SECURITIES & FUTURES BILL AND BANKING (AMENDMENT) BILL 2000

SUBMISSIONS OF THE SECURITIES LAW COMMITTEE OF THE LAW SOCIETY OF HONG KONG

INTRODUCTION

The Securities Law Committee of the Law Society is supportive of the objectives of consolidating the existing legislation relating to securities, futures and forex, and updating the regime in response to market developments, with a view to creating a modern legal framework that promotes market confidence, secures appropriate investor protection, reduces market malpractice and financial crimes and facilitates innovation and competition.

This paper sets out the Committee's comments on the Blue Bill, referring to various areas where we consider that amendments should be made to assist in the furtherance of the above objectives.

The Committee also made written submissions on the White Bill that was issued for public consultation in April 2000. Where appropriate, we highlight in this submission the extent to which changes have (or have not) been made in the Blue Bill in the light of our earlier comments.

GENERAL COMMENTS

In our previous submission, we made the comment that:

> *"…the layout and format [of the Bill] is a nightmare to navigate around, particularly in the context of the definitions".*

While the Bill is still a formidable and complex piece of legislation, we acknowledge that significant improvements in the layout and format have been made in the Blue Bill, through transferring a number of definitions to Schedule 1 to the Bill, and through some streamlining of Part XV of the Bill (relating to disclosure of interest in shares) and transferring to Part XV the provisions formerly within Schedule 9 to the White Bill.

Our other general comment on the White Bill related to the rule-making powers of the SFC. In this respect, no changes have been made to the Blue Bill. The SFC has extensive powers, under Parts VI and VII of the Bill (and also under Section 384 of the Bill) to make rules applying to intermediaries (and, in some cases, to any other person) breach of which, if committed "without reasonable excuse", would constitute a criminal offence, punishable with up to 2 years imprisonment and a fine of HK$200,000). This goes well beyond current rule-making powers of the SFC. For example, under the Securities Ordinance, the SFC only has the power to make rules in respect of the specific matters set out in Section 146 of that Ordinance, whereas the SFC's powers under the Bill extend to making rules:

> *"…providing for any other matters relating to the practices and standards relating to conduct in carrying on the regulated activities for which intermediaries are licensed or exempt (Section 163(2)(n)) and/or*
>
> *"…providing for any other matters for the better carrying out of the objects and purposes of [of the Bill]" (Section 384(1)(p)).*

Under the existing law, a breach of the rules made by SFC under its limited rule-making powers only attracts criminal liability if this is provided for by regulations made by the Chief Executive in Council (Section 146A of the Securities Ordinance).

We also note that (except for rules to be made under Section 384(2)), the SFC may exercise its rule- making powers without consultation with the Financial Secretary and/or public consultation.

We find it troubling that the SFC should have the power, in effect, to create criminal offences punishable with substantial fines and imprisonment, and that it can do so without market consultation. These offences would, it appears, be offences of strict liability, subject only to the defence of "reasonable excuse". In our view, only in clearly defined circumstances (for example, where a person has

acted with intent to defraud) should breach of SFC rules attract criminal sanctions. In the interests of certainty and justice, any other matters which are intended to attract criminal penalties should be set out in the Bill itself. Alternatively, any rules proposed to be made by the SFC which would attract criminal liability should be subject to public consultation, vetting by the Legislative Council and/or approval by the Chief Executive in Council.

The rest of this submission sets out more specific comments on particular aspects of the Bill and the Banking (Amendment) Bill 2000.

OFFERS OF INVESTMENTS

This section of this paper sets out the Committee's comments on the revised proposed legislation in relation to offers of investments as contained in Part IV of the Bill.

General Observations

Broadly speaking, Part IV of the Bill repeats the existing provisions in the Protection of Investors Ordinance and will be familiar to market participants and their advisers. This Part of the Bill also substantially repeats Section 72 of the Securities Ordinance. Besides following existing legislation, Part IV also expressly empowers the SFC to authorise investment products and not just advertisements, invitations or documents relating to investments. This was one of the Government's primary objectives in this Part of the Bill.

