SECURITIES AND FUTURES BILL
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A Summary of an Overview on the Blue Bill

by

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It would be a tall order for the Association to make any comprehensive comments on the Blue Bill of over 1000 pages published in late November last year seven weeks ago, which period happened to straddle long holidays of Christmas and the Chinese New Year. Being so pressed in time, we could merely attempt to offer a general overview on the Bill on certain matters in principle and leave specific comments to later occasions which would certainly present themselves during the following months of consultation.

It is to be commended that the present Blue Bill though resembles in bulk its predecessor, the White Bill, published earlier in the same year, has made some significant changes. Provisions which impose strict criminal liability on officers of a licensed corporation have been removed. So is the imposition of a vicarious criminal liability on a corporation for individual offences committed by its employees or agents. The subsection requiring executive officers of a licensed corporation to report to the Commission if any person attempts to prevent the proper discharge of his duties has been deleted. More thoughts have been put to sections previously triggering an automatic suspension of licence for the late payment of an annual fee or filing of an annual return. These are healthy changes and we welcome them. It is in this spirit that we propose to offer our overview on the rest of the Blue Bill.

1 Part V Licensing And Exemption

1.1 Executive officers

It is noted in section 23 in Schedule 9 to the Blue Bill that any director of a licensed corporation who is registered as a dealer, shall be regarded as licensed as a licensed representative and approved as a responsible officer of the corporation for a period of 2 years. Section 124(1)of the Blue Bill also provides:

"A corporation licensed under section 115 shall not carry on any regulated activity for which it is licensed unless -

(a) every executive director of the licensed corporation who is an individual is approved by the Commission as a responsible officer of the corporation in relation to the regulated activity;"

However, it must be noted that not all executive directors of a licensed corporation are directly concerned with the supervision of a certain regulated activity. Some may specialize in human resources, research development or company executive work. But under the present Bill all such directors have to be registered as a responsible officer. Firstly, for all practical purposes, this is unnecessary, since such executive directors are not directly responsible for supervising the entire corporation or over a certain regulated activity within its operation. Secondly, if required to be approved, such a director shall have to satisfy the Commission that

(a) he is a fit and proper person to be so approved; and
(b) he has sufficient authority within the licensed corporation .

It is not thought that by reason of his position, he is able to satisfy the Commission in respect of the above criteria.

1.2 **Exempt persons**

The introduction of an exempted-dealer status was an improvisation allowing banks to deal in securities over two decades ago and was thought to be a temporary measure. In those days banks rarely dealt in securities as a stock-brokering business. Securities appeared in their books more as a pledge for overdraft facilities than anything else. Nowadays, however, most licensed banks either by themselves or through their subsidiaries directly compete in stock-brokering business with stockbrokers. With this changed situation, however, the law of exempted-dealers which is more than 20 years old is still there, with no or little indication that this is to be brought in-line with the rest of the legislation. If ever we vouch to provide a level playing field in the securities industry in Hong Kong, it would be an absurdity to suggest that the law of exempted-dealers should remain status quo without a public debate that it is, in today's environment, really doing more good to the public than harm.

At this stage we would advance briefly three arguments in support of our proposition. Firstly, licensed stockbrokers have to comply with stringent Financial Resources Rules (FRR) which do not apply to exempted banks. During an active day's trading a licensed stockbroker governed by FRR, when he senses that he might be near the border line, has to hold his horses and stop trading to check if he has gone over the mark. This is obviously not conducive to good broker-client relationship when trading prices are volatile. Moreover, a contravention to these rules and failure to report the same may result in a suspension of the licence and upon conviction, an imprisonment for one year (section 142). An exempted bank has no such worries.

Secondly, Client money held by licensed corporation is required to be paid into segregated trust accounts. Again, licensed stockbrokers are required to comply with strict rules in dealing with client money. A breach of the rules made under this heading is a criminal offence and may result upon conviction in an imprisonment of 2 years. An exempted bank, on the other hand is not bound at all by these rules for all practical purposes. There is absolute freedom for a bank to use a client's deposit as an individual account and no rules are violated. The competition cannot be more unfair. A bank's capital can come from clients whereas for a stockbroker it can only come from himself.

