Paper No. 5H/01

Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

Parts V and VI – Additional information on the licensing and exemption regime

At the meeting on 9 March 2001 when the Bills Committee considered Parts V and VI of the Securities and Futures Bill (SF Bill), we undertook to provide further information on a number of issues raised by Members. This note sets out the information required and our views on such issues.

PART V

Clause 113 – Definition of "regulated function"

2. Members have sought clarification as to why lawyers were not categorically excluded from the definition of "regulated function" in clause 113 of the SF Bill. To recap, "regulated function" is defined as follows –

> " in relation to a regulated activity carried on as a business by any person, [regulated function] means any function performed for or on behalf of or by arrangement with the person relating to the regulated activity, other than work ordinarily performed by an accountant, clerk or cashier. "

3. The definition is adapted from the definitions of "representative" in the Securities Ordinance (SO) and the Commodities Trading Ordinance (CTO). The definition is introduced to clarify the role of an **individual** who performed acts that constituted, in whole or in part, a regulated activity (and thus triggered the licensing requirement). The reason for excluding accountants[1], clerks, or cashiers, is to clarify that the work ordinarily performed by them does not constitute any part of the regulated activities of an intermediary or an unlicensed entity.

[1] Accounting staff, not professional accountants.

4. When the definition of "regulated function" is read alongside the various definitions of regulated activities in Part 2 of Schedule 6 , the effect is that the activities of lawyers are excluded to the appropriate degree. The advice on securities, futures contracts and corporate finance given by a lawyer **wholly incidental to** the carrying on of his professional practice is excluded from the definitions of the three regulated activities involving the giving of advice. However, a lawyer who performs a function relating to a regulated activity for or on behalf of an intermediary may well trigger the licensing requirement. For example, the lawyer may be a member of a corporate finance team of an investment house giving a wide range of advice to clients concerning securities. Whether the licensing requirement is triggered will depend on the circumstances of the particular case. As is under existing law, it is not the policy to provide a blanket exclusion for lawyers or any other professional persons to engage in regulated activities without a licence.

Clause 114(6) – Defence for carrying on securities margin financing business without a licence

5. Members have asked us to clarify the policy to oblige a person carrying on money lending business (other than securities margin financier) to establish that the purpose of the loan was not for the acquisition and continued holding of listed securities.

6. Under clause 114(6) of the SF Bill, "a person shall not be regarded as contravening subsection (1) in relation to type 8 regulated activity [securities margin financing] by reason only of providing financial accommodation if he reasonably believes that the financial accommodation is not to be used to facilitate the acquisition of securities …; or the continued holding of such securities".

7. The provision is adapted from the Securities (Margin Financing) (Amendment) Ordinance 2000 (the Amendment Ordinance). By way of background, the Amendment Ordinance was introduced for better protection of investors following the liquidation of C A Pacific, a licensed money lender, and its associated entities in 1998. At the time, the provision of securities margin financing was not subject to adequate regulatory controls. The incident gave rise to a market crisis which investors flooded their securities dealers with demands to be issued with their scrip; such demands could not be met where imprudent lending practices had led to the wholesale pledging of securities as collateral for loans to the lenders (and even their directors and shareholders).

8. On the specific clause at issue, clause 114(6) is similar to the existing section 121C(3) of the SO as amended by the Amendment Ordinance. The latter subsection was inserted following a submission that, since the definition of "securities margin financing" contained the words "providing financial accommodation **in order to** facilitate acquisitions, etc.", it potentially introduced the concept of subjectivity of whether a person was engaging in securities margin financing. For the investor protection concern that may arise if leaving such activities unregulated, the policy intention was to ensure that recklessness could not be deployed as a defence to a charge of carrying on a business of securities margin financing without a licence. It was, accordingly, considered appropriate to impose upon persons carrying on the business of money lending an obligation to inquire the purpose for which the financial accommodation was sought.

9. Where a defendant alleges a reasonable belief that the financial accommodation is not to be used to facilitate the acquisition of securities listed on a stock market or the continued holding of such securities (clause 114(6)), the prosecutor must provide evidence to prove to the contrary. Where a lender has taken steps to inquire the borrower the purpose of the loan and if the lender purports that the loan was used for another purpose unbeknown to him, the lender should generally be considered as having such reasonable belief (even if the borrower had deceived him and used the loan for the purpose of acquiring securities).

Clause 131 – SFC to publish decisions to grant modifications and waivers

10. The Securities and Futures Commission (SFC) is required under clause 131(6) of the SF Bill to publish a notice in the Gazette specifying the name of the person, the modification/waiver granted in respect of any licensing condition and the relevant conditions imposed, as well as the period therefor. Members have asked us to consider the greatest extent of transparency possible through public disclosure of SFC decisions on such modifications and waivers.

11. The provision in question expands upon section 29(2) of the Securities and Futures Commission Ordinance which applies to modification to the financial resources rules only. Both the new and existing provisions do not require the SFC to state reasons for the modifications or waivers granted.

12. Modifications/waivers are provided for in the regulatory regime for the better regulation of intermediaries, which may run different lines of business of varying degrees of complexity and scale, and hence it will not always be possible to have a "one-size-fits-all" regulatory regime. The modification

power is essentially a necessary tool used by the SFC to provide flexibility where the rules do not fit certain intermediaries very well.

