SECURITIES AND FUTURES BILL
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A Submission on the Blue Bill

by

Hong Kong Stockbrokers Association

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(Part One)
dated
15 February 2001

Introduction

Having been invited to make a written submission to the Bills Committee of the Legislative Council at a meeting on 3 February 2001 when interested groups are allowed oral representations, the Association has submitted a brief overview on the Blue Bill, dated 29 January 2001. The Association has also previously offered comments to the draft White Bill issued in April 2000 on two occasions, one in June and another in August 2000. We wish to mention that comments made therein are relevant here unless they are obviously superseded by the amendments made to the White Bill or our subsequent comments.

We propose to comment on the draft sections of the Bill in the order they appear in the various Parts except when they are related to other sections or subject matters where cross reference has to be made. We intend to follow these with general comments in matters of principle which do not entirely, by their own nature, come under a particular section or part in the Bill.

Re Part III

Section 22 Immunity

"(1) Without limiting the generality of section 368(1), no civil liability, whether arising in contract, tort, defamation, equity or otherwise, shall be incurred by –

(a) a recognized exchange company; or

(b) any person acting on behalf of a recognized exchange company, including —

(i) any member of the board of directors of the company; or

(ii) any member of any committee established by the company,

in respect of anything done or omitted to be done in good faith in the discharge or purported discharge of the duties under section 21 or under the rules of the company."

Subsection (3) further provides that any failure by a recognized exchange company to comply with its rules in relation to a matter does not prevent the matter from being treated as done according to the rules unless it substantially affect the rights of a person entitled to their compliance.

Thus, when the exchange company fails to comply with its rules, there will be no consequences unless a party is substantially aggrieved. It and its directors, committee members, officers are immuned from any civil liabilities provided they can show that they were in good faith. The common law approach of reasonable care is not even applicable here. In contrast, a director of a licensed corporation has a vicarious liability in respect of a wrong committed by the corporation and he is presumed to have done so. The case in point can be illustrated by Section 107(2) which provides:

"..any person who was a director of the company or body corporate at the time when the misrepresentation was made shall, unless it is proved that he did not authorize the making of the misrepresentation, be presumed also to have, by the misrepresentation, induced that other person to do such act."

This is clearly a double-standard. Both the exchange and intermediaries serve the investing public but the exchange company holds a more important role. It is a public body owing a more onerous duty towards the public than a private enterprise and therefore should set a higher moral standard in its legal responsibilities. On the contrary, the exchange company here and officers acting on its behalf, have the absolute advantage of a statutory immunity over and above the rest of the public sector. Whereas in the case of a licensed intermediary, a director acting on its behalf, is in many instances liable for its defaults both in civil as well as in criminal law personally.

The situation is the same in the case of a recognized clearing house which enjoys the same immunity under section 39.

Section 23 Rules by recognized exchange company

Under this section the recognized exchange company may make rules for the performance of its duties to operate a stock market and among other matters, sub-paragraph (e) provides for the rule-making in respect of:

"the penalties or sanctions which may be imposed by the recognized exchange company for a breach of rules made under this section;"

Subsection (3) further provides:

"The Commission may, by notice in writing served on a recognized exchange company request the company—

(a) to make rules specified in the request within the period specified in that request; or

(b) to amend rules referred to be in the request in the manner and within the period specified in that request."

Subsection (4) provides that the Commission can make or amend the rules specified in the request instead of the company.

One can therefore see that the recognized exchange company can make rules and impose penalties or sanctions for breaching its rules and on top of that the Commission may direct the company to make or amend its rules. These rules to be made would have an impact of the market including listed securities, intermediaries or the investing public in general. However, there seems not to be a mechanism of market consultation before the making of these rules or their amendment thereafter. Where penalties or sanctions for breach are concerned, we have not seen that there are expressed avenues for review or appeal. In the interest of transparency for the market and justice to be seen we suggest that a mechanism be installed so that parties affected by the rules, and in particular their penalties or sanctions, can go somewhere to have their aggrievances heard. We therefore suggest proper market consultation for the rules and avenues of appeal in the application of penalties or sanctions.

Section 29(1)

provides as follows:-

"In addition to the powers of the Commission under section 28, the Commission may, after consultation with a recognized exchange company, by notice in writing served on the company, direct the company to cease to provide or operate such facilities or cease to provide such services as are specified in the notice for a period not exceeding 5 business days."

In is remembered that Hong Kong suffered an unprecedented turmoil, if not calamity, in its financial markets when the stock exchange suspended its trading for 4 days in October 1987 in the wake of the "Black Monday" in the United States. It is not an experience that we wish to see ever again. The cessation of business in the stock market for 5 days is an enormous decision for anyone to make with possible dire consequences and we suggest that the final responsibility in such emergency situations should rest either with the Financial Secretary or C.E. in Council.

