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30 January 2012

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Ms Anita Sit
Clerk to Bills Committee on
Securities and Futures (Amendment) Bill 2011
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Ms Sit,

**Bills Committee on Securities and Futures (Amendment) Bill 2011
Follow-up to meeting on 19 January 2012**

We refer to your letter of 20 January 2012 on the follow-up actions to the meeting held on 19 January 2012.

On item 1, the response of the Securities and Futures Commission (SFC) regarding the safe harbour proposed by Hong Kong Institute of Certified Public Accounts is at **Appendix A**.

On the other hand, the Bills Committee meeting on 19 January 2012 also discussed about the obligation of non-executive directors under the proposed regime on disclosure of price sensitive information, SFC proposed to provide additional guidance in the Draft Guidelines on officers' liability and obligations of non-executive directors at **Appendix B**.

...../Cont'd

Regarding items 2 and 3 on the proposed institution of proceedings before the Market Misconduct Tribunal by the SFC, our responses are respectively at **Appendices C and D**.

Yours sincerely,



(Miss Belinda Kwan)
for Secretary for Financial Services
and the Treasury

c.c. SFC (Attn: Mr Donald Lai)
 DoJ (Attn: Mr Boyce Yung)

Further consideration regarding the safe harbour proposed by HKICPA

1. In its submission, HKICPA “asked for an additional “safe harbour” to cover the situation where a corporation has appropriate internal control procedures in place, has taken reasonable steps to ensure a specific issue has been properly considered and the directors, having carefully considered the circumstances (taking professional advice, where appropriate), have exercised judgement, with reasonable prudence and in good faith, concluding that certain information is not PSI and does not warrant a disclosure at that time”.
2. We do not believe that the introduction of a safe harbour along these lines would be appropriate for the following reasons.
3. We have now specified in section 307B(2)(b) of the Bill “a reasonable officer” test to assess whether an item of information is inside information. This is an objective test to be applied based on the facts and circumstances at the time. The test determines whether a disclosure obligation has been triggered. Although it is not itself a ground for liability it takes account of whether a reasonable director would have properly assessed the information as being discloseable, and therefore it operates indirectly to protect officers who have behaved reasonably.
4. The very large number of disparate elements comprised in the proposed safe harbour (e.g. “acting in good faith”, “have exercised judgement”, “reasonable prudence”, “reasonable steps” or “properly considered” etc.) are overly complex and if grafted onto the carefully balanced provisions currently in the Bill would render the disclosure regime unworkable. For example, the phrase “have exercised judgement” (and indeed the whole proposal) is reminiscent of the well established “business judgement rule” in the US, which operates to assure directors that they can pursue reasonable business risk-taking without fear of personal liability in a highly litigious environment. However, the business judgement rule in the US has developed over many years through case law that is highly specific to that legal system. While it is part and parcel of the US federal law on directors’ duties, it is a concept that is alien to Hong Kong law. It would be inappropriate to import this concept only into the disclosure regime here where it has no place in any event. In addition, while both Canada and Australia have equivalents of the business judgment rule, it does not apply in the context of disclosure of price sensitive information.
5. Our policy is to enhance a continuous disclosure culture. The objective test requires a corporation to consider objectively and reasonably all relevant matters to determine whether a disclosure obligation arises. From an investor protection perspective this test strikes an appropriate balance between the need to ensure market transparency and the need to ensure that directors who have behaved reasonably are protected; the “reasonableness” standard is simple, certain, objective and properly takes account of the position of directors. This standard is widely used in Hong Kong law, is readily understandable and is the cornerstone of a coherent and internally consistent regime.
6. Moreover, triggering of the disclosure obligation does not mean that individual officers are automatically liable. An officer will only have liability under section

307G(2) **if** (a) the corporation is in breach of a disclosure requirement; **and** (b) the officer's intentional, reckless or negligent conduct resulted in the breach or the officer has not taken all reasonable measures to ensure proper safeguards exist to prevent the breach. (Please see our additional guidance on officers' liability for further explanation of these elements). Given that the mens rea and reasonableness tests apply to all officers and must be demonstrated to the MMTs satisfaction, it is wholly unnecessary to add any additional defences or safe harbours; to do so would be to ignore that the grounds of liability themselves offer adequate protection for officers who lack the necessary mens rea or behaved reasonably in ensuring the existence of proper safeguards.