Generally speaking, Part IV is not difficult to follow. However, the manner in which the definitions are presented leaves much to be desired. We found ourselves having to move constantly from place to place in the Bill to locate definitions.

Set out below are our comments on the specific sections of Part IV

Section 102

This section broadly follows section 4 of the Protection of Investors Ordinance. We believe that it would be helpful in terms of the layout and format of the Bill if subsection 102(2) expressly described what the different types of regulated activities are (i.e. instead of referring to them as Type 1, Type 2 etc.) so that readers do not need to refer to Schedule 6 and interrupt the flow of the legislation. For example paragraph 102(2)(a) could state "made by an intermediary licensed or exempt for dealing in securities, advising on securities, or advising on corporate finance…." as opposed to "made by an intermediary licensed or exempt for Type 1, Type 4, or Type 6 regulated activity ….".

If this suggestion is not accepted and the regulated activities are still referred to as "Types", then we would suggest that references in this section to "an intermediary licensed or exempt for Type 1.... regulated activity, or a representative of such intermediary" be redrafted so that they are consistent with the drafting in Section 108 – i.e. "Type 1 intermediary or representative". In addition, we suggest that the definition of the "Types" of intermediary or representative in Section 108 be moved to Section 101, the interpretation section of Part IV.

Although the exception for offers to professionals (paragraph 102(3)(j)) is a bit hard to find as it does not follow the format in the Protection of Investors Ordinance, we think that it is appropriate for this exemption to be stated in its own

paragraph as opposed to way it is presented in the Protection of Investors Ordinance.

We appreciate the efforts that Government has taken in order to provide some guidance as to what is meant by a "professional investor". However, we believe that the definition of "professional investor" narrows and unduly restricts the scope of the professional investor exemption. Presently, the professional investor exemption in the Protection of Investors Ordinance is found in subparagraph 4(3)(a)(vii) and covers "persons whose business involves the acquisition, disposal, or holding of securities". We strongly believe that the definition of "professional investor" in the Bill should be redrafted to include the persons and entities listed in Schedule 1 Part 1 but without restricting the generality of the definition and/or to expressly include "persons whose business involves the acquisition, disposal or holding of securities".

We query why subsection 102(3)(h) does not specifically refer to the SEHK as Hong Kong's exchange. We find this subsection quite difficult to read because it requires readers to cross refer to a number of definitions in Schedule 1 and also to refer to Sections 23 and 36. Generally, why does this subsection of the Bill not follow the comparable provision in the Protection of Investors Ordinance (paragraph 4(2)(h)) which was much more straight forward? We also query why the exemption in paragraph 4(2)(fb) of the Protection of Investors Ordinance is not repeated in the Bill.

With regard to subsection 102(5), we repeat our comments in relation to subsection 102(2).

We suggest that the definitions in subsection 102(13) be moved to subsection 101(1) so that the Bill is easier to navigate.

Section 103

We query whether the scope of the SFC's powers under subsection 103(4) are too broad and would like to know what recourse a collective investment scheme has if it believes that a condition imposed under this subsection is unreasonable.

Section 104

With regard to subsection 104(4), we repeat our comments in relation to subsection 103(4).

Section 107

We query whether subsections 107(4) and 107(6) are inconsistent.

Section 108

Why are Type 4 intermediaries (i.e. investment advisers) included in this section, which is in relation to offers of securities. The comparable provision in the Securities Ordinance (Section 72) only relates to offers by dealers.

Our comments on Section 102 (see above) in relation to the way different types of regulated activities are defined and in relation to the location in the Bill of the definitions apply equally to Section 108.

Section 109

We query whether subsection 109(8) is necessary given that the word "issue" is defined in subsection 101(1) which applies to Part IV in its entirety.