Section 35 Contract limits

Sub-paragraph (1)(a)provides:-

"..the Commission may make rules to –

prescribe limit on, or conditions relating to , the number of futures contracts which may be held or controlled, directly or indirectly, by any person, whether or not such contracts are traded on a recognized futures market or through the facilities of a recognized exchange company ;"

It is thought that matters of this nature should best be left with the market. Individual investors can assess their own financial positions in accordance with the market situation and the rules governing it. We believe that they do not wish to add to the market a further factor of unpredictability and uncertainty as to when and under what circumstances that the rules might be changed by the Commission. We suggest that the Commission, playing the role of a regulator, should try to act as an independent referee and not to be seen simultaneously to involve in setting the rules from time to time.

By the same token, we suggest that the functions and powers of the Commission under sub-paragraph (1) © in section 5:-

"promote and develop an appropriate degree of self-regulation in the securities and futures industry;"

should be removed to say section 63 to become a function of the recognized exchange controller. We believe that the promotion and the development of the securities and futures industry should be best performed by people closest to the market or carrying on a business in it, such as the recognized exchange controller and the intermediaries. The Commission, playing its regulatory role, should stand at arm's-length as a safe-guard to the welfare of the whole industry.

Re Part IV

Section 101 Interpretation

"representative"—
(a) in relation to a licensed corporation, means an individual—
(i) who is licensed as a licensed representative for a regulated activity; and
(ii) who carries on that regulated activity for the licensed corporation as a licensed corporation to which he is accredited; or
(b) in relation to an exempt person, means an individual—
(i) whose name is entered in the register maintained by the Monetary Authority under section 20 of the Banking Ordinance (Cap. 155) as that of a person employed by the exempt person in respect of a regulated activity; and
(ii) who carries on that regulated activity for the exempt person."

From the above interpretation we understand that a representative of a licensed corporation has to go through a licensing procedure in satisfying the Commission that he is a fit and proper person, touching upon his qualification, competence etc.(section 119) Such a licence granted shall be subject to conditions specified and to any other reasonable conditions as the Commission may impose (s.119(5)). The Commission may also at any time amend or revoke any condition imposed or impose new conditions as may be reasonable in the circumstances (ss.(7)).

However, in the case of an exempt person, no licensing is necessary for the representative. There is no "fit and proper" test, no condition as to his carrying on the regulated activity, and no approval is required for transfer to another employer. This is one of the many instances that exhibit the disparity between a licensed corporation and an exempt person in the industry. We shall comment in greater length on this issue as a matter of principle and it suffice here to say that unless this disparity is resolved, the notion of a level playing field is non-existent.

Re Part V

Section 115 Corporation licensing

Subsection (2)(c) requires the approval of the Commission in respect of the premises to keep records before the granting of a licence for a regulated activity. This poses a real-life problem in having to secure a premises for a certain period before the granting of a licence. It should be sufficient for the present purposes that the premises be proposed subject to confirmation upon the granting of a licence.

Subsection (4):--
"The Commission may make rules for the purposes of subsection (3)(c) that provide for—
(a) any security to be lodged and maintained by a licensed corporation with the Commission;

(b) the manner in which the security is lodged;
(c) the terms on which the security is maintained;
(d) the Commission's power to apply a security lodged and maintained with the Commission in such circumstances, for such purposes and in such manner as maybe prescribed in the rules;.."

However, as these rules are not included in the Bill, it would be impossible to comment on the section in its present form as all the details as described by the sub-paragraphs are important in determining whether these rules can be complied with and maintained to be so. Since under subsection (3) of the same section the Commission can refuse to grant a licence to an intermediary if, inter alia, these rules are not met, it is all the more crucial. We share the Law Society's view that since the Commission has the power of rule-making beyond the current powers of the SFC, it is more desirable to have the rules set out in the Bill itself. This section touches upon a matter of principle and we propose to address on it in general at a later stage, together with other sections where the same situation arises.

