noting that HKMC was initially set up with reference to the business model of Fannie Mae and Freddie Mac (Fannie/Freddie), some members were concerned whether the business operation of HKMC would be at risk like that of Fannie/Freddie during the sub-prime crisis. HKMC advised that while reference had been made to the business model of Fannie/Freddie back in 1997 when the Corporation was established, HKMC had adopted a much more prudent risk management framework. Unlike the "originate-and-sell" model adopted by Fannie/Freddie for profit maximization, HKMC had adopted a passive approach in making purchases from banks.

32. On members' concern whether HKMC's Mortgage Insurance Programme (MIP) was in line with the principle of "Small Government, Big Market", and had any crowding out effect in the mortgage insurance market, HKMC explained that its business activities would not lead to market monopoly. Interested enterprises which could meet the relevant regulatory requirements were free to enter the mortgage insurance market. HKMC's role was to act as a provider of mortgage insurance in order to promote wider home ownership in Hong Kong, and at the same time its stringent underwriting practice served as a model for prudent risk management in mortgage insurance business.

Market development

Islamic finance

33. On 3 May 2010, the Administration briefed the Panel on the proposed framework and schedule of the legislative exercise to amend the Inland Revenue Ordinance (Cap. 112) (IRO) and Stamp Duty Ordinance (Cap. 117) (SDO) to level the playing field for common types of Islamic bonds vis-à-vis conventional bonds in terms of tax liabilities. While members were supportive of the legislative proposal, they were concerned what other measures the Administration would take to facilitate the development of Islamic finance in Hong Kong. They considered that the Administration should expedite the efforts to develop a market for diversified Islamic financial products in Hong Kong.

34. According to the Administration and HKMA, the provision of a level playing field for the Islamic financial industry vis-à-vis the conventional financial industry, through the amendment of the relevant tax legislation, was a pre-requisite for development of the Islamic financial market in Hong Kong. Apart from the legislative exercise, measures had been and would be taken in collaboration with the financial sectors concerned to enhance training of professionals on Islamic financial services, develop diverse Islamic financial products, and promote Hong Kong's Islamic financial market. In particular, Hong Kong had joined the Islamic Financial Services Board as an associate member. Given the small Islamic population in Hong Kong, the Government would concentrate on the development of a wholesale capital Islamic financial market, rather than retail Islamic financial services, in order to provide a platform for investors from the Middle East to invest in the financial markets of Hong Kong, the Mainland and neighbouring areas. The Administration was taking a pragmatic approach in developing Islamic finance in Hong Kong and would assess the effectiveness of the strategy adopted at an appropriate juncture.

Review of the Trustee Ordinance and related matters

35. The Administration conducted a public consultation between June and September 2009 on the reform proposals made in the review of the Trustee Ordinance (Cap. 29), and briefed the Panel on 1 March 2010 on the consultation conclusions and the way forward. On members' concern how the trust law reform would facilitate the development of wealth management business in Hong Kong, the Administration advised that many potential settlors did not create trusts in Hong Kong mainly because Hong Kong's trust law was outdated. The purpose of the proposed reform of Hong Kong's trust law regime was to keep it up with the trust law development in other comparable jurisdictions. Apart from the trust law reform, there were other initiatives to support the development of wealth management in Hong Kong such as the abolition of the estate duty.

36. Noting that most respondents to the consultation were professional trustees, some members were concerned that the Administration had not given adequate

attention to protecting the interests of trust beneficiaries. Panel members were particularly concerned that the Administration decided not to legislate for the beneficiaries' rights to information for the time being. The Administration advised that due to the complexity of the subject matter, the Administration was not ready to decide which option to pursue, and had requested the Law Reform Commission to consider conducting a further study on the subject. The Panel urged the Administration to actively follow up the issues raised by members before introducing the relevant amendment bill into LegCo.

Development of a scripless securities market

37. On 1 February 2010, the Administration together with SFC and HKEx briefed the Panel on the proposed operational model for implementing a scripless securities market in Hong Kong. The Panel noted that with the development of a scripless securities market, Hong Kong would be keeping up with other leading markets that had already implemented dematerialization. This together with the other benefits of improved efficiency, enhanced corporate governance and better investor protection, would ensure Hong Kong's competitiveness and position as a leading market. While members were supportive of the direction of the proposal, they raised concerns about the availability of disaster recovery measures to cater for system failure, and the level of fees and charges on investors under the new operational model. Members also stressed the need to conduct extensive consultation with the financial services sector.

38. The Panel noted that to indicate its support for a scripless market, the Administration had included relevant legislative amendments into the Companies (Amendment) Bill 2010 which was introduced into LegCo in February 2010, and that specific legislative amendments, mainly to the Securities and Futures Ordinance (Cap. 571), to set out the framework for regulating the scripless environment would be introduced at a later stage.