Definition of Collective Investment Scheme

"Collective investment scheme" is defined very broadly and should pick up most types of collective investment products not only unit trusts and mutual funds. The definition appears to borrow heavily from the UK legislation. We query why the Government has chosen to follow the UK legislation when setting out the definition of "collective investment scheme" but has not chosen to follow the UK legislation when limiting the definition's effect. For instance none of the following are excluded in the Bill: contracts of insurance; arrangements where each of the participants carries on business other than investment business and enters the arrangements for commercial purposes related to that business; investment clubs; and occupational retirement schemes. Should mandatory provident fund schemes be expressly excluded? We urge the Government to review carefully the exclusions in the UK legislation and consider whether additional arrangements should be excluded in the Bill.

LICENSING REGIME

As set out in our previous submission, we are generally supportive of the proposed revised single licence regime in Part V of the Bill. We also welcome the fact that a number of changes have been made in the Blue Bill in the light of our previous comments:

- only "executive directors" (as defined in the Bill) of licensed corporations will need to be registered as "responsible officers"
- the requirement that at least one responsible officer must **always** be in Hong Kong has been modified to provide that there must be at least one responsible officer of the licensed corporation who is available at all times to supervise the business of the regulated activity for which the corporation is licensed.
- the personal liability of "responsible officers" has been reduced in the Blue Bill, and
- the "whistle blowing" provision has been deleted.

We have the following further comments:

Types of activities

Few changes have been made to the definition of "regulated activities" as set out in Schedule 6 to the Bill. We remain concerned that some of the definitions are extremely wide in scope. For example, the definitions of "dealing in securities" and "providing automated trading services" appear to overlap substantially, and both could be interpreted so as to apply to technology providers, who provide systems that assist licensed corporations to deal with their customers. At the very least, the SFC should provide clear guidance as to how the categories will be applied, and we believe that confirmation from the SFC that no licence is required should have binding effect under the Bill.

In respect of leveraged foreign exchange trading, we note that the exemption for contracts entered into for hedging purposes may now apply to any "corporation", but only if the hedging transaction is effected with a Hong Kong incorporated-company. The exemption should extend to transactions effected by a corporation with any other corporation, as long as it is for hedging purposes.

The definitions of "advising on securities" and "advising on corporate finance" are also very broad and overlapping. We note that the exemption in Part V of the White Bill, for advising on corporate finance other than on a regular basis and for remuneration, has been deleted. It appears that, for example, a securities dealer who occasionally gives incidental corporate finance advice will need to be licensed for both type 1 and type 6 activities. This contrasts with the category of

"advising on securities", where there is an exemption for a securities dealer who gives advice wholly incidental to the carrying on of securities dealing business.

In our previous submission, we had proposed that the exemption in Section 3 of the Securities Ordinance for dealings conducted:

- by or through a registered or exempt person or
- as principal with a "professional investor"

be extended to a wider range of regulated activities. While our suggestion appears to have been adopted in respect of "dealing in futures contracts" there is no equivalent exemption in relation to (for example) leveraged foreign exchange trading, and securities margin financing.

Where a "professionals exemption" applies (i.e. in relation to dealing in securities or futures contracts), we note that it has been extended to cover dealings with both:

- a person whose business involves the acquisition, disposal or holding of securities/futures and/or
- "professional investors"

The second category is a new definition in Schedule 1 to the Bill, broadly covering various types of regulated entities, and persons prescribed by rules which could be made by the SFC under Section 384 of the Bill.

We suggest that, rather than creating the two-fold exemption referred to above, the category of persons "whose business involves the acquisition, disposal etc. of securities or futures" (and, we suggest, other financial products) be included in the definition of "professional investors".

This is particularly important in respect of the provisions relating to marketing and cold-calling in the Bill, where the exemption in the current law is to be replaced by an exemption for marketing to "professional investors". As the Bill is currently drafted, this would restrict the scope of the existing exemptions to a significant extent, as not all persons whose business involves the acquisition, disposal etc. of investments would fall within the definition of "professional investors" in Schedule 1 to the Bill.

Conditions of Licences granted under section 115(1) etc.

Section 115(5) states that the licence granted under Section 115(1) "shall be subject to such reasonable conditions as the Commission may impose, and the Commission may at any time, by notice in writing served on the licensed corporation concerned, amend or revoke any such condition or impose new conditions as may be reasonable in the circumstances". Subsection (6) states that

any amendment or revocation of any condition or the imposition of any new condition takes effect when the notice of the amendment/revocation is served or at the time specified in the notice, whichever is the later.

