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**Paper for the House Committee meeting
on 11 February 2000**

**Report of the Bills Committee on
Exchanges and Clearing Houses (Merger) Bill**

Purpose

This paper reports on the deliberations of the Bills Committee on the Exchanges and Clearing Houses (Merger) Bill (the Bill).

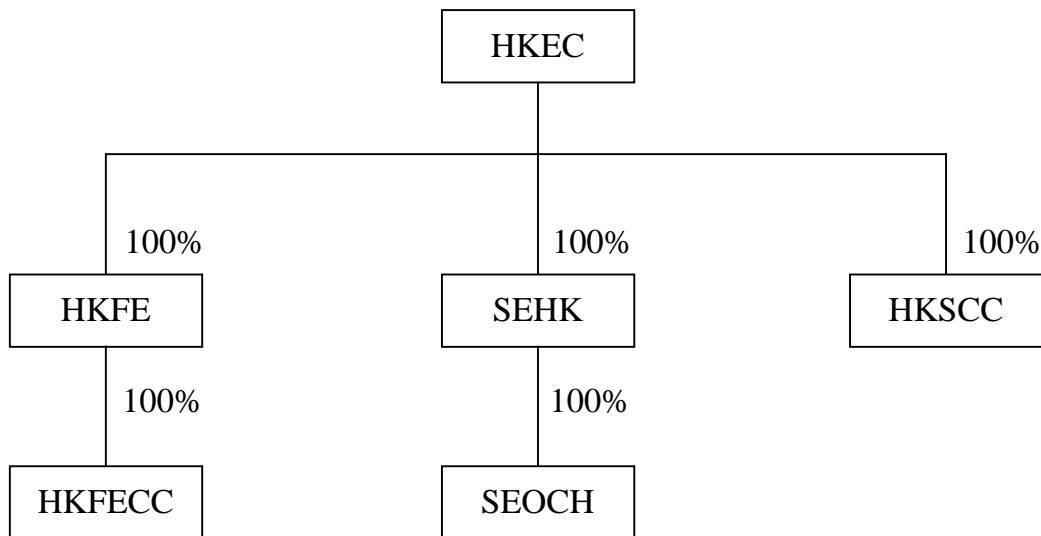
Background

2. The Financial Secretary (FS) announced in his Budget Speech on 3 March 1999 a comprehensive market reform for the securities and futures market to enhance its competitiveness. An integral part of the reform is the merger of the existing two exchanges and three clearing houses in the Hong Kong securities and futures markets. These five financial institutions, namely the Stock Exchange of Hong Kong (SEHK), the Hong Kong Futures Exchange (HKFE), Hong Kong Securities Clearing Company Limited (HKSCC), the SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKFECC), are basically self-regulatory and member-owned organizations. With the technological advances and globalisation of the financial markets, the fragmented market structure in Hong Kong has been found not capable of meeting the global and external challenges. FS's reform aims at putting the two exchanges and three clearing houses under a single-holding performance-driven commercial entity, separating ownership of exchanges and the right of access to the markets.

3. Commercial negotiations between the SEHK and HKFE on the terms of the merger took place since FS's announcement of the merger plan. The schemes of arrangement documents concluded as a result of the negotiations were endorsed by the two exchanges respectively on 27 September 1999 and

subsequently sanctioned by the Court on 11 October 1999.

4. Upon implementation of the merger, the SEHK and the HKFE will become wholly-owned subsidiaries of the holding company, known as Hong Kong Exchanges and Clearing Limited (HKEC). The SEOCH and HKFECC will remain wholly-owned subsidiaries of SEHK and HKFE respectively, while HKSCC will become a wholly-owned subsidiary of HKEC. The corporate structure of the HKEC Group will be as follows:



The Bill

5. The Bill does not directly deal with the merger process of the exchanges and clearing houses. Instead, it provides for the regulation of the exchanges and clearing houses upon merger by :-

- (a) prohibiting a person from becoming or continuing to be the controller of an exchange company or clearing house unless the person is a company recognized by the Securities and Futures Commission (SFC) as an exchange controller; and
- (b) regulating the recognized exchange controller of an exchange company or a clearing house.