7. Lastly, certainty as to the scope of legislation is essential. The proposed safe harbour is overly complex and inherently uncertain in its application. Notably, no other safe harbour of this type exists in respect of other types of directors or officers liability under the Companies Ordinance or any other Hong Kong statute as far as we are aware.

Securities and Futures Commission

January 2012

Additional guidance to be provided in the Draft Guidelines

Officers' liability

An officer would only have liability under section 307G(2)(a) **if** (a) the listed corporation is in breach of a disclosure requirement; **and** (b) the officer's intentional, reckless or negligent conduct resulted in the breach.

In the situation where an officer has actual knowledge of information which should have been disclosed the meaning of "intentional", "reckless" and "negligent" can be summarised as follows. The requirement for conduct to be intentional means that there must be evidence that the officer intended the corporation not to disclose information that was required to be disclosed under a disclosure requirement. The requirement for conduct to be reckless means that the officer was aware that there was a risk that by not disclosing the information the corporation may breach a disclosure requirement and it was in the circumstances known to him unreasonable to take the risk. The requirement for conduct to be negligent means the officer failed to exercise such care, skill or foresight as a reasonable officer in his situation would exercise to ensure or cause the corporation to comply with a disclosure requirement.

Obligations of non-executive directors

Given the unitary nature of a board and the indivisible legal duties of all directors, both executive directors and non-executive directors should exercise due care, skill and diligence to fulfil their roles and obligations. However, as acknowledged in the Code of Corporate Governance Practices issued by the Stock Exchange¹, non-executive directors normally are not involved in the daily operations of a corporation and would usually rely on a corporation's internal controls and reporting procedures to ensure that, where appropriate, material information is identified and escalated to the board as a whole. It is for this reason that the board's responsibility for establishing and monitoring key internal control procedures is of particular significance for non-executive

¹ See Listing Rule Appendix 14 - A.5.2. The functions of non-executive directors should include, but should not be limited to (a) participating in board meetings of a corporation to bring an independent judgement to bear on issues of strategy, policy, performance, accountability, resources, key appointments and standards of conduct; (b) taking the lead where potential conflicts of interest arise; (c) serving on the audit, remuneration and other governance committees, if invited; and (d) scrutinising the corporation's performance in achieving agreed corporate goals and objectives, and monitoring the reporting of performance.

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directors as this is an area where they are more likely to be directly involved. It is therefore more likely that sections 307G(1) and 307G(2)(b) will be of direct relevance to them.

Under section 307G(1) and section 307G(2)(b) officers must take all reasonable measures from time to time to ensure that proper safeguards exist to prevent a breach of a disclosure requirement. In this respect, officers, including non-executive directors, are responsible to ensure that appropriate systems and procedures are put in place and reviewed periodically to enable the corporation to comply with the disclosure requirements. Officers with an executive role would also have a duty to ensure the proper implementation and functioning of the mechanisms and that any material deficiencies are detected and resolved in a timely manner. In developing the systems and procedures, boards should take into account the particular needs and circumstances of the corporation. The following provides examples of reasonable measures which should be considered when establishing the systems and procedures. These are not hard and fast rules and should not be taken as a definitive or exhaustive list. It would depend on the specific circumstances to determine whether there was a breach of section 307G(1) or section 307G(2)(b) and the absence of some of the examples below would not be conclusive.

- (a) Establish controls for monitoring business and corporate developments and events so that any potential inside information is promptly identified and escalated.
- (b) Establish periodic financial reporting procedures so that key financial and operating data is identified and escalated in a structured and timely manner.
- (c) Maintain and regularly review a sensitivity list identifying factors or developments which are likely to give rise to the emergence of inside information.
- (d) Authorize one or more officer(s) or an internal committee to be notified of any potential inside information and to escalate any such information to the attention of the board.
- (e) Maintain an audit trail of meetings and discussions concerning the assessment of inside information.