Proposed new anti-money laundering legislation for financial institutions

39. In July 2009, the Administration launched a three-month public consultation on the conceptual framework of the proposed new anti-money laundering legislation (AML) for financial institutions. Taking into account the comments received in the consultation, the Administration drew up a set of detailed legislative proposals for further public consultation from December 2009 to February 2010, and briefed the Panel on the proposals on 14 December 2009.

40. Panel members expressed support for the legislative proposals in principle. Noting that under the current regime where a number of banks had refused to provide account services to remittance agents and money changers (RAMCs), members considered that the proposed licensing system for RAMCs would help improve the operational environment of RAMCs by alleviating the concerns of the banking sector about possible money-laundering activities involved in the remittance and money

changing business of RAMCs. Some members commended the Administration for taking on board the views of the financial sectors by raising the threshold for customer due diligence requirements for money changing transactions from \$8,000 to \$120,000 and introducing a single category of personal criminal liability with a clearly-defined mental threshold.

41. The Panel held a meeting on 24 May 2010 to receive views of deputations from the financial services sectors and other interested parties. The financial services sectors were generally supportive of the proposals, while some of them expressed concerns about the implementation arrangements especially those relating to the customer due diligence requirements. The Administration assured members that it would duly consider the concerns raised by the deputations in drawing up the new AML legislation, and undertook to actively engage the financial services sectors in drawing up relevant guidelines to facilitate their compliance.

Taxation

42. On 14 December 2009, the Panel received views of deputations from business and professional organizations on the depreciation allowances in respect of machinery or plants under "import processing" arrangements. The Panel noted the deputations' views that the denial of depreciation allowances under section 39E of the Inland Revenue Ordinance (Cap. 112) (IRO) in respect of machinery or plants used by Hong Kong manufacturers outside Hong Kong was unfair to genuine businesses and in contradiction to the principle of providing tax relief for costs incurred in generating taxable revenue. These deputations pointed out that the operations of manufacturers under the contract processing arrangement and import processing arrangement were the same in substance, and the change was merely made in response to policy requirements of the Mainland authorities.

43. Taking note of the deputations' views, members considered that the Administration should suspend actions on such tax assessments and conduct a review of the interpretation and application of section 39E of IRO. A motion was passed at the Panel meeting urging the Government to cease invoking section 39E of the IRO incorrectly for recovery of taxes from Hong Kong enterprises with no tax avoidance intention or acts, and to review and amend section 39E according to actual circumstances.

44. The Panel noted the Administration's written response that if the restriction under section 39E was relaxed, the completeness of the anti-avoidance provisions in the IRO would be affected. There were also practical difficulties in the implementation and the provision could easily be abused, resulting in substantial tax loss. While the Administration had no plan to amend section 39E at the present stage, it had invited the Joint Liaison Committee to study the issues involved. After completion of the study, the Administration would be pleased to consider any practical and feasible recommendations made by the committee.

Companies

Companies Ordinance rewrite

45. The Panel continued to monitor the progress of the exercise to rewrite the Companies Ordinance (Cap. 32) (CO). Taking into account the views received in the three topical public consultation exercises conducted in 2007 and 2008 on the more complex subjects, the Administration proceeded to draw up draft clauses of the Companies Bill for further consultation in two phases. The first phase consultation on 10 parts of the draft Companies Bill, focusing on issues relating to corporate governance, was launched in December 2009, and the second phase consultation on the remaining 10 parts of the draft Companies Bill, focusing on technical and operational issues was launched in May 2010. The Administration briefed the Panel on the progress of the rewrite exercise on 4 January and 7 June 2010.

46. As the Administration aimed to introduce the Companies Bill into the LegCo by the end of 2010, some members were concerned that there might not be sufficient time for LegCo to complete scrutiny of the Bill before the end of the current legislative term in July 2012. Members also expressed concerns and gave views on various issues, including -

- (a) whether the headcount test for approving a members' scheme of arrangement or compromise for listed companies, non-listed companies and creditors' schemes should be abolished, retained, or retained but allowed the court to have discretion to dispense with the test;
- (b) whether the disclosure of residential addresses of directors and identification numbers of directors and company secretaries on the public register should continue;
- (c) whether the rules on giving financial assistance by a company for the purpose of acquiring its own shares should be further streamlined; and
- (d) whether the Companies Bill should provide for the preparation of a directors' remuneration report in addition to the annual accounts.