This theme runs through various types of licences granted under Part V, including temporary licences granted under Section 116, exemptions granted to authorized financial institutions under Section 118, licenses granted to individuals to carry on one or more of the regulated activities (under Section 119) and temporary licences granted to representatives under Section 120.

Because all amendments, revocations or impositions mentioned in these sections can take effect immediately they are notified, they need to be adhered to regardless of whether the conditions meet the requirement of reasonableness. Although there is an avenue for appeal to the Securities and Futures Appeal Tribunal in Part XI of the Bill, the validity of the relevant licence is in the meantime open to question, and any application for a stay of a specified decision may be subject to conditions such as costs and further payment of money. We suggest that the amendment, revocation or imposition of conditions should not take effect until the Commission has given reasons and the period for appealing to the SFAT has elapsed or an appeal has been heard.

“Responsible Officers”

Under Section 124, a corporation licensed to carry on regulated activities is not permitted to carry on such activity unless every executive director is approved as a responsible officer of that corporation; and at least 2 individuals (including an executive director) are licensed as responsible officers.

Under Section 125, the approval of an individual as a responsible officer of a licensed corporation is deemed to be revoked if the individual ceases to act as a licensed representative of that corporation.

The general comments on the changes issued by the Financial Services Bureau state that the regulatory catch for “responsible officers” is, due to changes made to the White Bill, limited only to “directors who actively participate in or are responsible for directly supervising the conduct of the regulated activities” thereby avoiding the need for non-executive officers, directors of administrative functions or non-Hong Kong based directors who have no responsibility for the regulated activities to apply for approval as a responsible officer. In this respect the changes are welcome.

Of course, the changes still mean that non-Hong Kong based directors of a Hong Kong licensed corporation in a multinational group could not be involved in supervising the conduct of regulated activities without becoming subject to the licensing requirements for representatives (including examinations and CPT). This

may mean that local staff of licensed entities will lose the benefit of oversight by knowledgeable senior persons located in their overseas offices or head offices. Also, directors who are involved in areas such as Compliance and Legal may still require to become registered as responsible officers and licensed representatives. This may be impractical given that they may not have financial markets-related qualifications. Their role, although vital, would risk being subject to relegation to a position outside the Board to avoid the registration requirements. This would be unfortunate.

SUPERVISION, INVESTIGATION AND DISCIPLINE

Supervision

The provisions in the Bill seeking to expand the power of the SFC to conduct preliminary investigations of the records and documents of listed companies are generally acceptable.

Section 178 entitles the Commission, when certifying non-compliance with Section 172, 173, 174 or 176 to proceed by way of Originating Summons or Originating Motion. There is no need for such a dual approach. A single procedure should be adopted for certification by way of Originating Summons (which must therefore be supported by Affidavit evidence) and reference to an Originating Motion procedure should be deleted. (The same comment applies in relation to Section 204).

Section 180 provides that where a person is asked to answer written or oral questions pursuant to the exercise of the Commission's powers under Section 172 or 176 he must be reminded of the right to claim privilege against self-incrimination and the limitations that are imposed on the admissibility in evidence of the information provided.

There is, however, no such obligation under Section 173 or 174. The Commission's position is that Sections 173 and 174 contain powers which are exercised on a routine basis and for supervisory rather than investigatory purposes, and that where they highlight matters which require investigation, it is the practice of the Commission to then commence a specific investigation. That notwithstanding, it is not difficult to envisage circumstances in which a person who is the subject of a request for information under Section 173 or 174 discloses information which incriminates that person. There is, at present, no restriction on the use to which that information can be put.

Accordingly, consideration should be given to extending the right to claim privilege against self-incrimination to Section 173 or 174. Alternatively, there should be restrictions imposed on the extent to which information provided pursuant to Section 173 or 174 can be used against the persons providing that information.