13. The SFC has discussed with members of the brokerage community as to whether it is possible to enhance transparency in granting modifications/ waivers. While there is general support for more disclosure to enhance transparency, this must be weighed against disclosure that ends up giving away commercial secrets of individual firms. One broker indicated reluctance in a case to apply for a modification to the financial resources rules because its client did not want his positions and strategies to be discussed with the SFC, let alone revealed to the public at large.

14. The SFC believes that transparency in the granting of waivers and modifications is necessary. It better ensures that the SFC is accountable for its actions. It allows those who would deal with intermediaries to do so on an informed basis. It also makes known to other intermediaries the possibility that they may obtain corresponding waivers and modifications. It is an aid to consistency and fairness of treatment. The SFC, therefore, believes that it should generally publish full details of the terms and conditions of waivers and modifications, including the identify of the beneficiary of the waiver or modification, and summary description of the reasons.

15. Departure from this policy of transparency should only occur in exceptional cases, where the SFC is satisfied that to disclose full details of the terms and conditions of a waiver or modification would also disclose commercial information of a highly confidential and valuable nature. For example, this may involve disclosure of detailed information about prospective transactions, trading strategies, clients or counter-parties. In such cases, the SFC believes there should still be a disclosure of the identity of the beneficiary of the waiver or modification together with general information about the waiver or modification and the terms and conditions upon which it was granted. The SFC should also disclose the fact that it has not made full disclosure of those terms and conditions and why it has decided not to do so.

16. We shall consider introducing a Committee Stage Amendment to this effect to assure the market that the power to grant waivers or exemptions will be exercised in an open and transparent manner and information regarding the granting of such exemptions and waivers will, through such publication, be properly disseminated to all market participants to ensure a fair and open market.

17. Checks and balances have been put in place to guard against abuse of power by the SFC in granting modifications/waivers. Applicants whose

requests for modifications/waivers have been rejected can appeal to the Securities and Futures Appeals Tribunal for a review. We believe that the Tribunal will consider precedent cases in determining the appeal and, where necessary, can consider an appeal in private. Any aggrieved party may of course also seek judicial review.

18. The relevant practice in the US and the UK are summarized in paragraphs 19 to 22 below.

United States

19. This is handled by the staff of the Securities and Exchange Commission (SEC) on a case by case basis. Generally when the SEC issues an order granting a modification or waiver to a broker-dealer, it will make public the following information –

(i) the name of the broker-dealer;

(ii) the modification or waiver;

(iii) the conditions for grating the modification or waiver; and

(iv) the reasons for granting the modification or waiver.

20. Where the case involves "trade secrets", then only the name of the broker-dealer is disclosed.

United Kingdom

21. Under the current regime, there are no statutory requirements relating to publication of modifications or waivers. The Financial Services Authority (FSA) basically takes a view on whether disclosure will be of value to all or any stakeholder, and based on that decision may publish the waiver, in full or in part.

22. Under the new Financial Services and Markets Act, the FSA will make public waivers or modifications granted unless the FSA believes it is inappropriate or unnecessary to do so. Publication is presumed unless the commercial interests of the regulatee are to be unfairly prejudiced. Where the FSA does publish such directions regarding waivers and modifications, the directions will be published in such a way as the FSA thinks suitable.

PART VI

Clauses 155 and 156 – SFC's power to appoint auditor

23. Under clauses 155 and 156 of the SF Bill, the SFC may under prescribed circumstances appoint auditors to examine and audit the accounts and records of a licensed corporation and its associated entity. They are adapted from existing provisions under the SO (ss.90 and 91), the CTO (ss.52 and 53) and the Leveraged Foreign Exchange Trading Ordinance (ss.33 and 34). Members have asked us to consider adopting the alternative approach under the Banking Ordinance (BO).

24. Under section 59 of the BO, the Hong Kong Monetary Authority (HKMA) may, after consultation with an authorized financial institution, require the institution to appoint an auditor or auditors to prepare a report of it; and such auditor or auditor must be approved by the HKMA.

25. As we understand it, Members' major concern lies with the SFC's power to appoint auditors of its own choice for a licensed corporation or its associated entity. We would like to stress that the SFC has never had to exercise its power to appoint an auditor. Instead, the SFC has always managed to come to an arrangement with the corporation concerned to appoint an auditor for the purpose of conducting the special task. The SFC does not have a list of approved auditors, and will consider the suitability of the auditor nominated by the corporation based on the nominee's experience, capabilities, available resources, etc. There has never been any difficulty in finding auditors acceptable to both the SFC and the corporation concerned.

26. The above approach proposed under the SF Bill is similar in effect to that under the BO, where although the HKMA does not itself appoint the auditor or auditors, the appointment of the auditor or auditors has to be approved by it. We see no particular reasons for changes to the SF Bill in this respect to follow the Banking Ordinance. We are however prepared to consider including a "consultation arrangement" for SFC before approving an auditor.

Securities and Futures Commission
Financial Services Bureau
12 May 2001