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**Report of the Bills Committee on**
**Securities and Futures Bill and Banking (Amendment) Bill 2000**

## PURPOSE

This paper reports on the deliberations of the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000.

## BACKGROUND

2. In March 1999, the Financial Secretary (FS) announced in his Budget Speech a legislative reform for the securities and futures market to enhance Hong Kong's competitiveness as an international financial centre and protection for investors. This reform, which would be reflected in a composite Securities and Futures Bill (SFB), aimed to create a modern regulatory and legal framework for the market. In July 1999, the Administration conducted a public consultation exercise on the major reform proposals to be embodied in the SFB and received representations from market organizations, trade and industry associations, professional bodies, the Consumer Council, academics and individual investors. In the Legislative Council (the Council), a subcommittee (the LegCo Subcommittee) was set up under the House Committee to conduct a detailed study on these proposals. Due to the far-reaching impact of the reform on the securities and futures market, the LegCo Subcommittee recommended that the draft SFB should be put to public consultation before its introduction to the Council.

3. In April 2000, the SFB was published as a White Bill and the Administration invited the public and the market to give views on the legislative proposal. The LegCo Subcommittee was reactivated to study the major new policy proposals set out in the White Bill. The LegCo Subcommittee received representations from deputations, and submitted its report to the House Committee on 23 June 2000. In view of the complexity of the SFB, the Subcommittee recommended that a Bills Committee be formed to study the Bill upon its introduction into the Council.

4. On 29 November 2000, the SFB was introduced into the Council. The Banking (Amendment) Bill 2000 (BAB), which provides corresponding changes to the Banking Ordinance for the regulation of authorized institutions regarding their conduct of regulated activities (defined in Schedule 6 of the SFB), was also introduced on the same day.

**The Securities and Futures Bill**

5. The purpose of the SFB is to consolidate and modernize ten existing Ordinances[1] regulating the securities and futures market, which were written over the course of the last 25 years, into one single ordinance. It aims to enshrine a user-friendly regulatory regime for the development of a fair, orderly and transparent market that is competitive internationally as well as attractive to investors, issuers and intermediaries.

6. The SFB is divided into 17 Parts and 9 Schedules. The provisions enshrining the major regulatory initiatives are:

(a) to establish the regulatory objectives, functions and constitutional framework of the Securities and Futures Commission (SFC) (Part II and Schedule 2);

(b) to meet new market needs by adopting a flexible approach to the regulation of automated trading services, and providing for regulatory matters concerning other market operators (Part III and Schedule 3);

(c) to enhance protection for investors through regulating the offer of investment products (Part IV, and Schedules 4 & 5);

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[1] The ten Ordinances are:
(a) the Securities and Futures Commission Ordinance (Cap. 24) (enacted 1989);
(b) the Commodities Trading Ordinance (Cap. 250) (enacted 1976);
(c) the Securities Ordinance (Cap. 333) (enacted 1974);
(d) the Protection of Investors Ordinance (Cap. 335) (enacted 1974);
(e) the Stock Exchanges Unification Ordinance (Cap. 361) (enacted 1980);
(f) the Securities (Insider Dealing)Ordinance (Cap. 395) (enacted 1990);
(g) the Securities (Disclosure of Interests) Ordinance (Cap. 396) (enacted 1988);
(h) the Securities and Futures (Clearing Houses) Ordinance (Cap. 420) (enacted 1992);
(i) the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (enacted 1994); and
(j) the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000).

(d) to improve the regulation of market intermediaries[2] by introducing a single licensing/exemption regime, to impose capital and other requirements, and to regulate business conduct in respect of market intermediaries (Parts V, VI, VII and Schedule 6);

(e) to stipulate SFC's inquiry, supervisory, investigative, disciplinary and intervening powers (Parts VIII, IX and X);

(f) to provide for appeal of SFC's decisions made in respect of its regulatees (Part XI and Schedule 7));

(g) to establish a flexible framework for setting up a new investor compensation scheme (Part XII);

(h) to combat market misconduct by establishing the Market Misconduct Tribunal as a civil regime (Part XIII and Schedule 8) and expanding the existing criminal regime to deal with market misconduct and other offences (Part XIV);

(i) to upgrade the disclosure requirements on persons and listed corporations in respect of interests in shares and other investment instruments (Part XV); and

(j) to provide for miscellaneous, repeals, transitional arrangements and consequential amendments (Parts XVI, XVII and Schedule 9).

**The Banking (Amendment) Bill 2000**

7. Under the current regulatory regime, banks, referred to as authorized institutions (AIs) under the Banking Ordinance (BO) (Cap. 155), are granted "exempt status" by SFC to conduct activities regulated by SFC notwithstanding that the institutions are supervised by the Hong Kong Monetary Authority (HKMA). The Administration proposes to put in place a new regulatory mechanism under the SFB and the BO that will apply a wider range of regulatory requirements and sanctions over the conduct of such activities by AIs. The BAB proposes changes to the BO to enhance HKMA's regulatory functions in relation to the securities business conducted by AIs.

8. The major provisions in the BAB are to put it beyond doubt HKMA's regulatory powers cover the whole of AIs' businesses (clause 3), to allow HKMA to share supervisory information with SFC in relation to exempt AIs' regulated activities (clause 11), to empower HKMA to reprimand exempt AIs

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[2] The term "intermediary" refers to "licensed corporation" or "exempt person" in the SFB.

which are guilty of misconduct (clause 5) and to provide a channel of appeal to the Chief Executive (CE) in Council (clause 12), as well as to require HKMA to keep for public inspection a register of exempt AIs' front-line staff involved in conducting the regulated activities (clause 4).

## THE BILLS COMMITTEE

9. At the House Committee meeting on 1 December 2000, a Bills Committee was formed to study the SFB and the BAB (the Bills). The membership list of the Bills Committee is in **Appendix I**.

10. Under the chairmanship of Hon SIN Chung-kai, the Bills Committee has held 55 meetings (70 sessions) with the Administration over a 14-month period. In examining the details of the Bills, the Bills Committee has met with deputations from the brokerage and banking industries, legal and accounting professions, academics and small investor groups and sought their views on the Bills. The Bills Committee has received a total of 48 submissions from 21 organizations and four individuals. The list of organizations which have given views to the Bills Committee is in **Appendix II**. The Bills Committee has also conducted an overseas duty visit[(3)] to study the financial systems in the United Kingdom (UK) and the United States (US) and to meet with major international market players in these places.

## OVERSEAS DUTY VISIT

11. Noting the progressive globalization and convergence of international financial markets, the Bills Committee has found it important to ensure that Hong Kong shall have the most effective and up-to-date regulatory regime for its securities and futures market, which is in keeping with the development of the world's major financial centres. In view of the importance of the Bills for Hong Kong to maintain its position as an international financial centre, the Bills Committee considers it necessary to study the experiences of the financial regulators and market practitioners of leading financial centres on their regulatory and legislative reforms to cope with challenges posed by globalization. The Bills Committee hence conducted an overseas duty visit to London, Washington DC, and New York in April 2001.

12. In the course of its deliberation, the Bills Committee has made constant reference to the findings from the overseas visit which it considers to be extremely useful for the examination of the Bills. Some of the observations of

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(3) The overseas duty visit was jointly conducted with the LegCo Panel on Financial Affairs and was participated by four Members of the Council. The Bills Committee deliberated on the delegation's report at its meetings on 1 and 5 June 2001. The report was tabled at the Council meeting on 4 July 2001.

the delegation which are of relevance to the Bills are highlighted in this report. The Bills Committee is aware that the systems and practices of the US and the UK could only be used as reference in view of the different characteristics of these economies from Hong Kong, including the political and constitutional setting, market size, historical development of the financial services industry, and degree of consumer awareness, etc.