Section 358 incorporates the existing secrecy provisions currently in Section 59 of the Securities & Futures Commission Ordinance. It is the common practice of the Commission, in particular when conducting investigations or requiring the production of books and records, to regard Section 59 as imposing an obligation of secrecy upon third parties and not only the Commission and its staff. The terms of Section 59 do not support such an interpretation and the Commission's approach can in practice cause difficulties. For example, if a bank is required to disclose information relating to a customer's account then the Commission's

approach suggests that the bank can not inform its customer of this. The position should be considered further and the Section should make clear the precise extent of the secrecy obligations intended to be imposed by the Section.

Discipline

The extension of the range of disciplinary measures available to the Commission is unobjectionable in principle. The provision enabling the Commission to negotiate the terms of disciplinary measures to be imposed are also be welcomed.

However, Section 193 entitles the Commission, when exercising its broad ranging powers under Section 187(1), (2), 188(1), (2) or (7) to have regard to any information or material in its possession, regardless as to how that information or material has come into its possession. A person who is the subject of disciplinary action should know the full extent of the case against him/her. Accordingly, consideration should be given to imposing an express obligation on the Commission to disclose all information upon which it does rely in making any decision.

MARKET MISCONDUCT

We note that a number of the points raised in our previous submission have been addressed to some extent, including:

- a reduction in the number of offences of strict liability
- deleting the provision imposing criminal liability on a corporation for the acts of an employee or agent
- some streamlining of Parts XIII and XIV of the Bill, by merging the identical categories of market misconduct relating to securities and futures.

However, the framework created by the White Bill remains intact, with considerable scope for a single incident to lead to multiple criminal, civil and disciplinary actions against the same person or group of persons. We remain of the view that some of the categories of "market misconduct" are very broadly drafted and that it will be very difficult for market practitioners and their legal advisers to determine with an acceptable degree of certainty whether a particular trading strategy or transaction will infringe the new legislation. While we entirely support the aim of discouraging and penalising improper market conduct such as rat trading, we consider that the very broad drafting of Parts XIII and XIV of the Bill, and the retention of "strict liability" in a number of the statutory provisions, may have a chilling effect on legitimate market activities as well.

Insider dealing

We have the following comments:

As mentioned in our previous submission, we find the new "defence" in what is now Sections 262(7) and 284(7) unclear, and would be grateful for clarification.

The existing Hong Kong legislation, and the provisions in the Bill, do not include a number of exemptions frequently found under the insider dealing laws of other jurisdictions, and without such exemptions there is a risk that legitimate market activities could constitute "insider dealing". For example, if a substantial shareholder wishes to increase its stake in a company, and instructs its broker to buy shares in the market, the proposed increase in the stake may be sufficiently material to be "relevant information". Therefore, the acquisition of the shares in the market by the broker would constitute "insider dealing" both by the substantial shareholder and the broker. This contrasts with the position in the United Kingdom, where there is an express defence, under Schedule 1 to the Criminal Justice Act 1993, for acts carried out in connection with an acquisition or disposal, and with a view to facilitating the accomplishment of such acquisition or disposal, where the "insider information" relates to the acquisition or disposal itself.

As another example, a bank may make a loan to a substantial shareholder of a listed company, secured against shares in the listed company. If the substantial shareholder gets into financial difficulty, this may amount to “relevant information” in respect of the shares in the listed corporation. This could preclude the bank from enforcing its security, by disposing of those shares in the market. In Australia, there is a safe harbour, under the Corporations Regulations 1990, Reg. 7.11, for a sale of securities under a mortgage or charge, and it may be appropriate to include an equivalent exemption from insider dealing in the Bill.

The need for a safe harbour is particularly relevant as “insider dealing” will become a criminal offence under the Bill, and investors will have a statutory right of action in respect of transactions which constitute insider dealing.

False trading in securities

The provisions as regards creating a “false or misleading appearance” in respect of securities or futures previously imposed a purely objective test of liability, and we welcome the fact that an element of “intention or recklessness” is now required in all cases. However, as a drafting point, it still seems that, if a person intentionally does something that, in the view of the Tribunal or court, resulted in misleading the market, he will be guilty of “false trading” even though his dealings were effected for legitimate reasons and not for the purpose of creating a false or misleading appearance with respect to the market. The relevant provisions should be amended to cover conduct engaged in <u>for the purpose</u> of creating false or misleading appearance, or the provisions should at least be redrafted to make clearer that the element of intention/recklessness extends to whether a false or misleading appearance would be created.