The Bills Committee

6. The House Committee agreed at its meeting on 12 November 1999 to form a Bills Committee to study the Bill. The membership list of the Bills

Committee is at **Appendix I**. The Bills Committee, under the Chairmanship of Hon Ronald ARCULLI, has held 13 meetings with the Administration. The Bills Committee invited public views through advertisement in local press and approached major groups in the industry and professional bodies for views on the Bill. A list of the organizations which have submitted views to the Bills Committee is at **Appendix II**. The Hong Kong Stockbrokers Association Ltd. has made an oral representation at one of the meetings of the Bills Committee.

Deliberations of the Bills Committee

7. A gist of the deliberations of the Bills Committee is given in the following paragraphs.

Board of directors of the new Hong Kong Exchanges and Clearing Limited

8. After the merger, the HKEC board will comprise a maximum of 15 members with no more than six directors to be elected by shareholders. The FS under clause 20, may appoint up to eight directors to represent public and market interests. The board chairman will be elected by the directors and the appointment will be subject to the approval of the Chief Executive. The Chief Executive Officer of the HKEC will be a director ex-officio and his appointment, under clause 12, shall be approved by SFC.

9. Taking into account the grave concern expressed by the industry groups, members examined in detail the composition of the board which is widely considered to be subject to strong government influence with more than half of its directors to be appointed by FS. Members shared the industry's concern that government's control over HKEC appears excessive particularly in the long term.

10. In addressing members' concern, the Administration explained that apart from pursuing its commercial interests, the new HKEC would have important public functions of ensuring an orderly and fair market in securities and futures trading as well as prudent risk management of activities of the new HKEC, the exchanges and the clearing houses. The appointment of a number of directors by FS is therefore necessary, particularly when HKEC is newly established, and there is a need to ensure adequate representation of public and market interests in the decision making body of HKEC. The Administration nevertheless assured members that the composition of the board would be further reviewed and subject to change following the diversification of the shareholdings in HKEC.

11. The Bills Committee accepts that there is a need to ensure that HKEC will perform its public functions, but there should also be adequate representation of shareholders' interests. The composition of the future boards of HKEC should also be spelt out in the Bill apart from setting out the initial board composition at inaugural stage. In view of members' grave concern, the Administration has eventually agreed to put forward a Committee Stage Amendment (CSA) to stipulate in the Bill that by 2003, the number of directors appointed by FS will not exceed the number of directors allowed to be elected by shareholders under the constitution of HKEC.

12. As regards the request of industry groups for defining in the Bill the professions/constituencies of the appointed directors and, if possible, the number/quota for individual profession/constituency so as to ensure a balanced representation on the board. The Administration has assured members that directors will be appointed by FS from among, inter alia, market professionals and members of the community who can represent the public interest. Members noted this assurance.

Establishment and functions of Risk Management Committee

13. Members have noted that under clause 9(1), a Risk Management Committee (RMC) will be established to formulate policies on risk management matters relating to the activities of the HKEC Group. Under the proposal, the RMC will be chaired by the chairman of HKEC and comprise three to five members appointed by FS, and no more than two members appointed by the HKEC board of directors. Members are of the view that to ensure representation of shareholders' views on RMC, the Bill should stipulate that of the two members appointed by the board, at least one member shall be a board director elected by shareholders. The Administration agrees that representation of shareholders on RMC should be ensured and therefore has undertaken to make CSA to that effect.