## DELIBERATIONS OF THE BILLS COMMITTEE

13. The ensuing part of the report summarizes the Bills Committee's deliberation on the Bills, highlights the main policy issues enshrined in the Bills, the market's responses to the proposals, as well as the Bills Committee's observations and views. The main subjects of deliberation are as follows:

(a) regulatory objectives and functions of SFC (para. 14 to 17);

(b) SFC's autonomy and accountability to practitioners and consumers (para. 18 to 34);

(c) regulation of market operators (para. 35 to 45);

(d) regulation of intermediaries and provision of a level playing field between licensed and exempt persons (para. 46 to 62)

(e) powers of SFC (para. 63 to 91);

(f) checks and balances on powers of SFC (para. 92 to 101);

(g) combating market misconduct through civil and criminal regimes (para. 102 to 121);

(h) investor protection and enhancing market transparency (para. 122 to 145); and

(i) investor compensation arrangements (para. 146 to 150).

### (A) Regulatory Objectives and Functions of SFC

14. The operations of SFC and its constitutional framework, as provided in Part II and Schedule 2 of the SFB, largely follow the existing provisions in the Securities and Futures Commission Ordinance (SFCO) (Cap 24). The Bills Committee notes that the regulatory objectives of SFC, including its duty to maintain and promote a fair, open and orderly market in the securities and futures industry, and to protect the investing public, have for the first time been included in the legislation under clause 4. The regulatory objectives cover the

regulatory focus in broad terms, and they are to be achieved through the exercise of the detailed functions referred to in clause 5, and in the manner as set out in clause 6. The Bills Committee notes that market players welcome the inclusion of these clauses as it will provide a sound foundation for SFC to effectively regulate the market and set the benchmarks for judging SFC's performance.

15. There is however concern by an industry association over the lack of provisions in the SFB to reflect SFC's function in developing an appropriate degree of self-regulation in the industry. The industry association considers that the promotion and development of the industry should be best performed by the industry itself. In this respect, the Administration stresses that the legislation has provided the essential mechanism for the delegation of responsibility, e.g. the listing functions has been delegated to the Stock Exchange of Hong Kong (SEHK) to allow for self-regulation. The SFC's role as a regulator is to facilitate business and the promotion of the market through the adoption of a supportive, constructive and facilitative approach to regulation.

16. As regards members' comment on SFC's regulatory objective to "secure an appropriate degree of protection" for investors being not positive enough, the Administration agrees to amend clause 4(c) to read as "to provide protection" for investors during Committee Stage.

17. The Bills Committee notes that the SFB has given a wider range of powers and discretion to SFC in order to enable it to perform its functions effectively under the new regulatory framework. In studying the range of powers of SFC under the new framework, the Bills Committee has paid special attention to the accountability arrangements for SFC and the mechanism to ensure adequate checks and balances in the exercise of its powers.

**(B) Autonomy and Accountability of SFC**

18. One of the main focuses in the examination of SFC's roles and functions is how far SFC can remain autonomous in discharging its duties yet maintain a high degree of accountability to the public, in particular to practitioners and the investing public. The Bills Committee recognizes the need to strike a balance between possible abuse of powers by SFC, which imposes a burden on market participants, and too much restriction on its powers, which prevents SFC from protecting investors.

19. According to the Administration, in exercising its powers and performing its functions, SFC is expected to be both transparent and accountable, subject to adequate consideration being given to its statutory secrecy obligations. The SFB has preserved all existing accountability arrangements, which include statutory rights of appeal, judicial review, sanctions by the Council, and scrutiny by the Director of Audit, the Ombudsman and the Independent Commission Against Corruption (ICAC). In addition, the inclusion of SFC's regulatory

objectives serves as benchmarks by which the public and the industry will be able to measure SFC's performance. Moreover, the list of non-delegable functions of SFC which are important powers and functions to be exercisable only by SFC's full board has been greatly expanded to ensure that they are properly exercised by SFC. Other accountability measures include the establishment of the Securities and Futures Appeals Tribunal (SFAT) under the SFB and the non-statutory Process Review Panel (PRP) which is to review aspects of SFC's internal operations. The Administration considers that these measures are comparable to, if not beyond, international practices.

Power of the Government over SFC

20. The Bills Committee notes that Part II of the SFB has reproduced the existing provision under the SFCO whereby the Chief Executive (CE) has power to appoint the chairman and the deputy chairman of SFC who are executive directors, and other members of SFC Board (Schedule 2), to give written directions to SFC (clause 11), and to approve estimates of SFC's income and expenditure to be laid before the Council (clause 13). Clause 12 requires SFC to furnish information to FS.

21. Some members are very concerned that clause 11, which provides CE with the power to give written directions to SFC regarding the performance of its functions, may compromise the independence of SFC. There is also concern about clause 12 which provides wide power to FS to obtain information from SFC. Members are concerned that the work of SFC will be subject to political interference if the extensive power provided by these clauses were abused.

22. The Administration explains that it is responsible for providing an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre under Article 109 of the Basic Law. According to the Administration, clauses 11 and 12 have their origin in existing provisions of the SFCO and are incorporated in the SFB for the purpose of maintaining the financial stability of Hong Kong. It clarifies that under clause 12, SFC can only be required to provide such general information on the principles, practices and policy it is pursuing or adopting, or propose to pursue or adopt, in furthering any of its regulatory objectives or performing any of its functions.

23. In respect of clause 11, although no direction has ever been given by formerly, Governor, or at present, CE since the enactment of the SFCO in 1989, the Administration considers it necessary to retain the provision to enable the Government to continue to perform its role in the regulatory structure and to be accountable to the legislature and the public for effective regulation of the financial market as provided for under the Basic Law. The Government recognizes that while delegating its regulatory responsibilities to SFC, SFC plays the role of an independent market regulator and is not required to be answerable to the Government on its day-to-day exercise of regulatory powers.

Nonetheless, it remains the Government's duty to ensure that SFC does its job properly, and that ultimately the Government will be held accountable if SFC fails to perform its duty. The public also expects the Government to play an effective co-ordinating role among the various financial regulators as financial institutions are becoming increasingly involved in multi-sector services and there is a greater need to respond quickly to rapid changes in the financial system. This goes beyond the regulatory remit of SFC as its functions and powers cover basically the securities and futures market, and hence could not address matters which straddle different financial sectors and affect the economy as a whole.

24. The Administration stresses that the power under clause 11 is subject to statutory safeguards including prior consultation with the Chairman of SFC, the "public interest" test, and the requirement that written directions must be for the furtherance of SFC's regulatory objectives or performance of its functions as stipulated in clauses 4 and 5. These are all new safeguards as compared with existing legislation that provides CE with the power to issue written directions. The Administration further explains that such a reserve power is fairly common in other statutory bodies. For instance, the Mandatory Provident Fund Schemes Ordinance (Cap. 485) and the BO also empower CE to give directions to the Mandatory Provident Fund Schemes Authority and HKMA with respect to the exercise of their functions.