Under the provisions on “false trading” and “price rigging”, it remains an offence of strict liability (subject to a defence if the person can demonstrate that his purpose was something other than creating a false or misleading appearance) for a person to effect a sale or purchase not involving a change in beneficial ownership, or a sale or purchase to an associate, or for a company or associated companies to input sale and purchase orders at around the same time.

It appears that the purpose of these provisions is to prohibit “wash trades” and we wholeheartedly support this objective. However, because the provisions are so widely drafted, they appear to catch a number of legitimate transactions (subject only to the availability of the defence). We therefore question whether the justification for the retention of “strict liability” as set out in the Legislative Council briefing i.e. that the sections only apply to “common manipulative devices with relatively few innocent explanations”, is correct.

Price rigging

We note that Clauses 266 and 288 substantially overlap with the provisions relating to false trading and stock market manipulation, and we question why it is necessary to retain these clauses (which go further than the equivalent provisions in the Australian Corporations Law).

Liability for misrepresentations

Previously, the White Bill imposed strict liability for misrepresentations, subject only to a very narrow defence. The provisions have now been amended so that criminal liability and/or a finding by the Tribunal of "market misconduct" arises where false or misleading statements have been made knowing, reckless or negligent as to whether the information is false or misleading.

Generally, criminal liability for representations only arises (under the laws of Hong Kong and other jurisdictions) where a defendant knew, or was reckless, as to whether the information was false or misleading.

It seems unjust and inappropriate to create a serious criminal offence (with a maximum penalty of 10 years imprisonment and a fine of HK$10 million) for careless mis-statements.

DISCLOSURE OF INTERESTS

General observations

We are pleased that the format of the legislation has been simplified to delete the previous Schedule 9. This will certainly help the reader of this complex legislation.

While there have been changes to the draft legislation since the Committee's last comments, there has not been much alteration to the general nature and extent of the proposed law, particularly in relation to disclosures arising from cash settled derivatives and stock lending and borrowing. We understand that some of these aspects of the proposed new legislation give concern to financial intermediaries and investment banks because of the increased compliance requirements and additional complexity.

Notwithstanding that those institutions will deal directly with you on their concerns, we are also concerned (as mentioned in our earlier paper) that extending the legislation to cash settled derivatives may risk hindering the continued growth of this market in Hong Kong.

We deal below with drafting and interpretation concerns, some of which have been raised before.

Technical concerns

- In Section 299(6), we request that there is a percentage threshold set as opposed to the use of the term "substantial number", which leaves the reader unclear as to what type of basket derivative is excluded and what type of basket derivative is still caught.
- The definition of "listed corporation" includes a company which only has warrants or debt securities listed on the Exchange. In practice, exemptions are often given by the SFC in respect of shareholdings in such companies, but the exemption needs to be applied for and a fee paid. We recommend that the definition should be confined to companies with share capital listed on the Exchange, and disclosure only required in respect of share capital which is listed (unless this is going to be covered by an exemption under Section 300(1)).
- While it may appear theoretical, difficulties might arise from paragraph (b) in the definition of "relevant share capital". This refers to unissued shares of any class and Section 299(2) refers to the nominal value of issued share capital being determined by reference to the issued shares of each class. We would suggest that the concept of aggregating unissued shares also be qualified by aggregating unissued shares of one class with issued shares of that class (see the effect of Section 305(1) for example).