Review of corporate rescue procedure legislative proposals

47. The Administration launched a three-month public consultation on 29 October 2009 on the review of corporate rescue procedure legislative proposals. On 7 December 2009, the Administration briefed members on the proposals. Given that the majority of enterprises in Hong Kong were small and medium-sized enterprises (SMEs), some members doubted the need of the corporate rescue procedure, as SMEs in financial difficulties might not have the resources to go through the procedure. The Administration explained that the legislative proposals

for the procedure aimed to provide an option to bridge the gap of the existing statutory and non-statutory arrangements for companies to survive through financial difficulty. The provisional supervision and the moratorium proposed under the corporate rescue procedure would improve the chances of survival of corporations, as more time would be allowed for the provisional supervisors to work out the voluntary arrangement proposal for approval of the creditors. Preliminary consultation with the business sector indicated that the corporate rescue procedure could help corporations to tide over difficulties during financial crisis.

48. Some members expressed concern about the protection for employees' interests during the proposed corporate rescue procedure. The Administration assured members that employees' interests would be protected under the proposed corporate rescue procedure by ensuring that their entitlements and rights would not be worse off than in the case of winding up. In formulating the consultation proposals, the Administration had taken into consideration views of Members and stakeholders on the difficulties of a financially troubled corporation to provide sufficient funds in a trust account for settlement of all outstanding wages and statutory entitlements of employees before commencing the corporate rescue procedure. The Administration was consulting the public on various options to settle the outstanding entitlements, including the proposal put forward in 2003 of capping the trust account amount to mirror that of the Protection of Wages on Insolvency Fund.

Work of the Financial Reporting Council

49. As in the past years, the Panel received a briefing on 8 April 2010 by the Administration and the Financial Reporting Council (FRC) on the work of FRC in the past year. Members noted that since FRC became fully operational in July 2007, it had carried out five investigations and four enquiries. One investigation case and four enquiry cases had been completed. Members were concerned that given its small establishment of 11 staff, FRC might not have the capacity to take proactive actions to follow-up possible non-compliance cases, such as those reported in the mass media. FRC advised that its staff were deployed in such a way that both its investigation work and other functions could be carried out as scheduled. Since July 2008, FRC had started a proactive approach by making reference to modified auditors' reports on financial statements of all listed entities to identify potential non-compliance with accounting requirements. If warranted, FRC would follow up by reviewing the relevant financial statements. FRC had engaged temporary staff during periods of heavy workload. If necessary, FRC would consider outsourcing its work, in which case FRC would be mindful of the need to safeguard information confidentiality.

50. On members' concern about FRC's cross-border cooperation enforcement initiatives, FRC advised that FRC had signed a Memorandum of Understanding with the Ministry of Finance of the Central People's Government to set up an investigation cooperation framework, which would enable the FRC to investigate, through the Ministry, relevant matters involving Mainland accountants and/or auditors of Hong

Kong listed entities under the proposed new arrangements of accepting Mainland accounting and audit standards and qualified audit services provided to Mainland incorporated companies listed in Hong Kong.

Other issues

51. Apart from the briefing on the relevant policy initiatives by the Secretary for Financial Services and the Treasury, the Administration and HKMA have briefed the Panel on several issues including possible budgetary measures, modality of Hong Kong's participation in the multilateralisation of the Chiang Mai Initiative, and the Framework Agreement on Hong Kong/Guangdong Co-operation related to financial services.

52. The Panel has also examined the Administration's proposal to enhance the efficiency of the existing tax appeal mechanism, and the proposed arrangements for Hong Kong's subscription to the Fifth General Capital Increase of the Asian Development Bank.

53. From October 2009 to June 2010, the Panel has held a total of 15 meetings.

Council Business Division 1
Legislative Council Secretariat
5 July 2010

Legislative Council

Panel on Financial Affairs

Terms of Reference

1. To monitor and examine Government policies and issues of public concern relating to financial and finance matters.
2. To provide a forum for the exchange and dissemination of views on the above policy matters.
3. To receive briefings and to formulate views on any major legislative or financial proposals in respect of the above policy areas prior to their formal introduction to the Council or Finance Committee.
4. To monitor and examine, to the extent it considers necessary, the above policy matters referred to it by a member of the Panel or by the House Committee.
5. To make reports to the Council or to the House Committee as required by the Rules of Procedure.

**Legislative Council
Panel on Financial Affairs**

Membership list for 2009 - 2010 session

Chairman Hon CHAN Kam-lam, SBS, JP

Deputy Chairman Hon Ronny TONG Ka-wah, SC

Members Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon James TO Kun-sun
Dr Hon Philip WONG Yu-hong, GBS
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Vincent FANG kang, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon WONG Ting-kwong, BBS, JP
Hon CHIM Pui-chung
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king, JP
Dr Hon LAM Tai-fai, BBS, JP (since 21 December 2009)
Hon Paul CHAN Mo-po, MH, JP
Hon CHAN Kin-por, JP
Hon CHAN Tanya (up to 28 January 2010)
Hon Mrs Regina IP LAU Suk-yee, GBS, JP

(Total : 20 members)

Clerk Ms Anita SIT

Legal Adviser Mr KAU Kin-wah