25. The Bills Committee notes that some market players consider the provision an effective safeguard against possible malfunctioning on the part of SFC. CE's power to issue written directions was indeed an essential safeguard recommended by the Securities Review Committee in 1988, along with its recommendation to establish a new market regulator outside the Government leading to the subsequent establishment of SFC. The provision is the only statutory tool available to the Government for the effective application of remedial measures in a critical situation, hence conducive to enhancing the regulator's accountability to the Government for proper performance of its functions in the public interest. The Bills Committee notes the Administration's explanation that CE will not resort to the power unless in unforeseen and extreme circumstances and in the public interest. In exercising his power, CE should seek appropriate advice and take into account all circumstances prevailing at the time, and will endeavour to enhance transparency in making the directions.

26. In this respect, the Bills Committee has referred to the findings of the overseas delegation which studied the accountability arrangements for regulators in the UK and the US. In the UK, the Financial Services and Markets Act 2000 (FSM Act) which commenced in December 2001 has established the Financial Services Authority (FSA) as an independent regulator for the financial market. While members of FSA Board are appointed by and may be removed by the Treasury, there is no provision in FSM Act empowering the Treasury or the executive branch of the government to give directions to FSA. Instead, other

accountability arrangements, such as empowering the Treasury to commission inquiries into FSA's regulatory matters of public concern, requiring FSA to give evidence to the Parliament periodically, and to appoint an independent review on resources management of FSA, etc, have been put in place. As regards the situation in the US, the securities and futures markets are regulated by the independent Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) respectively. Their Commissioners are appointed by the President with the consent of the Senate. They are required to make reports to the Congress and to attend hearings regularly but the Congress has no power to interfere with the work of these bodies. Neither the executive branch nor the legislature has any power of direction over the Commissioners. The delegation has observed that the UK and the US legislation have refrained from giving the executive branch of the government any overriding power to direct the activities of the regulators. The means to make the regulators accountable is not through reserve power of the government but the power to appoint and the requirement for them to make reports and give evidence to the legislature.

27. The Administration however draws members' attention to differences in the constitutional frameworks governing the operation of market regulators. While overseas governments may influence the regulators through political/administrative means which will not be transparent by merely surveying overseas statutes, the Hong Kong government considers it appropriate to adopt a transparent approach to provide in the SFB the tool for it to perform the roles as the "watchdog to the watchdog" and as the overseer of financial stability. The approach will strike a reasonable balance between protecting the public interest and ensuring the autonomy of SFC. While most members find the Administration's approach acceptable, a number of members are still concerned about the extent of the powers vested in CE. Hon Margaret NG indicates that she will propose to the Council to oppose inclusion of clause 11 in the SFB.

Composition of SFC and its mode of operation

28. The Bills Committee notes that SFC Board shall remain in its present structure to comprise an executive Chairman and no less than seven other members (Schedule 2). There are an equal number of executive (including the Chairman) and non-executive directors on the Board. Some members of the Bills Committee consider that to enhance the governance of SFC and ensure checks and balances on its powers, the number of non-executive directors should exceed that of executive directors. Reference has been made to the Board of FSA which comprises of 11 non-executive directors (including the Deputy Chairman) and five executive directors (including the Chairman). The Administration has taken on board members' view and will move CSA to stipulate that SFC should consist of a majority of non-executive directors. It also takes notes of members' view that the quorum of a SFC meeting should not be set at a fixed number in view of the variable number of SFC members. Hence,

CSA will be moved to stipulate that the required quorum of a meeting will be one third of the executive directors and one third of the non-executive directors. On the other hand, members note that SFC Chairman will have a casting vote but he has to consult FS in exercising the vote. The Administration explains that the consultation requirement is a safeguard which is adopted from the SFCO.

Accountability to practitioners and consumers

29. The Bills Committee also observes that despite it is a regulatory objective of SFC to provide protection for the investing public, there is no specific provision in the SFB setting out its obligation to specifically involve investors. According to the deputation representing small investors groups, it is not easy for small investors in Hong Kong to make known their views to the regulator. The Bills Committee understands the difficulty lies in the collation of views from consumers as the latter are not a homogeneous group and there is no strong consumer association in Hong Kong representing a sufficiently broad cross-section of consumers. On the other hand, members consider it important for SFC to hear practitioners' views and to enlist their assistance in formulating its policies and rules.

30 In this respect, some members find the arrangements in the UK particularly relevant. In the UK, a Consumer Panel and a Practitioner Panel are established under FSA as required under FSM Act. Members of the **Consumer Panel** are appointed by FSA through an open recruitment process to ensure that those appointed are experienced and dedicated to protecting consumer interests. Those appointed to the **Practitioner Panel** are representatives with intimate knowledge of the regulatory framework who are appointed through consultation with trade associations in the financial services industry. FSA has a statutory obligation to consult the two panels on its policies and practices. Where FSA disagrees with the views expressed or proposals made by these panels, it is required by law to give its reasons in writing. The two panels appear to have worked harmoniously together and as partners each putting forward its own views from their own perspectives, yet noting the concerns of the other. Some members therefore consider it necessary for SFC to set up similar statutory panels to engage the views and needs of investors and practitioners, which will also play a significant role in checking the powers of SFC. These members, in particular, consider that the proposal on the Consumer Panel worth pursuing. They note that the Consumer Panel of FSA also commissions surveys and research studies on areas of consumer concern. A formalized statutory consumer panel will not only consolidate the views of investors at large and make known their needs to the regulator, but also contribute to enhancing their understanding of the market. It will be an effective means for SFC to fulfil its regulatory objective on investor protection.

31. Nevertheless, the Bills Committee also notes SFC's current efforts in engaging investors and practitioners in formulating and implementing its regulatory objectives and proposals in the SFB to enhance these efforts. SFC fully recognizes members' views about the advantages of having a formalized consumer group to help it achieve the regulatory objective of protecting the interests of investors. To this end, a Shareholder Group has been established in early 2001, which comprises members from retail and institutional investors, professionals, academics, prominent advocates of investors rights, and the Consumer Council, to provide an organized means of engaging investors and harnessing their views on issues relating to shareholders' rights and interests. On investor education, the Investor Education Advisory Committee has been established to advise SFC on investor education issues, and the Electronic Investor Resources Centre launched to provide a wide range of investors information on-line.

32. Under clause 6 of the SFB, SFC is statutorily required to act in a way which is compatible with its regulatory objectives (two of the six are to promote understanding by the public of the operation and functioning of the securities and futures industry and to provide protection for members of the investing public) and which it considers most appropriate for meeting them. Proposals in the SFB to enhance involvement of practitioners and investors include re-enacting the existing SFC Advisory Committee and specialized standing committees under clauses 7 and 8 of the SFB. These statutory committees are to advise and assist the work of SFC and have broad-based membership capable of representing the interest of market participants including investors, market intermediaries and issuers. Working groups on specific subjects of relevant market experts and professional bodies may also be formed under clause 8 which SFC will consult during the drafting of rules, codes and guidelines.

33. In the light of members' views, SFC agrees to upgrade the current Shareholder Group to a statutory standing committee under clause 8 of the SFB. The Administration believes that the new statutory committee will facilitate investors as a group to participate more effectively in SFC consultation exercises. The work of the committee will be reported through press releases, newsletters and annual reports of SFC (the latter is required by law to be laid before the Council). Furthermore, responding to members' views about formalizing the consultation arrangement with market practitioners and the public, the Administration will move CSA (new clause 384A) to include a statutory public consultation requirement with respect to any rules before they are made by SFC (see details in para. 64 to 69) whereby SFC is also required to give its response in writing to the comments received.