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- (f) Restrict access to inside information to a limited number of employees on a need-to-know basis. Ensure employees who are in possession of inside information are fully conversant with their obligations to preserve confidentiality.
- (g) Ensure appropriate confidentiality agreements are in place when the corporation enters into significant negotiations.
- (h) Disseminate inside information through the electronic publication system operated by the Stock Exchange before the information is released via other channels, such as the press, wire services or posting on the corporation's website
- (i) Designate a small number of officers or executives with the appropriate skills and training to speak on behalf of the corporation when communicating with external parties such as the media, analysts or investors.
- (j) Develop procedures to review the presentation materials in advance before they are released at analysts' or media briefings.
- (k) Record briefings and discussions with analysts or the media afterwards to check whether any inside information has been inadvertently disclosed.
- (l) Develop procedures for responding to market rumours, leaks and inadvertent disclosures.
- (m) Provide regular training to the employees to help them understand the corporation's policies and procedures as well as their relevant disclosure duties and obligations.
- (n) Document the disclosure policies and procedures of the corporation in writing and keep the documentation up to date.
- (o) Publish the disclosure policies and procedures of the corporation so that the media and other stakeholders understand the corporation's statutory disclosure obligations.

Response to item 2 – regarding the proposal to empower the Securities and Futures Commission (SFC) to institute proceedings before the Market Misconduct Tribunal (MMT) direct and to appoint the Presenting Officers in MMT proceedings, the Administration is requested to provide the following information, particularly with regard to the issue of checks and balances

(a) A comparison, in tabular form or diagrams, between the existing and proposed procedures for instituting criminal and civil proceedings in respect of market misconduct cases under the Securities and Futures Ordinance (Cap 571)

When the Securities and Futures Ordinance (SFO) was introduced in 2003, the key objective of establishing the MMT was to create a speedy civil fast track for market misconduct cases. The proposed direct institution of MMT proceedings by the SFC is in line with this objective and would allow for a streamlined process to enforce the new disclosure requirement.

2. SFC's policy and established practice is to examine all options and bring criminal prosecution against market misconduct as a matter of priority if there is sufficient evidence and where criminal prosecution is in the public interest. Since the Department of Justice (DoJ) is entrusted with the control of criminal prosecutions under Article 63 of the Basic Law¹, SFC will refer all cases of suspected market misconduct to the Prosecutions Division (PD) of DoJ for consultation in the first instance. Where the SFC considers the case should be referred to the FS to consider whether proceedings should be commenced before the MMT, the SFC consults the Prosecutions Division (PD) because the institution of MMT proceedings will bar criminal prosecution for the same matters. In criminal cases, PD will take control of the conduct of prosecutions brought before the District Court and the Court of First Instance (CFI), whereas the SFC initiates and conducts prosecution of those cases before the magistrates' courts under its own name.

3. If no criminal prosecution is to be brought, the SFC may refer the case to the Financial Secretary (FS) as a potential MMT case via the civil route. Flow charts on the existing and proposed processes for instituting proceedings in dealing with market misconduct cases through the MMT regime under the SFO are at **Annex A**. In sum, under the existing practice, before a case is referred to the FS by the SFC, SFC

¹ Article 63 of the Basic Law stipulates that the DoJ of the HKSAR shall control criminal prosecutions, free from any interference.

consults the PD under the arrangements described in paragraph 2 above. On receipt of PD's confirmation, the SFC seeks its Board's approval on reporting the case to the FS for instituting MMT proceedings. After FS has received the referral from SFC, the Financial Services and the Treasury Bureau (FSTB) will, on behalf of FS, seek the advice of the Civil Division (CD)/DoJ on the case. Upon receipt of CD's advice, FSTB would formulate a recommendation to FS for approval to institute MMT proceedings.

4. As one can see from the above, the current arrangement involves more than three parties (i.e. SFC, DoJ (PD and CD), FSTB and FS Office) in examining the same case though for different purposes and from different perspectives. As all the parties will need to examine the information and materials in detail in order to formulate their own recommendations, and it is not uncommon to involve several rounds of clarifications and questions, the whole process takes time to complete. In view of our experience gained in the past years and SFC's experience in managing other civil proceedings itself, we consider that there is room to streamline the current procedure. At present, SFC is able to make direct applications to the CFI for injunction and other orders under section 213 of the SFO and handle disciplinary proceedings and review of SFC's decisions before the Securities and Futures Appeals Tribunal (SFAT) respectively under Parts IX and XI of the SFO. As with MMT proceedings, these proceedings are all civil in nature and are heard by judges² (with lay members in SFAT cases). Currently, the MMT is the only proceeding of a civil nature under the SFO which is instituted by the FS but not the SFC.

5. Without derogating from the powers of the Secretary for Justice (SJ) in criminal prosecution, the SFC already has power to invoke section 388(1) to prosecute offences under its own name before a magistrate.