Thirdly, we would suggest that there is nothing so difficult as to prevent a bank setting up a separate entity with a separate designated capital to conduct its regulated business and be governed by the existing law and regulated by the Commission as any other licensed corporation. There the competition may be fairer and the playing field more level. With the size of the capitals of licensed banks in Hong Kong, the financial resources required for such an operation would be minimal in comparison. In this proposal, the HKMA would no longer have to burden itself on something which is entirely alien to its proper monetary responsibilities and business and the Commission would have no difficulties in accommodating the same. This shall also have the obvious advantage of eliminating any chance of overlapping or underlapping in regulating the industry and by all measures, most cost-effective and fair to all participants.

2 Part VI Capital Requirements, Client assets, Audit etc.

2.1 Rules on Financial Resources, Client Securities and Money etc.

We maintain that any constructive comments can only be made when the rules are available in draft form. Because the implementation of these rules affect the basic structure as well as the daily routine of the operations of the industry, they cannot be taken lightly. Since these rules constitute a host of subsidiary legislation, it is to be stressed that market practitioners be given ample time to study them at the very early stage instead of being given a tight deadline before rushing them to the Legislative Council.

2.2 Power of Commission to appoint auditors

This power of the Commission basically arises out of two different natures of complaint against a licensed corporation or its associated entity. The licensed corporation has either, under section 156(1)

(a) failed to account to the person for any client assets held on behalf of the person by the licensed corporation or the associated entity; or

(b) failed to act in accordance with instructions given by the person to the licensed corporation or the associated entity and has failed—

(i) to account to the person for any profit that may have been secured or increased by the person had the instructions been followed; or

(ii) to compensate the person for any loss that may have been avoided or reduced by the person had the instructions been followed.

There has been no cause of dispute for section 156(1)(a) which originates from the existing provision under section 91(1) of the Securities Ordinance. However, the new provision of 156(1)(b) is controversial. It has been analyzed in detail in our earlier submission in August 2000. If a complaint arises out of client's instructions not being followed, it is only natural that, where an investigation is justified, it be conducted by the Commission to determine the truthfulness of the complaint. Where such instructions are disputed, they are more likely to be oral than written in documents. What is there to audit in the books to determine whether such instructions exist at all? It is a fundamental flaw in concept in equating client instructions to client assets. Assets can be valued in money terms, and are traceable and identifiable. Instructions can be verbal, equivocal and become obsolete by change of circumstances. We would repeat that if this becomes a statutory cause of complaint leading to an audit on the intermediary generally, it would be a nuisance to the industry and shall be taken advantage of by clients trying to settle a hard bargain against their brokers. The fact that the cost of the audit may be directed against the intermediary further doubles the effect of the consequences. Measured in terms of effectiveness in either cost or supervision, this is not a situation where the Commission should depart from its power to investigate and leave it to an appointed auditor.

2.3 It is suggested that the presumption of guilty intent be removed from sub-paragraph (3) of section 159. The reason has been given in previous submissions.

3 Part VII Business Conduct

3.1 Under section 163, the Commission may make rules requiring intermediaries and their representatives to comply with such practices and standards in their conduct in carrying on the regulated activities for which they are licensed as specified in the rules. This is another piece of subsidiary legislation. It shall be a criminal offence if a representative contravenes any specified provision of the rules and on conviction by indictment he can be imprisoned for 2 years. Our earlier comments under 2.1 equally apply here. Until the rules are available in draft no further comments can be made at this juncture.

3.2 Short Selling

Section 165 provides against short selling with certain exceptions. What it does not provide however, is the situation where short selling is effected by human error. Market practitioners will know that pressing the wrong button on the trading terminal is a frequent occurrence. It can result in short selling without any intent at all. On discovery, the transaction can be reversed later on but it does not help the fact that according to the section, an offence has been committed and there is no defence for it whatsoever. It is suggested that to cope with situations of this nature, genuine human errors should be afforded a defence. We suggest (4) be slightly amended to read as follows: "A person who contravenes subsection (1) without any reasonable excuse commits an offence and is liable on conviction to a fine at level 6 and to imprisonment for 2 years." This approach is in line with subsection (12) of section 166 on requirements to confirm short selling order.

4 Part VIII Supervision and Investigation

4.1 Section 173 deals with the supervision of intermediaries and their associated entities. The effect of this section extends the Commission's extensive supervision power to any other person whether or not connected with the intermediary or the associated entity. Also the person authorized by the Commission may require any person to answer any question regarding any record or document of the intermediary or its associated entity.

The Financial Services and Markets Act passed in UK in June 2000 has similar provisions on information gathering and investigations. The provisions however do not go beyond the limit of a person who is connected with the licensed person. And a person who is connected is clearly defined as member of A's group, (A, being the person under investigation) or in the case of a body corporate, its officer, manager, employee or agent.