34. Some members concur with the Administration that the efforts and proposals mentioned above will be able to achieve the same goal in the local context. They note that among the legislative frameworks in all leading jurisdictions, the Consumer Panel of FSA is a unique feature. Its effectiveness

has to be considered against the fact that FSA has a much wider ambit and powers than SFC. For instance, FSA has "extra-parliamentary" powers to make rules which carry legislative effect without any form of scrutiny by the Parliament.

## (C) Regulation of Market Operators

35. The Bills Committee notes that the SFB largely retains the current regulatory framework for the existing market operators namely, exchange companies, clearing houses, and exchange controllers. SFC being the regulator of the securities and futures market has the responsibility to ensure proper discharge of regulatory functions by market operators. The Bills Committee also notes that in Part III and Schedule 3 of the SFB SFC's regulation has been extended to cover two new types of operators, namely the investor compensation companies and providers of automated trading services.

Investor Compensation Companies

36. Members note that the SFB has set up a new compensation scheme to provide compensation to investors in the event of defaults by market intermediaries. The SFC may recognize an independent Investor Compensation Company (ICC) to deal with investor compensation matters. Some members note that SFC may transfer certain of its regulatory functions to ICC under clause 80 but the details of which have not been specified in the provision. The Administration stresses that SFC has the overall responsibility to manage and administer the compensation fund. Nonetheless, it recognizes member' concern that it may be inappropriate to transfer important functions such as signing the financial statements of the investor compensation fund and to submit them to FS. The Administration will move CSA to exclude these two from SFC's transferrable functions. The Administration also stresses that any transfer of functions to market operators will be subject to approval of CE and the legislature and the transferred functions can be resumed. Deliberations on the new investor compensation scheme are outlined in paragraphs 146 to 150.

Automated trading services providers

37. The Bills Committee also notes that a flexible regulatory approach similar to that of the US and the UK will be adopted to enable SFC to authorize automated trading services (ATS)[(4)] providers in Hong Kong and to regulate those ATS activities which are conducted overseas but targeted at investors in Hong Kong. The regulatory net for these overseas ATS activities is confined to the ATS actively marketed to local investors who are not their existing clients.

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(4) Automated trading services referred to in Part III means business enabling on-line trading in securities and futures contracts in a manner resembling the operation of a stock market or futures market rather than the activities of a broker.

The SFC will examine each application on the basis of the specifics of each application to determine the regulation to be applied.

38. To enhance transparency of operation, SFC has consulted the market on the draft guidelines setting out the details on the application procedures, authorization criteria, and proposed regulation for ATS providers. According to the Administration, the guidelines have conformed to the general principles of maintaining a level playing field between ATS providers and the Hong Kong Exchanges and Clearing Limited (HKEx). It is also clear that SEHK will continue to enjoy statutory monopoly to operate a stock market for the same scope as that under the existing legislation. In deciding applications from overseas exchanges for providing ATS in Hong Kong, SFC will consider whether the exchanges are subject to regulations in their home countries comparable to the regulation of exchanges in Hong Kong and consistent with international standards. In this respect, the Administration has accepted the Bills Committee's suggestion to stipulate a statutory requirement for SFC to maintain for public inspection a register of the authorized ATS providers with information including the name and business address, and conditions of authorization imposed on providers (new clause 98A), in the same manner as that SFC is providing a register for licensed persons and exempt AIs (clause 133).

Proposed regulatory framework for market operators

39. Key features of the proposed regulatory framework are for SFC to recognize suitable companies to be market operators, to impose certain statutory duties on recognized operators corresponding to their nature of operation, and to make rules for regulating recognized operators in the discharge of their duties.

*Recognizing market operators*

40. Some members note that in recognizing market operators, a number of provisions in Part III have referred to "public interest" and "interest of the investing public" separately. Having considered members' view, the Administration will move CSA to add a new clause 7A in Schedule 1 to clarify that "the interest of the investing public" shall not be contrary to "the public interest" throughout the SFB.

*Regulatory measures against market operators*

41. Regarding the proposed regulatory measures against market operators, the Bills Committee has no disagreement that restriction notices (clause 92) and suspension orders (clause 93) are important checks on the powers of the operators. There is however concern that SFC's power to direct the exchange company to cease its operation under clause 29 might be too severe a sanction as such is not available to overseas regulators except SEC in the US. Members note that the Hong Kong Stockbrokers Association (HKSbA) has suggested that this

power should rest with the Government instead of SFC. According to the Administration, the sanction under clause 29 is a reserve power which already exists in the current regulatory regime but has never been invoked by SFC. The grounds to invoke this power are clearly prescribed in the legislation, which are mainly for dealing with emergency circumstances such as natural disaster, economic or financial crisis. Checks and balances, including prior consultation with the recognized exchange company concerned, the closure period not exceeding five business days, extendable to further periods not exceeding ten business days in total, and the right of appeal to CE in Council against a closure order (clause 33) are incorporated to prevent abuse of power by SFC.

42. To maintain consistency with the right available to market operators to appeal to CE in Council on SFC's decision to impose restriction notice, the Administration has taken on board members' suggestion and will move CSA to clause 93 to provide market operators with the same channel of appeal against a suspension order imposed by SFC.

*Rule making power of market operators*

43. The Bills Committee notes the industry's concern over the power given to some market operators to make rules which carry sanctions. For instance, under clauses 23(3) and 40(4), SFC may request the recognized exchange company and recognized clearing houses to make rules, but the circumstances under which the request could be made are not specified. The industry therefore proposes that consultation with FS and the market operators concerned should be required. The Administration agrees to move CSA to that effect.

44. As regards the industry's concern over the extent of sanctions under the rules made by market operators, the Administration clarifies that these rules are not subsidiary legislation and criminal sanctions cannot be prescribed. Any change in substance to the rules will go through market consultation. The rules are also subject to SFC's approval or amendment.

*Civil liability of market operators*

45. On providing immunity from civil liability to recognized exchanges, clearing houses, exchange controllers and ICC if they are discharging their statutory duties "in good faith" (clauses 22, 39, 64 and 81), some members are concerned that the threshold for the statutory immunity is too low and opine that market operators acting with "gross negligence" or "recklessness" should not be exempted from liability. They suggest that the threshold should be raised to "with due diligence". The Administration explains that the same threshold is adopted for the existing regulatory framework and there have been no adverse comments from investors and market participants. As such, there is no compelling reason to alter the immunity threshold under the SFB. It is the

Administration's policy intention to apply the "in good faith" threshold for all statutory immunity under the SFB where performance of public duties of functions is concerned. This will include the general immunity under clause 368 to persons (including SFC staff) acting in the performance or purported performance of any function under any of the relevant provisions, as well as the specific immunity under clause 369 to auditors in assisting SFC in discharging its duties.

**(D) Regulation of Market Intermediaries**

A single licensing system

46. The Bills Committee notes that the SFB introduces a single licensing system for market intermediaries to replace the existing multi-registration system. Under the proposal, an intermediary will only need one single licence to engage in all types of regulated activities, except for the provision of securities margin financing service, which is subject to sole-business requirement. Members welcome this new regulatory initiative as it, together with other SFC initiatives, will help to reduce administrative costs and burden on SFC in the long run, as well as cutting down the compliance costs for intermediaries and permitting them to structure their activities within one licence, thereby allowing them greater flexibility in capital and resources deployment. Clients will also have the benefit of a one stop service from their intermediaries. Corporations that carry on any of the nine regulated activities defined in Schedule 6, and representatives working on their behalf are required to be licensed. Clause 118 provides that an AI is required to apply to SFC for exemption for carrying out regulated activities. FS is empowered to amend Schedule 6 by way of subsidiary legislation to cater for future development.