6. Under the proposed procedure, after obtaining the Board's approval to institute MMT proceedings, the SFC will seek consent from the SJ under the proposed section 252A (Clause 21) for market misconduct cases. The SJ will not give his consent if (a) market misconduct offences under Part XIV are contemplated or (b) other indictable offence(s) are contemplated or instituted in respect of the same conduct and the institution of MMT proceedings would be likely to cause serious prejudice to the

² "Judge" is defined for the purpose of MMT and SFAT under sections 245(1) and 215 of the SFO as (a) a judge or deputy judge of the CFI; (b) a former Justice of Appeal of the Court of Appeal; or (c) a former judge or a former deputy judge of the CFI.

investigation or prosecution of such offence(s). On obtaining SJ's consent, the SFC can then implement its Board's decision to institute the case before MMT. No duplication of time, resources and efforts by the FS, FSTB and the CD/DoJ will be involved in the process. The proposal will significantly streamline the process and strengthen individuals' rights to a timely and fair proceeding without compromising the integrity of the system.

(b) The procedures of other local regulatory/statutory bodies for instituting legal proceedings which are comparable to MMT proceedings, including the situations where the consent of other authorities is required to institute the proceedings

7. We are not aware of any procedures of other regulatory/statutory bodies in Hong Kong that are similar to MMT proceedings. We note that regulators/bodies such as the Telecommunications Authority, the MTR Corporation Limited and Equal Opportunities Commission may determine if certain matters should be brought before a court. Details are set out at **Annex B**.

8. These bodies do not require a referral to the Government for instituting an enforcement proceeding. Nevertheless, each statutory body and ordinance is established to cater for specific purposes, and may not be directly comparable.

(c) Apart from the Hong Kong Bar Association, the views of other parties regarding the proposal

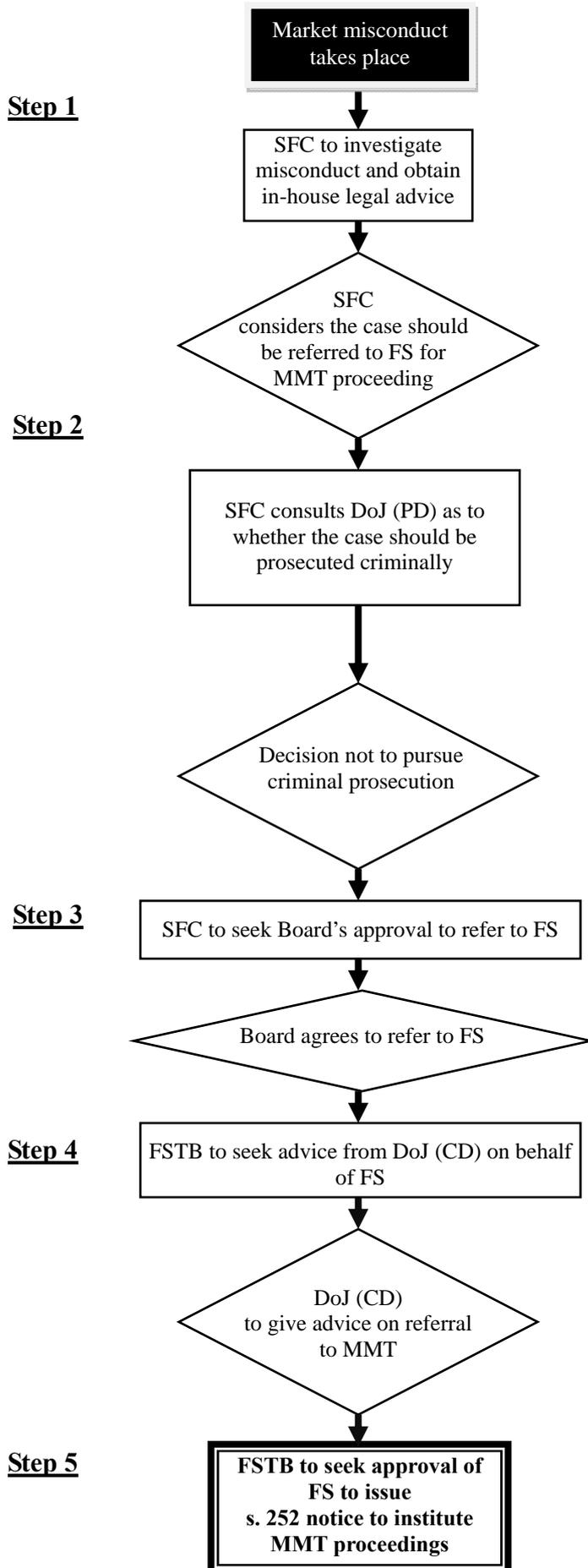
9. The Administration launched a consultation exercise between March and June 2010 on the proposed statutory codification of certain requirements to disclose price sensitive information by listed corporations. The direct access proposal was also included in the consultation paper. The relevant extract of the consultation feedback and our response which were submitted to the Legislative Council Panel on Financial Affairs at its meeting on 21 February 2011 is at **Annex C**.