- Since much stock borrowing and lending is conducted by fund managers, custodians and others who are not members of the Exchange, it does not appear that the exemption in Section 304(11) is sufficient to avoid multiple notifications for those who lend stock as part of their daily business. We recommend that those who have the stock and have made a notification in respect of such stock and then who lend that stock should not have to make a notification on the loan or the return of such stock if the loan and return is all part of the same stock borrowing transaction.
- As mentioned in our earlier paper, we are concerned that temporary rights under provisional allotment letters may give rise to notification obligations which are inadvertently missed. Could an exemption be included for such temporary rights?
- Section 305(2) seems to have the effect that a person who maintains his equity percentage following a rights issue still has to make a notification of a change in interest because the person has to calculate his interest by reference to the pre-rights issue share capital of the company. Is this correct? If so, perhaps an exclusion for such circumstances should be included.
- Section 307(7) is not clear as to what is intended. As well as parents having an interest in shares held in the name of children, this language would appear to extend the notification obligation to the children because they are deemed to have an interest in shares in which parents or their parents' controlled companies have an interest. It would also cause overlapping notifications to be made by subsidiaries. We recommend this section be deleted or clarified.
- Section 320 is being amended to extend the power of investigation by the company from anything which is an "interest in shares" to cover interests in equity derivatives. The burden of complying with the notice in giving particulars relating to equity derivatives might be very considerable, and most of the information provided would be unlikely to be of interest to the listed company, since such notices are usually issued where a listed company is concerned about stake building and/or potential takeover bids. We recommend that Section 317 be restricted to interests in issued equity share capital only.
- We are still concerned as to the effect of Section 358(3) on derivative counterparties. They may have no knowledge of an order being made in relation to a derivative and seek to exercise it and then find the exercise is void. Depending on the financial status of the derivative, this might benefit the wrongdoer (i.e. the person against whom the order was made) to the

detriment of the innocent counterparty. Should not the exercise of the derivative only be prohibited for the person against whom the order is made.

- Another concern is in relation to derivatives which automatically are exercised on the last day of the exercise period. We assume the drafting in Section 358(3)(b) is not intended to catch these instruments. We note though that the ability to exercise on the last day of the exercise period (in the White Bill) has been removed, although it is not clear why.

BANKING (AMENDMENT) BILL 2000

Note: references to sections are to sections of the Banking Ordinance (Cap. 155) as proposed to be amended by the Banking (Amendment) Bill 2000.

In the context of the Securities and Futures Bill, there is an obvious need for the Banking Ordinance to be amended to dovetail the two pieces of legislation.

The Committee notes the transition period of two years in paragraph 25 of Schedule 9 to the Securities and Futures Bill in relation to "exempt" status for authorized institutions. Current exempt dealer status will be treated as amounting to "exempt" status during that period. The Committee supports the transitional period and assumes that, as a practical matter, normally, where an authorized institution has enjoyed "exempt dealer" status for a substantial period, the new "exempt" status would be forthcoming.

Section 7(2) - HKMA's powers

Section 7(2) will be amended to provide that that HKMA's regulatory powers extend to all business conducted by authorized institutions and is not limited to banking business or the business of taking deposits. However, Section 7(2)(g)(ii) may be unduly restrictive in that it only refers to the carrying on of all such business "in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors." Since exempt authorized institutions will be carrying out "regulated activities" within the meaning of the Securities and Futures Bill, we do not believe that the term "depositors or potential depositors" effectively covers other categories of investors who may be affected. Section 7(2) can be contrasted with section 58A's provisions relating to misconduct which refer to the interests of "the investing public" and "the public interest".

Section 20 - register of employees

There are specific requirements for employees carrying out a "regulated function" in relation to "regulated activities" of exempt authorized institutions. Under the amended section 20(1)(ea), their appointments and related details must be notified to the HKMA, which will then keep a register of such employees. Exempt authorized institutions will also need to demonstrate the existence of suitable arrangements for providing appropriate training to such employees in line with the expectations of the SFC for its licensees.

Section 20(4A) provides that the above register "shall be made available to public inspection". However, this would appear to be redundant since section 20(5) already provides for public access to the register maintained by the HKMA under section 20(1).

Section 58A - reprimands/discipline

The Committee recognises that it will be helpful to the HKMA to have the statutory authority to reprimand authorized institutions, publicly or privately, if guilty of "misconduct". This would mirror the SFC's power to reprimand under the Securities and Futures Bill. (There is no proposed power for the HKMA to impose pecuniary penalties - such power is vested in the SFC under the Securities and Futures Bill).