14. Members have also raised grave concern over the power of RMC. Under clause 9(5), the decision of the RMC will prevail unless overruled by a two-third majority of the members of the HKEC board. The Bills Committee is of the view that this majority requirement is excessive and that the decision of RMC should not be binding on the board, as the latter carries ultimate responsibility for HKEC. After considering of the views of the Bills Committee, the Administration has agreed to make CSAs to delete clause 9(5) and to add to clause 9(1) that the duties of RMC are to formulate risk management policies and to submit them for consideration of the board.

Shareholding limit

15. Clause 6(1)(a) states that a "minority controller" means any person who, either alone or with any associates, is entitled to exercise, or control the

exercise of, 5% or more of the voting power at any general meeting of HKEC or its holding company. Clause 6(2) further stipulates that a person shall not become a minority controller unless approved by SFC. The Administration has explained that the 5% limit is set to prevent control of HKEC by any individual party or parties acting in concert. Members however are concerned that fund managers, custodians, nominee companies, and those carrying on normal company activities such as appointing the same person as a proxy to exercise voting rights at a general meeting might be considered as "associates" and the proxy may therefore fall within the definition of "minority controller". Noting members' concern, the Administration has agreed to improve clarity of the provisions and to make CSAs to refine the definitions of "associate", "indirect controller" and "minority controller" and to give specifications of persons or class of persons who do or do not fall into such definitions in the new Schedules 1 and 3 respectively. Members have noted that the proposed amendments still do not exclude fund managers, custodians and nominee companies from being caught by the definition of "minority controllers" since the Administration considers it more appropriate to deal with their applications on a case by case basis.

16. As regards application for approval of becoming a minority controller, members have also requested that the Administration should set out in the Bill the criteria for approving a person to be a minority controller. Taking note of members' concern, the Administration has agreed to make CSA to stipulate in the Bill that SFC will not approve an application unless it is in the interest of the investing public or in the public interest. When it refuses to give an approval, it is also required to give reasons for the refusal.

Re-delineation of the financial services functional constituency

17. The composition of FSFC is provided in section 20U of the Legislative Council Ordinance (Cap.542). At present, FSFC includes, inter alia, members of SEHK and HKFE who are entitled to vote at their respective general meetings. Given the separation of the shareholding of the two exchanges from the right to trade on and through the respective exchanges upon the merger, members have noted the need to re-delineate the FSFC. However, they are concerned about the 21 non-trading members in SEHK who might not be eligible to become electors under the proposed re-delineation of the FSFC.

18. According to the Administration's explanation, upon the merger, each member will be issued a "trading right" for each share held in the respective exchanges. He will be deemed to be an "exchange participant" under clause 23 of the Bill and will be able to continue to trade on or through the exchanges provided that he satisfies the requirements imposed by HKEC and registers with SFC as dealers. The Administration considers that the concept of "traders of the exchanges" which is central to the current delineation of FSFC should continue to apply after the merger. The Administration believes that

the replacement of "members" by "exchange participants", is in line with the general policy and the existing delineation of FSFC. In other words, "exchange participants" of SEHK and HKFE will be eligible to register as electors of FSFC.

19. As regards the 21 non-trading members, the Administration has confirmed that these 21 members, same as other SEHK members, will be deemed to be "exchange participants" upon merger and thus will become eligible as electors for the FSFC, unless their registration with SFC are suspended or revoked, in which case these members will be unable to vote at the general meeting of the exchange. In such case, they will not be eligible as voters under the proposed re-delineation as it is the case under the existing delineation.

Commencement dates of the Bill

20. Members have noted that as part of the merger reform, HKSCC, which is at present a company limited by guarantee, has to be converted to a company limited by shares. Clauses 22(1) and 22(2) provide the legal basis for such conversion through amendments to HKSCC's constitution and for SFC to approve such amendments. To enable the conversion to take place prior to the coming into effect of the merger, these two provisions will therefore have to take effect before the rest of the Bill.