(d) How the board of SFC would consider and decide whether a case should be brought before MMT

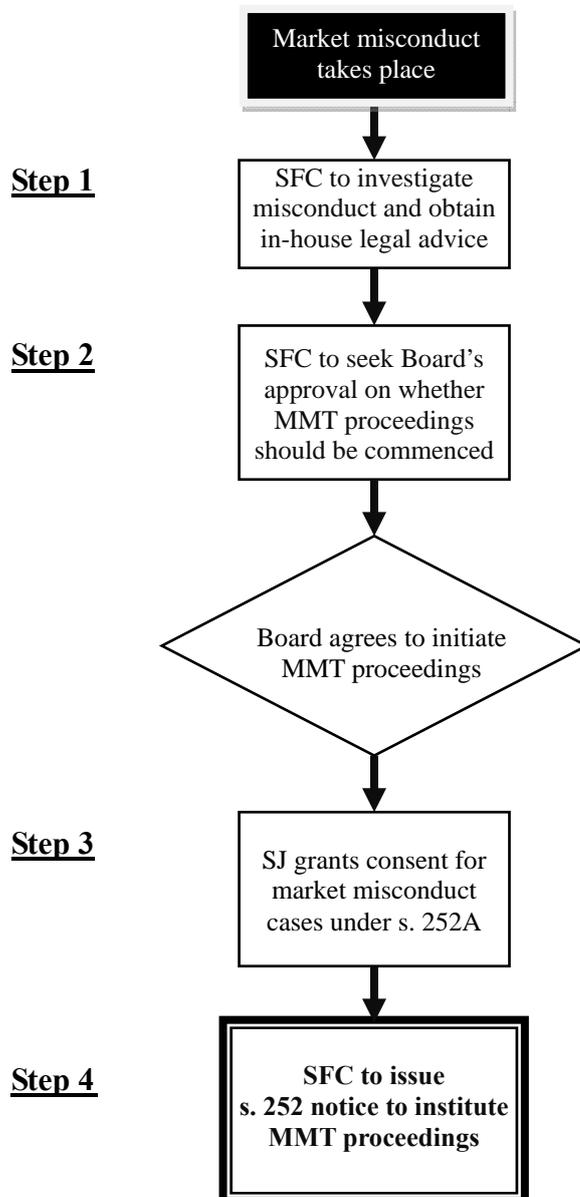
10. We note Members' comments on the checks and balances mechanism in bringing a case before the MMT. Under the proposed procedure, although SFC is no longer required to seek FS' approval before instituting MMT proceedings, there are numerous checks and balances built

into the system, including the Board of the SFC as detailed at **Annex D**.

Existing process of initiating MMT proceedings by the FS in cases where criminal proceedings are not contemplated



Proposed process of initiating MMT proceedings by the SFC in cases where criminal proceedings are not contemplated



Procedures of other regulatory/statutory bodies

Regulatory/statutory bodies	Procedures
Broadcasting Authority (BA)	Section 28 of the Broadcasting Ordinance (Cap 562) provides that the Broadcasting Authority may apply to the Court of First Instance for an imposition of a financial penalty of a sum not exceeding 10% of the turnover of the licensee in the relevant television programme service market in the period of the breach or \$2,000,000, whichever is the higher.
Equal Opportunities Commission (EOC)	<p>Section 82 of the Sex Discrimination Ordinance (Cap 480), section 78 of the Disability Discrimination Ordinance (Cap 487), section 60 of the Family Status Discrimination Ordinance (Cap 527) and section 76 of the Racial Discrimination Ordinance (Cap 602) provide that the EOC may apply to the District Court for:</p> <ul style="list-style-type: none"> • an injunction restraining a person from doing any discriminatory conduct; and • an order imposing a financial penalty on a person not exceeding \$10,000 for the first occasion and \$30,000 for the second and any subsequent occasion.
Mandatory Provident Fund Schemes Authority (MPFA)	Section 45F of the Mandatory Provident Fund Schemes Ordinance (Cap 485) provides that the MPFA may apply to the Court of First Instance for injunctive orders.
MTR Corporation (MTRC)	Section 56 of the Mass Transit Railway Ordinance (Cap 556) provides that the prosecution of criminal offences under this Ordinance may be brought in the name of MTRC.
Telecommunications Authority (TA)	Section 7A of the Broadcasting Ordinance (Cap 562) provides that the TA may apply to the court for an order to forfeit unauthorized decoders and section 36C of the Telecommunications Ordinance (Cap 106) provides that the TA may make an application to the Court of First Instance if he considers that imposing the financial penalty would not be adequate for a breach.