Subsections (5) &(6) provide that the Commission may modify or impose new conditions for the licence. There should be some checks and balances on this administrative power. The right for the decision to be reviewed does not alleviate the situation as the modification or imposition shall take effect at the time of the service of the notice or at the time specified. The present proposed review procedures do not provide for an immediate stay of execution on review or appeal, which is another subject matter to be addressed in Part XI. Furthermore, there is no clear indication at this stage as to what conditions are considered to be" reasonable". It might clear the air if the Commission can produce a policy statement in advance with full market consultation on what conditions are considered reasonable and under what circumstances they would be invoked, modified or revoked. A full disclosure of what might be expected and the reason for their modification or imposition would go some distance in removing uncertainty in this area. We endorse and fully support the view expressed by the Law Society that such administrative decisions should not take effect until the period for appeal has elapsed or the appeal has been heard

Section 118 Exempt persons

This particular issue has been raised in our overview dated 29 January, 2001 and because of its importance and for ease of reference, our comments are reproduced here. We shall extract from throughout the Bill various provisions where the treatment of an exempt person is different from the others who are not exempt, and address the issue as a matter of principle and on the Government's manifestation that there shall be a level playing field.

The introduction of an exempted-dealer status was an improvisation allowing banks to deal in securities some two decades ago and was thought to be a temporary measure. In those days banks rarely dealt in securities as a stockbroking 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 stockbroking 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.

Section 124 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;"

It has been mentioned in our overview on the Bill that not all executive directors of a licensed corporation are directly concerned with the supervision of a certain regulated activity. Some may specialize in particular areas such as human resources, research, marketing or company administration. 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, it is not thought that by reason of his duties in the corporation, he is able to satisfy the Commission in respect of the conditions for approval. Such directors would face an impasse whether to resign as an executive director or to assume authority on something which he does not specialise in in order to be registered.

Under subsection (2), an exempt person does not have to face this situation. It only has to nominate two executive officers who do not have to go through the process of approval by the Commission as responsible officers under section 125. This is another example to illustrate that in situations of this sort, there is no level playing field.

Section 125 (2) provides:--

"The Commission shall refuse to approve an applicant as a responsible officer of a licensed corporation under subsection (1) unless the applicant satisfies 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."

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It is not known at this stage what is considered to be "sufficient authority" by the Commission and without further clarification, this might create a lot of doubt and uncertainty as to who may or may not be qualified to be so approved. We wonder whether a policy statement to categorize what is sufficient and what is insufficient authority might help to eliminate any mistaken interpretation of this term.

Subsection 127(2) provides :--

"In considering an application referred to in subsection (1), the Commission may have regard to any information in its possession whether provided by the applicant or not."

We consider that it is only just and fair if there is more transparency in the Commission's decision to refuse an applicant, and in the information it has considered to arrive at such a decision. If the information in its possession, not provided by the applicant, is adverse to his application, we suggest that its source and contents are to be disclosed to the applicant so that he has an opportunity to be heard and respond. We further suggest that such information must be lawfully obtained, with its authenticity and truthfulness of contents verified. Otherwise, if the Commission acts on unsubstantiated information, justice can be miscarried.

Section 128 provides for the criteria in determining whether a person is "fit and proper" for the purposes of licensing in that Part. Subparagraph (d) provides:--

"(d) the reputation, character, reliability and financial integrity, of –

(i) where the person is an individual the person himself;

(ii) where the person is a corporation (other than an authorized financial institution), the corporation and any officer of the corporation;.."

It is considered that reputation, character etc. are abstracts based on conceptual and morality values without any recognized standards and any information on those abstract qualities can only be hearsay evidence at the best, unless the applicant is personally known to the Commission. Provisions similar to subsection (d) is not to be found in the present Securities Ordinance. In UK's recent legislation, the Authority
only takes into account a candidate's qualification, training or level of competence, which can be proved or measured

It is not clearly understood under sub-paragraph (d)(ii) why the fitness of a corporation should be affected by the reputation of "any officer of the corporation". This sub-paragraph also illustrates the different treatment of an exempt person inconsistent to the concept of a level playing field.

Section 129 provides that premises to be used by a licensed corporation for keeping records or documents have to be approved by the Commission in the prescribed manner and for payment of a fee and a licensed corporation cannot use any premises for such purposes without the prior approval of the Commission in writing. It appears that premises used for keeping records are of a paramount importance. We seem lost in understanding why this is necessary to be so. The practical difficulties have been briefly mentioned under section 115 in the licensing of a corporation. We can only try to speculate if the Commission may wish to put aspects such as security or fire hazards into its licensing considerations.

Schedule 9

Section 23 provides that any director of a licensed corporation shall be approved as a responsible officer for 2 years upon the commencement of this new ordinance. It does not provide for the situation after this 2 year period. It is suggested that the law should produce a more comprehensive "grandfathering clause" to take care of these directors in the longer term.

Section 24 similarly deals with the situation of a registered dealer's representative upon the commencement of this new ordinance. It does not provide for further registration after the initial period of 2 years. It is suggested that a proper grandfathering clause be inserted.