47. All corporations or individuals admitted to the regulatory regime must meet the "fit and proper" criteria (clause 128). These include the applicant's financial status, qualifications, experience, ability, reputation, character, reliability and financial integrity, etc. For a corporate applicant, its internal control procedures and risk management systems are also considered. To enhance investor protection, a "management responsibility" concept has been introduced. Each licensed corporation or exempt AI must have for each regulated activity at least two "responsible officers" (ROs) approved respectively by SFC under clause 125 of the SFB or HKMA under clause 9 of the BAB. In the case of a licensed corporation, all executive directors must be approved by SFC as ROs. ROs are persons responsible for directly supervising the conduct of the regulated activities of the licensed corporation or exempt AI.

Level playing field between licensed persons and exempt persons

48. Some members express serious concern about the proposed arrangements for AIs under the new regulatory framework. They consider that

to level the playing field for all market intermediaries, an AI should no longer be entitled to exempt status in respect of its conduct of regulated activities, and that the supervision of regulated activities should be carried out by SFC alone. The Bills Committee takes note of the concerns expressed by some deputations, including HKSbA and the Institute of Securities Dealers Limited (ISDL), that under the proposal, intermediaries will be subject to two regulatory regimes and that there is a risk that the regulatory standards and requirements will not be consistently applied to SFC licensees and exempt AIs. There is also concern that AIs would take advantage of their exempt status which would result in unfair competition in the securities and futures market. For example, exempt AIs are not required to comply with the stringent Financial Resources Rules (FRRs) (clause 141) made by SFC prescribing requirements on the maintenance of financial resources by a licensed corporation and the Client Money Rules (clause 145) in dealing with client money. The deputations hold the view that as securities business is no longer incidental to banking services and some banks have already registered with SFC their subsidiaries operating securities business in order to gain direct access to the stock exchange, there is no justification for continuing the granting of exempt status to AIs. Furthermore, it would not be difficult for a bank to set up a separate entity with separate designated capital to conduct the regulated activities and be regulated by SFC as any other licensed corporations. For the purpose of providing a level playing field and for better utilization of resources and clear division of responsibility, there should be a single regulator for securities business and a separate regulator for banking activities.

*Dual regulator approach versus single regulator approach*

49. In this respect, the Bills Committee has made reference to the overseas duty visit delegation which finds that the increasing engagement in multi-business by financial institutions is also a common feature in the US and the UK. But the two jurisdictions have adopted regulatory structures for their market intermediaries different from that proposed for Hong Kong. In the UK, FSM Act has established FSA as the single regulator for the entire financial services industry. The problem of inconsistency in regulatory approach therefore does not exist. As for the US, due to historical reasons, separate financial regulators are maintained for different trades. The Gramm-Leach-Bliley Act of 1999 enables the creation of a financial holding company (FHC) whose functional subsidiaries are permitted to engage in specified financial activities such as banking, insurance and securities dealing. While SEC will continue to regulate the securities activities of a FHC, the banking regulators will look at the banking activities and the Federal Reserve Board will become the "umbrella regulator" of a FHC to regulate it on a consolidated basis.

50. The delegation is of the view that in essence, both the UK and the US have adopted "the same regulator for the same regulated activities" approach. They recognize that the focus of a bank regulator should be on prudential

supervision to ensure that the supervised institutions have adequate capital and liquidity to discharge their liabilities and to avoid systemic risks, while supervision of securities business should focus on conduct regulation where attention is more directed to the day-to-day operations of the institutions and the compliance with standards and codes. It has been the common view of the regulators and market practitioners in the UK and the US that it will be more competent for those in the trade to regulate the conduct of the trade. The Bills Committee notes the delegation's view that although the supervision of AIs by HKMA does cover prudential and conduct supervision, the emphasis is on prudential supervision. HKMA has to rely on AIs themselves to carry out conduct supervision of staff. In contrast, SFC has maintained prudential supervision as the starting point, and invested much resources in conduct supervision at both corporate and individual levels. The delegation therefore considers that there is no compelling argument for AIs to remain exempted from SFC's regulatory regime.

51. The Administration nevertheless points out that the exemption in the Gramm-Leach-Bliley Act has, in fact, permitted banks to continue providing securities services in the form of trust and fiduciary activities or as an accommodation to certain customers. These activities are not subject to SEC's regulation. The US model is therefore not really a "same regulator for the same regulated activities" approach.

*Level playing field under the new regulatory regime*

52. Regarding members' concern about the exempt status of AIs, the Administration accepts that "exempt person" is a misnomer and does not reflect the proposed regulatory framework under the SFB and the BAB. AIs engaging in regulated activities are subject to a whole range of regulatory requirements and disciplinary sanctions. Despite that under the SFB, there is a new requirement that SFC shall consult HKMA in deciding whether or not to grant the exempt status (clause 118), SFC may impose conditions on the operation of regulated activities by an AI and can revoke its exempt status. The consultation requirement is appropriate as HKMA has detailed knowledge about the AI from its capacity as the banking regulator under the arrangement. To address members' concern, the Administration will move CSAs to replace the term "exempt person" with "registered institution", "exempt" with "registered", and "exemption" with "registration" throughout the Bills. Moreover, to rationalize the respective roles of SFC and HKMA in the registration of AIs for carrying on a regulated activity, CSA will be moved to clause 118 of the SFB to stipulate that SFC "shall have regard" to and "may rely wholly or partly" on the advice by HKMA in making the decision on whether to "register" the AI.

*Regulation of securities business of "exempt"[5] AIs*

53. The rectification of the misnomer on the "exempt status" of AIs still has not addressed the fundamental question of what would be the best way in regulating the AI's securities business. Some members of the Bills Committee and a number of deputations have put forward the suggestion that AIs should be required to conduct their securities business through a subsidiary. The Administration has pointed out that this arrangement would not serve the best interests of investors and does not address the supervisory overlap between HKMA and SFC. While some AIs perceive that there are commercial and management benefits in setting up a separate entity specializing in the securities business, others may choose to enter into strategic alliance with independent exchange participants in handling customer orders. The decision on whether to set up their own subsidiaries for such purpose is a business decision for individual AIs.

54. In this respect, the Hong Kong Association of Banks (HKAB) and some academics are of the view that in their capacity as "agents", AIs provide additional convenience to investors. There are a significant number of investors who maintain securities trading accounts with AIs. Investors should be allowed to choose whether to conduct their securities trading through an AI or with a broker. Given the increasing sophistication of financial markets nowadays, banking and securities business are becoming increasingly intertwined. It is difficult, if at all possible, to impose any artificial barrier between the two types of services. The Administration concurs with this view and considers that the involvement of AIs is beneficial to the overall development of the securities and futures market. To compel AIs to set up subsidiaries for their securities business would not serve the best interests of investors. At present, AIs are not required to set up subsidiaries for their insurance or MPF businesses, and HKMA remains the front-line regulator for the operations of AIs in these areas of activities. This arrangement is in line with the regulatory framework proposed in the SFB.