**Proposed Statutory Codification of Certain Requirements to Disclose
Price Sensitive Information by Listed Corporations**

**Consultation Conclusions
(Extract)**

Question 3(c): Do you agree to grant the SFC direct access to the MMT to institute proceedings on breaches of the statutory disclosure requirements?

Respondents' views

93. The majority of the respondents who did not agree with the proposal were from listed corporations, believing that this would lead to a loss of checks and balances. Some were concerned that the SFC should not be both the investigator and prosecutor. Two respondents from the legal and banking sectors sought further elaboration on the reasons for granting the SFC direct access. A few respondents raised concerns about the resource implications to the MMT as a result of direct access. At the same time, a major professional body in the legal sector agreed with the proposal. It pointed out that the SFC has direct and expert knowledge of the securities market and law, and it would suffice to rely on the SFC's judgment as to whether a case should be referred to the MMT. Involving the Financial Secretary or the Department of Justice ("DoJ") to institute proceedings before the MMT would amount to duplication of efforts with the SFC. The professional body also pointed out that the MMT itself provides the best checks and balances in the enforcement regime.

Our response

94. Indeed, the MMT proceedings have already provided for appropriate checks and balances. The MMT is an independent tribunal. All MMT cases are heard by a high court judge assisted by two members appointed by the Chief Executive¹³. The MMT

¹³ Or appointed by the Financial Secretary under delegated authority.

is able to inquire into the matter and issue orders to obtain further evidence during the proceedings pursuant to the SFO. Legal representatives are entitled to appear at the MMT on behalf of persons suspected of having engaged in market misconduct; and any person who is dissatisfied with the MMT's findings may appeal to the Court of Appeal¹⁴. It is the MMT, not the SFC, which will determine whether there has been market misconduct or whether there has been a breach of the PSI disclosure requirement.

95. At present, under the SFO, a decision to refer a case to the Financial Secretary for considering institution of proceedings before the MMT is exercised by the SFC¹⁵, and such function of the SFC cannot be delegated to any of its director or employee. With direct access, it is still the SFC (not certain director or employee) which will decide whether a case should be referred to the MMT.
96. In addition, most major financial services regulators including those in the UK, United States and Australia are empowered to institute and manage its own civil enforcement work for serious market misconduct where civil remedies exist. Streamlining the referral procedure is consistent with international practice.
97. The MMT is already handling the existing six types of market misconduct cases. The addition of PSI cases may have implications on the workload of the MMT, and we would keep in view the need for additional resources.
98. In the light of the above, we are of the view that the SFC should be granted direct access to the MMT to institute proceedings on the existing six types of market misconduct and the breaches of the statutory PSI disclosure requirement.

¹⁴ The appeal can be made on a point of law or on a question of fact.

¹⁵ As a matter of statutory requirement, non-executive directors of the SFC outnumber executive directors.

99. While breaches of the PSI disclosure obligation will only be subject to civil sanctions, the existing six types of market misconduct may be subject to criminal proceedings¹⁶. Since DoJ has been given the exclusive responsibility for the control of criminal prosecutions in Hong Kong under the Basic Law, the SFC has been referring cases of suspected market misconduct to DoJ for advice in the first instance.¹⁷ This arrangement in respect of the six types of market misconduct will remain consequent upon granting the SFC direct access to the MMT.

¹⁶ Under Part XIV of the SFO, the SFC may report its investigation findings to DoJ to consider criminal prosecution. Under Part XIII of the SFO, the FS may institute proceedings before the MMT whether or not following any report by the SFC or any notification by DoJ.