The SFC could, under the Securities and Futures Bill, revoke an authorized institution's "exempt" status, although there is no power to suspend it (except for suspension where there is no payment of fees). Revocations must be effected only after consultation with the HKMA.

This means that the disciplinary tools available in respect of exempt authorized institutions would be split, in relation to regulated activities, between the SFC and the HKMA. It therefore would be highly important for the SFC's "consultation" obligation to the HKMA to be strenuously adhered to, so as to provide a co-ordinated approach to the securities and futures regulation of exempt authorized institutions. We assume that the HKMA would, as the proposed front line regulator, in practice have the final say in such matters? We also assume that the HKMA would reciprocate in terms of consulting with the SFC before taking any disciplinary action on which the HKMA proposed to take against an exempt authorized institution. This would enhance the perception of there being a level playing field in this respect between exempt authorized institutions and registered entities.

The Committee is surprised that (save in respect of unpaid fees) there is no power of suspension available to the SFC under the Securities and Futures Bill in relation to the "exempt" status of authorized institutions, instead of just revocation. The power of suspension may be a helpful measure in the context of co-operation with other regulators.

Section 58A - "misconduct"

The definition of "misconduct" for disciplinary purposes mirrors the Part IX of the Securities and Futures Bill definition of that term. Particularly in respect of the element of the definition of "misconduct", regarding acts or omissions relating to carrying on a regulated activity which in the HKMA's opinion "is or is likely to be prejudicial to the interest of the investing public or to the public interest", we have concerns. The definition in our view adds too much potential subjectivity to determining whether there has been "misconduct", where two different regulators will be making determinations. The Committee is of the view that Section 58A, and the corresponding provision in Section 187 of the Securities and Futures Bill

should refer to the "reasonable" opinion of the HKMA or SFC, as the case may be, to introduce at least an element of objectivity to the provisions.

If the Bill remains as drafted, we assume that the HKMA would consult with the SFC before arriving at such an opinion? This should be enshrined in the Bill.

Section 59B - financial year end - criminal offence

The Committee finds it disproportionately severe that Section 59B, which contains reporting and accounting requirements, provides for breaches to be treated as strict liability criminal offences leading to potential imprisonment.

The Committee is also of the view that it is unreasonable for "every director and every manager" of an authorised institution which breaches Section 59B to be guilty of the offence.

The same concern arises in respect of other provisions of the Banking Ordinance, which might usefully be amended in the Banking (Amendment) Bill.

Section 71C - executive officers

Section 71C prohibits any person from being an "executive officer" of an exempt authorized institution without the prior written consent of the HKMA. (We assume that the HKMA will either issue guidelines setting out the criteria it will take into account in determining whether or not an applicant (i) is "fit and proper", (ii) is "competent" and (iii) has "sufficient authority" or adopt the equivalent standards used by the SFC?)

All exempt authorized institutions must have at least two "executive officers". Sections 2 and 71D effectively define an "executive officer" as a person "responsible for directly supervising the conduct of the business [in Hong Kong] conducted by the institution that constitutes a regulated activity". On its face this definition has the potential to include a large number of persons who have any responsibility for any part of the regulated activity, including, potentially, non-executive directors and various levels of management. The Committee is of the view that the drafting should be amended either:

(i) to clarify that only the officers with overall responsibility for the supervision of the regulated activities [in Hong Kong] as a whole should require the HKMA's approval before taking up office; or

(ii) that only two such approved executive officers are required and other management do not require the HKMA's approval as executive officers before taking up office.

In addition, the Committee considers it somewhat strange that it is the SFC which has the power to grant "exempt" authorized institution status but it is the HKMA

which approves the appointment of executive officers in respect of regulated activities carried on by such exempt authorized institutions.

Drafting points

Section 58A(5) - The second line should be amended to read: "….. to reprimand an exempt authorized institution ……"

Section 71C(7)(b) - This should be amended to read: "…… in relation to substantially the same regulated activity …."