55. The Bills Committee has carefully examined how far the new regime could help minimize regulatory overlap. In line with international practice, HKMA exercises consolidated supervision of AIs (e.g. returns on the assets and liabilities of financial subsidiaries of AIs are required to be consolidated with those of the AIs concerned and submitted to HKMA regularly). This reflects the fact that HKMA has an overall supervisory concern over the financial subsidiaries of an AI which have impact upon the financial health of the AI concerned. In essence, it is not possible to "compartmentalize" supervisory responsibilities in such a way that the regulatory overlap between SFC and HKMA could be eliminated. The Administration considers that the current

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[5] For the purpose of this report, the "exempt AI" mentioned in the ensuing paragraphs are those AIs granted with "exempt status" under the Blue Bills but renamed as "registered institution" at Committee Stage.

division of supervisory responsibilities between SFC and HKMA is appropriate in Hong Kong's special circumstances and provides an effective solution to provide the requisite degree of protection for investors yet avoids subjecting AIs simultaneously to two regulatory processes administered by HKMA and SFC on a day-to-day basis. Members are assured that AIs will be subject to the day-to-day front-line supervision by HKMA, using the regulatory standards set by SFC, e.g. Codes of Conduct for Licensed or Exempt Persons under clause 164 of the SFB. The SFC rules and codes/guidelines will apply directly to "exempt" AIs and their securities staff unless there are equally or more stringent requirements under the BO. For instance, FRRs and the Client Money Rules will not apply to AIs as there are already more stringent requirements on initial paid-up capital, capital adequacy and liquidity, large exposure, etc. under the BO to ensure AIs' prudential safety and protection for clients' interests. The administration of the new regulatory framework will be underpinned by a revised Memorandum of Understanding between SFC and HKMA. To facilitate regulatory co-operation, clause 11 of the BAB and clause 366 of the SFB will relax the official secrecy provisions to enable exchange of regulatory information between the two regulators concerning exempt AIs on a timely basis. The HKMA currently has three specialized securities teams (each with three staff) to perform the day-to-day supervision of the securities business of AIs. These teams are of equal status and structure as those teams dealing with bank organizations. Further internal resources will be deployed if necessary to take up additional tasks arising from the proposed regime. The disciplinary regime applicable to exempt AIs is explained in paragraphs 78 to 81.

56. Regarding the brokerage industry's concern that employees who conduct regulated activities for exempt AIs are not required to be licensed by SFC, the Administration explains that under the BAB, HKMA will maintain a register of individuals who perform for or on behalf of an exempt AI any regulated function in a regulated activity. The HKMA will adopt the same fit and proper criteria promulgated by SFC in respect of its licensees for admitting AIs' representatives to the register including the examination and continuous professional training requirements. The primary responsibility for ensuring observation of the criteria rests with the management of the AI. The AI will be required to demonstrate that suitable arrangements have been put in place to ensure its representatives receive appropriate training in line with such criteria, the compliance with which will be inspected by HKMA during on-site examinations. The HKMA will conduct appropriate background checks, in particular with SFC. If such checks reveal anything negative against a representative, or he/she is not fit and proper, HKMA will use its powers under the BO to require the AI concerned to take appropriate action, such as to remove the representative concerned from the performance of "regulated activities".

57. To address members' concern that only qualified personnel will be engaged by AIs for the conduct of regulated activities, the Administration will move CSA to impose a statutory obligation on a "registered institution" to ensure

its securities staff are "fit and proper" (revised clause 118(8) of the SFB). This requirement will become a statutory condition for the registration of "registered institutions", a breach of which constitutes misconduct for the purpose of the disciplinary regime. In addition, amendment will be made to the BAB to require HKMA to maintain the public register of securities staff engaged by AIs in a manner consistent with that of the register of licensed representatives kept by SFC (revised clause 4 of the BAB).

Regulation of the market intermediaries

58. Members note that the financial and operational requirements that apply to licensed corporations and representatives and exempt AIs and their securities staff are basically set out in Parts VI and VII of the SFB. The BAB and the BO also supplement, in those parts which are considered more appropriately to be dealt with, in these legislative instruments for the regulation of an exempt AI.

59. Under the SFB, the general approach is to empower SFC to make rules (which are subsidiary legislation), or non-statutory codes or guidelines prescribing details of the regulatory requirements with sufficient flexibility for SFC to respond rapidly to market needs.

*Financial Resources Rules*

60. The most important rules to be made by SFC are the FRRs which prescribe requirements for the maintenance of financial resources by a licensed corporation. In view of the importance of these rules, SFC is obliged to consult FS before making any FRRs. Members note the industry's grave concern over the criminal sanctions for breach of certain FRRs. They share that criminal sanctions are too harsh as breaches may be triggered by volatility of the market which is beyond the control of corporations. In this respect, the Administration clarifies that a licensed corporation will only commit an offence in respect of the maintenance of financial resources requirements if it fails to notify SFC and cease business when it is aware that it no longer maintains the required amount of financial resources, or continues business without complying with conditions imposed by SFC. In order to facilitate operation of licensed corporations, SFC will impose conditions orally. Nonetheless, to address the concern of the brokerage industry that orally imposed conditions may cause misinterpretation, the Administration will move CSA to allow licensees to request to have the imposition of conditions in writing (new clause 142(7A)).

*Other regulatory requirements*

61. Other important rules to be prescribed by SFC include, inter alia, stipulating the requirements for licensed corporations in handling client securities (Client Securities Rules (clause 144)), and money (Client Money

Rules (clause 145)); and those related to the keeping of accounts and records (clauses 147 and 148), and audit related matters (clauses 149 to 159).

62. The Bills Committee notes the brokerage industry's concern about clauses 155 and 156 where SFC is given wide power to appoint an auditor to examine the accounts of a licensed corporation on its own initiative or upon application by any person, and to recover the expenses from the corporation. SFC clarifies that in practice it will consult the corporation in the appointment of auditor, and experience reveals that there is no difficulty in finding auditors acceptable to both SFC and the corporation. As to whether clause 156 could easily be abused by clients of the corporation with unjustified complaints, the Administration explains that safeguards against frivolous applications are provided under the clause. For example, SFC must satisfy that the applicant has a good reason and he must verify all statements in his application by statutory declaration, and where appropriate, SFC may order the applicant to bear the cost for appointment of the auditor. To address the concern about unreasonable cost to be borne by the corporation, the Administration agrees to introduce a CSA to require SFC to give the concerned corporation an opportunity of being heard before any cost order is imposed. The Administration also takes on board members' suggestion to limit the audit cost to be payable by the applicant to that reasonably incurred for ascertaining matters to which his application relates.

**(E) Powers of SFC**

63. The Bills Committee notes that SFC, in addition to having the power to make rules and non-statutory codes and guidelines, has been given a wider range of powers and discretion under the SFB. The intention, as the Administration explains, is to enable SFC to perform its functions effectively under the new regulatory framework. To ensure that the powers given to SFC are fully justified and appropriate, the Bills Committee has studied in detail the following powers of SFC:

(a) the powers to make rules and publish codes and guidelines for regulating the conduct of market practitioners;

(b) the inquiry, inspection, surveillance and investigative powers in respect of suspected misconduct of listed corporations and non-compliance of regulatory requirements by market intermediaries, or their related corporations;

(c) the powers to discipline market intermediaries and practitioners for misconduct or for conduct that reflects on their fitness and properness; and

(d) the powers to protect the interests of the investing public by intervening in the business or affairs of licensed corporations.

Rule-making power

64. The Bills Committee notes that the SFB has provided SFC with power to make specific rules for the proper discharge of its regulatory functions in particular for prescribing detailed regulation of market practitioners. These include FRRs, the Client Securities Rules and Client Money Rules as well as others prescribed under various parts of the SFB. Clause 384 further provides SFC with the general rule-making power for miscellaneous matters and those necessary for the furtherance of SFC's regulatory objectives and performance of its functions. A list of the subsidiary legislation needed to be made for commencement of the SFB is given in **Appendix III**.