21. According to the Administration, it is their intention to announce commencement of clause 22(1) and 22(2) on the same date when the Bill is gazetted after enactment. The commencement date of the rest of the Bill will coincide with the effective date of the schemes of arrangement governing the merger. The Administration expects that there will be an interim period of two weeks between the enactment of the main body of the Bill and the coming into effect of the schemes to allow ample time for various parties including HKEC, HKSCC and the exchanges to complete all the necessary procedural steps for the implementation of the merger. Hence, the main body of the Bill will take effect about two weeks later with the actual commencement date to be announced by notice in the gazette. The Administration will therefore make CSA to clause 1(2) to provide for the arrangement.

Other amendments to be moved by the Administration

22. In the light of members' views, the Administration has also undertaken to make CSAs to reflect the following :

- (a) Members have pointed out that a “working day” may not be a “trading day”. In order to avoid confusion between "working day" and "trading day", the Administration will make CSA to substitute “5 working days” in clause 22(3)(e) with “7 days” which means 7 calendar days. Consequential to this amendment, the definition of “working day” in clause 2(1) will be deleted;
- (b) Members have expressed concern that where a person fails to comply with the requirements set under clauses 3, 6 and 7, he commits an offence and is liable to pecuniary penalty as well as imprisonment. As such, members consider that the defence of "all due diligence" in clauses 3(5)(b)&(11), 6(4)(b)&(10) and 7(4) provided to the accused might not be adequate. The Administration has agreed to replace "all due diligence" by "reasonable diligence" in the relevant provisions in the Bill;
- (c) Under clause 8(3), no liability shall be incurred by a recognized exchange controller or any person acting on its behalf as long as the person has performed in good faith in the discharge of his obligation under this clause. Members have considered that such exemption from liability should be extended to board directors and any member of the committees under HKEC and its subsidiaries. The Administration has agreed to make suitable amendments;
- (d) Under clause 8(1), HKEC has the duty, amongst others, to ensure an orderly and fair market. Under the relevant existing legislation, some of the subsidiaries to be of HKEC have similar duty. Members are concerned that HKEC and its subsidiaries may conflict in the discharge of their respective statutory duty. In the light of members' comments, the Administration will redraft clause 8(1) and add clause 8(4) to remove such conflict, namely, that where HKEC has discharged its obligation under clause 8(1), the duty of the subsidiary will not apply; and
- (e) In order to be fair to the party concerned and make the procedure transparent, the Administration has agreed to state in clause 10(3) that SFC is required to give reasons for its refusal to give approval to the amendments of the constitution, rules or amendments of the rules as proposed by a recognized exchange controller.

Committee Stage Amendments

23. The draft CSAs to be proposed by the Administration are at **Appendix III**. Members are invited to note that there may be some textual adjustments before the final version of the CSAs is produced. The Bills Committee has not proposed any CSAs.

Recommendations

24. The Bills Committee recommends that, subject to the CSAs to be moved by the Administration, the Second Reading debate on the Bill be resumed on 23 February 2000.

Advice sought

25. Members are invited to note the deliberations of the Bills Committee and support the recommendation at paragraph 24 above.

Legislative Council Secretariat

10 February 2000

**Bills Committee on
Exchanges and Clearing Houses (Merger) Bill**

Membership list

Hon Ronald ARCULLI, JP (Chairman)
Hon LEE Kai-ming, SBS, JP
Hon NG Leung-sing
Hon CHAN Kam-lam
Hon SIN Chung-kai
Dr Hon Philip WONG Yu-hong
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin

Total : 8 Members

**Bills Committee on
Exchanges and Clearing Houses (Merger) Bill**

**List of organizations
which have submitted views to the Bills Committee**

1. The Hong Kong Securities Industry Group Limited
2. The Hong Kong Society of Accountants
3. The Hong Kong Stockbrokers Association Ltd.
4. The Institute of Securities Dealers Ltd.
5. The Law Society of Hong Kong
6. The Securities and Futures Market Reform Members' Concerns Co-ordinating Group