¹⁷ The SFC's policy is to examine all options and bring criminal prosecution as a matter of priority if there is sufficient evidence and where criminal prosecution is in the public interest. It is only after DoJ has ruled out a market misconduct case for criminal prosecution that the SFC will consider other enforcement options, including the MMT proceedings.

Checks and balances under the proposed direct referral regime

A. Investigation and recommendation by the Securities and Futures Commission

Investigation of market misconduct or disclosure breaches is conducted by the Enforcement Division (ENF) of the Securities and Futures Commission (SFC). On completion of investigation, the ENF instructs the Legal Services Division of the SFC to give legal advice. The SFC's lawyers (who are Hong Kong qualified barristers or solicitors) assess the evidence in detail and advise on the merits of the case. On the basis of this legal advice, the head of the ENF, namely its Executive Director (ED), decides whether to recommend to the board of the SFC to commence proceedings of the Market Misconduct Tribunal (MMT).

B. Consent by the SJ

2. Under the new section 252A, the SFC must obtain the consent of the Secretary for Justice (SJ) before it may institute MMT proceedings to ensure the primacy of criminal prosecution¹.

C. Approval by the SFC Board

3. SFC would need to submit a paper to the SFC Board for approval to institute MMT proceedings subject to the consent of the SJ under the new section 252A. Under the new section 2(81) of Part 2 of Schedule 2 (Clause 27), the decision to institute MMT proceedings by the SFC will be a non-delegable one, i.e., the decision must be made by the Board.

4. There is a significant level of independent views on the Board. As prescribed under Section 1 of Part 1 of Schedule 2, the Board comprises a chairman, a chief executive officer (CEO) and other EDs and non-executive directors (NEDs) appointed by the Chief Executive (CE) (or the Financial Secretary (FS) under authority delegated by the CE). It is also stipulated that the number of NEDs shall exceed the number of EDs. At present, the Board comprises a non-executive Chairman, seven NEDs and five EDs (including the CEO). Non-executive representation on the Board is drawn from acclaimed members in the financial services-related sector, including experienced accountants, senior

¹ SJ's consent to institute MMT proceedings is however not applicable to disclosure breaches which will not give rise to criminal liability.

barristers and solicitors, academics and a member of the Legislative Council².

D. The MMT proceedings

5. The statutory framework governing MMT proceedings provides another level of check-and-balance. MMT is an independent tribunal chaired by judges appointed by the CE on the recommendation of the Chief Justice, and members are appointed by the CE (or the FS under delegated authority), all of whom are independent from the SFC. Parties before it are entitled to legal representation. MMT is not obliged to merely rely on the materials and evidence gathered by the SFC and has full powers to inquire into a case referred to it, including powers to require a person to give evidence and produce any record/document relating to the subject matter of the proceedings, etc. (section 253), and to obtain further evidence through the SFC during the proceedings, including provision of relevant records, document and information, etc. (section 254). The MMT will determine whether there has been market misconduct after considering all the evidence and submissions from the parties. Under section 252(6), the MMT shall not identify a person as having engaged in market misconduct without first giving the person a reasonable opportunity to be heard.

6. Further, under section 266, any person who is dissatisfied with the MMT's finding or determination may appeal to the Court of Appeal.

² The non-executive Chairman is Dr Eddy Fong, GBS, JP. The 7 independent non-executive directors are The Hon Chan Kam-lam, SBS, JP, Professor Leonard Cheng, JP, Mr Anderson Chow, SC, Ms Angelina Lee, SBS, JP, Mr Lawrence Lee, JP, Mr Carlson Tong, JP, Mr Wong Kai-man, BBS, JP.

Appendix D

Response to item 3 - regarding clause 28(7) which introduces new section 32A, the Securities and Futures Commission (SFC) is requested to confirm whether the withdrawal or discontinuation of proceedings of the Market Misconduct Tribunal (MMT) would be subject to the agreement of the board of SFC

Regarding the new section 32A to Schedule 9 concerning withdrawal or discontinuation of MMT proceedings, if the SFC subsequently considers that the case should be withdrawn, the decision has to be made by the management of the Enforcement Division which, like all operations of the SFC, is overseen by the Chief Executive Officer. The Executive will inform the Board of important developments in enforcement proceedings, including withdrawal or discontinuation of MMT proceedings, in monthly reports as necessary. All Board members are able to request separate updates or to request more information at the board meeting as required.