65. Various provisions in the SFB also provide that SFC may publish codes or guidelines for guidance to intermediaries in complying with regulatory requirements. Clause 385 provides SFC with the general power to issue codes and guidelines. Although these instruments do not have legal effect, SFC reiterates that compliance will be secured by virtue of the negative implications of breaches on the assessment of the fitness and properness of the market practitioners. These codes and guidelines are often preferred to rules as they are more flexible and may be expressed in simple market language to promote good practice. A list of the non-statutory codes and guidelines to be made under the SFB is provided in **Appendix IV**.

66. Some members, however, notice that under the SFB, some requirements which are currently dealt with in the primary legislation will be stipulated by way of rules made by SFC. As pointed out by the dealers and stockbrokers associations as well as the Law Society of Hong Kong (LSHK), the SFB has provided SFC the power to create criminal offences punishable with substantial fines and imprisonment, and this can be done without market consultation. These members and organizations therefore consider it necessary for any matters that will attract criminal sanctions to be set out in the Bill itself, or any rules proposed to be made by SFC that will attract criminal sanctions to be subject to statutory public consultation, and scrutiny by the Council or approval by CE in Council.

67. In this respect, the Administration explains that the rule-making approach is adopted to prescribe detailed and technical requirements. The approach is consistent with modern securities legislation in other jurisdictions. Effective regulation depends upon the regulator having the flexibility to address changing market practices and global conditions by proposing amendments to the rules rather than amendments to the primary legislation. The Administration reiterates that such rule-making power is already a part of the existing law. Under the SFB, all "rules" made by SFC, CE in Council or Chief Justice will be subsidiary legislation (unless expressly provided otherwise which will then carry no legislative effect and can prescribe no criminal sanctions) and will require

negative vetting by the Council. The Administration clarifies that the penalty maxima for contravention of any SFC rules have been stipulated in the SFB. To address market concern that offences of certain rules will create strict liability, the Administration has also proposed changes to the effect that for most of the rules made under Parts VI and VII of the SFB, an offence will only be committed for breaches of these rules if the relevant act or omission is done without reasonable excuse or with intent to defraud (e.g. clauses 142(14) and 145(4)).

68. The Administration also points out that as a standard practice, SFC does conduct consultation with the market on emerging draft subsidiary legislation, codes and guidelines. The SFC has already started preparing the key rules and guidelines to be made under the SFB and has formed various working groups with market practitioners, and where appropriate, professional bodies to seek market input at an early stage in drafting those which are of more concern to the industry. Most of the draft rules, codes or guidelines have been put to the market for consultation.

69. Members welcome the enhanced checks on SFC's rule-making power where SFC has to consult FS prior to making rules relating to the furtherance of SFC's regulatory objectives and performance of its functions under clause 384(2). They further support the Administration's proposal to add a new clause 384A to impose a statutory requirement for SFC to consult the public before making any rules.

Investigative and supervisory powers

70. The Bills Committee notes that Part VIII of the SFB provides the inquiry, inspection, surveillance and investigative powers of SFC in respect of suspected misconduct of listed corporations and non-compliance of regulatory requirements by market intermediaries, or their related corporations. These provisions are essentially carried from the existing law. Members note the support expressed by the Hong Kong Bar Association and the Consumer Council for the enhanced investigative and supervisory powers of SFC to address current deficiencies and remove ambiguities.

*Conduct of preliminary inquiries*

71. In respect of SFC's power to conduct preliminary inquiries into suspected crime or misconduct in listed corporations, members are aware of the concerns expressed by deputations, in particular the Hong Kong Society of Accountants (HKSA), over the scope of SFC's power to obtain audit working papers under clause 172, and impose criminal sanctions on persons for failure to produce the required information or give explanations. Members share the view that although there is the "reasonable excuse" proviso, the threat of heavy criminal liabilities could nonetheless be used to enforce onerous or unreasonable requests from SFC.

72. The Bills Committee notes in accordance with clause 172, SFC has to certify in writing that it has "reasonable cause to believe" that the documents sought from third party are related to the affairs of the listed corporation under inquiry, in the person's possession, and relevant to the grounds for the inquiry. The Administration also explains that the offences in clause 172 are intended to deter non-compliance by any person (e.g. company directors, auditors, bankers and transaction counterparties) from whom SFC may request information under the clause. To secure a conviction for a failure to produce documents, the prosecution must prove beyond reasonable doubt that a person has failed to produce the required documents and he has no reasonable excuse for the failure to do so. In case of non-compliance, SFC will usually first go to the Court for an order to compel compliance (clause 178) rather than resorting to criminal prosecution. The Bills Committee also notes that in order to protect the third party providing the information, SFC is bound by clause 366 (in Part XVI) to preserve the secrecy of information it has gathered in the course of performing its statutory functions. Clause 368 further provides that no person will incur civil liability by reason only of complying with a requirement to produce or to explain records or documents to SFC.

73. To address the concern of the accounting profession that SFC's power is not intended for "fishing expeditions", SFC advises the Bills Committee that it is prepared to particularize the nature of any documents requested and modify the scope of the request if an auditor has genuine and reasonable concerns about the scope of documents requested. Members understand that SFC is working with HKSA to prepare guidelines to its members on compliance with requests from SFC for audit working papers.

*Conduct of supervisory inspections and investigation of misconduct*

74. Clauses 173 and 174 empower SFC to conduct supervisory inspections of licensed or exempt persons and their associated entities to ensure they comply with regulatory requirements. It provides that SFC may obtain information from third parties where it is relevant to the inspection. Members note that to safeguard the interests of the third parties, SFC may only exercise the power if the information cannot be obtained from the intermediaries, its related corporations or associated entities in the first place. Clauses 175 and 176 provide SFC with powers to investigate possible crime, misconduct or conduct prejudicial to the public interest or the interest of the investing public, within its regulatory scope.

75. In relation to the concern expressed by members and market players about possible self-incrimination against a person who is obliged to provide information or explanation under Part VIII, the Administration explains that current provisions under the SFCO also oblige a person to provide self-incriminating information in a preliminary inquiry into the misconduct of listed

corporations and investigation by SFC. Clause 180 has already been suitably amended to protect the person from self-incrimination by providing that the information he/she so provides must not be used in any criminal proceedings against him/her except in circumstances such as perjury. As in existing practice, SFC is obliged under clause 180 to inform and explain to the person concerned of his/her rights before the inquiry or investigation process begins, including the right to claim privilege against self-incrimination.

Disciplinary power

76. Part IX of the SFB consolidates, revises and expands the existing disciplinary framework to enable SFC to take disciplinary actions against licensed persons and exempt AIs for misconduct[6] or for conduct that reflects on their fitness and properness. Disciplinary sanctions available under the existing legislation are private or public reprimand, suspension and revocation of licence. Members note that clause 187 has introduced the following three new types of intermediate disciplinary sanctions:

(a) partial suspension or revocation of licence which aims at providing SFC with the flexibility to tailor the scope of suspension and revocation to affect only a certain part of the business activities of a licensed corporation;

(b) disciplinary fines under which SFC can impose fines on an intermediary which has profited from its improper conduct the amount not exceeding the greater of $10 million or three times the profit secured or increased or loss avoided as a result of the relevant misconduct; and

(c) prohibition order where SFC is empowered to prohibit a licensed corporation or a licensed representative from applying to be licensed, and a person from applying to be approved as a responsible officer of a licensed corporation for a specified period.