Unless we see it fit that administrative powers should not be bound by any limits, it must be shown that these provisions could only involve people who are connected with the person under investigation.

5 Part IX Discipline

5.1 Misconduct

Misconduct is defined under section 186 (1) as

(a) a contravention of any of the relevant provision;
(b) a contravention of any of the terms and conditions of a licence or an exemption under this Ordinance;
(c) a contravention of any other condition imposed under or pursuant to any provision of this Ordinance;
(d) an act or omission relating to the carrying on of any regulated activity for which a person is licensed or exempt which, in the opinion of the Commission, is or is likely to be prejudicial to the interest of the investing public or to the public interest, and "guilty of misconduct" shall be construed accordingly;

Subsection 5 (c) of section 56 of the Securities Ordinance is on similar lines with (d) above, but without the phrase "in the opinion of the Commission".

If a person has not contravened any of the provisions of law and any terms and conditions of a licence, he should not guilty of anything. He should not be guilty of misconduct under 5(c) above merely for reason that it is so in the opinion of the Commission. The Commission being the executive arm of the government, is already the investigator as well as prosecutor. In the sections that follow, it performs the part of a judge to pass penalty. Here we have everything in one authority, from prosecution to jury to judge. The principle of checks and balances have a lot of work to do here.

5.2 Neglect

Section 186(2) provides that where any person is guilty of misconduct which occurred with the consent or connivance of or was attributable to any neglect on the part of a responsible officer, or a person involved in management, then the latter is also regarded as guilty of the same misconduct. Here neglect is put in the same category as consent or connivance, disregarding the element of mens rea in the mind of the person in question. Culpability may go to a responsible officer or to a person involved in management. Is it possible that we can pin-point an act of neglect in the management to a certain person in each and every case of alleged misconduct?

6 Part XI Appeals Tribunal

6.1 Section 210 S & F Appeals Tribunal

"(1) There is established a Tribunal to be known as the Securities and Futures appeals Tribunal which shall have jurisdiction to review specified decisions in accordance with this Part and Schedule 7."

Section 225 Appeals to C E in Council

"(1) A person aggrieved by an excluded decision of the Commission made in respect of him may appeal to the Chief Executive in Council against the decision."

It is apparent that if a person is aggrieved by the decision of the Commission and wished to apply to the Tribunal for review, that decision must be a specified decision as listed in Part 2 of Schedule 7. If it is not, it is not a proper matter for review by the Tribunal which cannot hear it. By the same analogy, if the matter is not one of those listed in Part 3 of Schedule 7, it is not a matter which can be heard by the C.E. in Council. If a person is aggrieved by a decision of the Commission which does not fall within those categories there is no redress for him.

By comparison, if one would look at Part IV of the UK's F.S.& M. Act, which deals with "Permission to carry on Regulated Activities", one can find the terms of reference of the Tribunal in section 55 there, which is quoted here:

"(1) An applicant who is aggrieved by the determination of an application made under this Part may refer the matter to the Tribunal.

(2) an authorised person who is aggrieved by the exercise of the Authority's own-initiative power may refer to the matter to the Tribunal."

The Commission is an executive arm of the Government and as such is vested with administrative powers. It can exercise its powers by its own initiative and make its own policies and decisions. If one is aggrieved by its exercise of its powers, in the interest of public justice, one should be entitled to appeal to an independent body without any restrictions. We therefore suggest an all-embracing right to review and appeal by an aggrieved party instead of the present definitive rights in the Bill.

6.2 Stay of Execution

The present Bill does not provide for stay of execution during review unless by application to the Tribunal..

Section 220:

"(1) a person who has made an application for review may, at any time before the review is determined by the Tribunal, apply to the Tribunal for a stay of the specified decision to which the application relates."

Before the application for stay of execution is heard, one is bound by the decision under application for review. In some instances damage may have occurred and no later review can alleviate the situation.

In contrast, the existing law is more liberal, allowing the hearing of a review under a more open-minded environment. Section 21(4) of the Securities and Futures Commission Ordinance states:" Subject to section 44(2), a decision in respect of which an appeal may be made to the Panel other that a decision to impose conditions referred to in section 19(1)(b)…. shall not come into operation until the time for making the appeal has expired or, where an appeal is made, the appeal is determined or withdrawn." We suggest that the spirit of the existing law be followed.