77. According to the Administration, the BO and the BAB supplement the disciplinary framework for exempt AIs. Clause 5 of the BAB empowers HKMA as the frontline regulator to reprimand an exempt AI for its misconduct. The HKMA may also withdraw the consent to the appointment of an executive officer of an exempt AI if it is no longer satisfied that he/she is a fit and proper

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[6] Misconduct as defined in clause 186 of the SFB means: a contravention of any of the relevant provisions (defined in section 1 of Schedule 1), or any of the terms and conditions of a licence or an exemption which, in the opinion of SFC, is or is likely to be prejudicial to the interest of the investing public or to the public interest. For the BAB, "misconduct" is similarly defined under clause 5.

person, or has sufficient authority within the AI to be an executive officer under clause 9 of the BAB. Furthermore, HKMA, can remove the name of an employee of the AI from the public register if he/she is considered not fit and proper or not in compliance with the requirements imposed on him/her under the Codes of Conduct made by SFC under relevant provisions of the SFB.

*Disciplinary sanctions and appeal mechanism for licensed persons and exempt persons*

78. Some deputations are concerned about the differences in the disciplinary sanctions and appeal mechanism for persons regulated by SFC and exempt AIs and their securities staff. They note that while SFC's licensees are subject to all types of disciplinary sanctions prescribed under the SFB, the only sanction applicable to exempt AIs under the Bill is the revocation of exempt status. The three new types of disciplinary sanctions i.e. partial suspension or revocation of licence, disciplinary fines and prohibition order do not apply to exempt AIs. There is concern as to how consistency in the quality of services provided by SFC licensees and exempt AIs for the purposes of providing a level playing field and enhancing investor protection can be ensured. As regards appeals against decisions of SFC, some members are concerned that exempt AIs and SFC licensees are subject to two different appeal mechanisms. While the SFB provides for decisions made by SFC in respect of licensees to be appealable to SFAT; under the BAB, an aggrieved AI could only appeal to CE in Council the operation of which is less transparent than that of SFAT.

79. To address the above concerns, the Administration proposes a revision of the disciplinary sanctions applicable to exempt AIs. Under these revised proposals, exempt AIs and their securities staff will be subject to the same range of sanctions as SFC licensees, namely revocation, suspension, prohibition orders, public and private reprimands and fines. The specific provisions are set out as follows:

(a) For individual front-line representatives of exempt AIs who have committed an act of misconduct or are considered not fit and proper, HKMA will be empowered to take their names off the register, after consultation with SFC. This includes removal from the register for a specified period of time and effectively amounts to revocation and suspension of the representatives from conducting regulated activities on behalf of the exempt AI (revised clause 5 of the BAB);

(b) The SFC will be empowered, after consultation with HKMA, to suspend or revoke the exemption of an exempt AI on grounds of misconduct or fit and proper considerations (new clause 189A of the SFB); and as the authority for granting consent to executive officers, HKMA will be empowered, after consultation with SFC

to suspend or withdraw the consent granted to the appointment of executive officers of exempt AIs (revised clause 9 of the BAB);

(c) The sanction of reprimand will be extended to individual staff of exempt AIs, including the executive officers, senior staff involved in the management of the regulated activities, and front-line staff engaged in such activities. This power will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB);

(d) Prohibition orders will be introduced as an additional sanction for exempt AIs and their securities staff, which means that AIs may be prohibited from applying for exempt status while individuals may be prohibited from engaging in the regulated activities. This power will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB); and

(e) Exempt AIs and their staff involved in the regulated activities will be subject to a pecuniary fine as a possible sanction under the SFB. The power to order a payment of fine will be exercised by SFC after consultation with HKMA (new clause 189A of the SFB).

80. In the light of the revised sanctions, the Administration also proposes to standardize the appeal channels by routing all appeals against decisions in respect of the regulated activities of exempt AIs and their relevant staff to SFAT. Appealable decisions made by SFC and HKMA in respect of AIs will be included in Schedule 7 to the SFB. The SFAT, being the single appellate body, will ensure consistency in the nature and degree of disciplinary sanctions applied by the regulators in similar circumstances.

81. Members generally welcome the Administration's proposal to revise the disciplinary sanctions applicable to exempt AIs and to standardize the appeal channels for exempt AIs and SFC licensees. They believe that this will partly address the concern of market intermediaries about the need to maintain a level playing field in the securities and futures market.

*Other circumstances for disciplinary action*

82. Other circumstances for disciplinary action applicable on licensed persons and exempt persons are stipulated in clauses 188 and 190 respectively. These circumstances include financial difficulties, conviction of a criminal offence, and mental illness suffered by the person, etc. Members note that in addressing HKSbA's concern about mental incapacity of one of the directors of a licensed corporation as a strict ground for disciplinary sanction (clause 188), the Administration will amend the clause to expressly provide that "mental

incapacity" can be a disciplinary ground only if it affects the fitness and properness of the corporation concerned. As regards the situation for exempt AI, members understand that under the BO mental incapacity will call into question the fitness and properness of a director of an AI which will result in withdrawal of consent given to the director or cast doubt on whether the AI should remain authorized.

*SFC's discretion in exercising its disciplinary power*

83. The Bills Committee has examined some members' concern about the "centralization of power" in SFC and whether adequate safeguards have been put in place to ensure that the disciplinary functions are exercised fairly, transparently and consistently. The Administration maintains that as SFC is the specialist body charged with the responsibility for licensing and supervising market intermediaries, it is appropriate that it also has the ability to discipline if there is any breach of requirements. This is necessary for protecting the investing public and for proper regulation of the market. To ensure that the disciplinary functions are carried out effectively and impartially, there is a functional separation between the supervision and discipline functions in SFC. The requirements expected of intermediaries have been set out clearly in the primary legislation, SFC rules, codes and guidelines, which are subjects of extensive market consultation. Only breaches of the legislation may result in criminal sanction if so stipulated therein. In these cases, the prosecution will be decided by the Department of Justice, and sanctions will be imposed by the Court.

84. In order to ensure that any disciplinary decision is informed, balanced and transparent, clause 191 requires SFC to observe the procedural requirements of providing the relevant party an opportunity of being heard before coming to the final decision, and giving written notice in respect of any disciplinary decision and the reasons therefor. In addition, any party aggrieved by any of the disciplinary decisions of SFC made against him can appeal to SFAT which is empowered to review both the merits of a SFC decision and its procedural regularity and legality, or seek redress through judicial review. According to the Administration, the SFB already contains sufficient safeguards to ensure that SFC acts professionally and impartially and makes reasoned, proportionate decisions. The range of disciplinary sanctions as well as the review mechanism under the SFB is comparable with those in other leading jurisdictions. The newly established PRP will also help ensuring that SFC will establish due process and procedures for proper exercise of its disciplinary power.

85. The Bills Committee also notes some deputations' opinion that SFC has too much power in determining whether a person was guilty of misconduct on "public interest" grounds (clause 186(1)(d)). These deputations consider that SFC should not have a residual power to find people guilty of misconduct on the strength of "its own opinion" alone. In this regard, members have questioned the

need to retain the reference to "public interest" and "in the opinion of the Commission" in clause 186(1)(d). According to SFC, no disciplinary action has been taken on the ground of "public interest" alone over the past two years. Experience has however shown that the conduct of individual regulatees may affect the interest of investing public and the interest of public in general. The Administration therefore considers that there is a need to retain the reference to "public interest" in the relevant provisions to cover extreme cases. It also assures the Bills Committee that SFC is obliged to consider whether "misconduct" has occurred in the light of the codes or guidelines issued. These are the standards of ongoing conduct it expects of licensed persons. To address the concern, the Administration will move CSA to expressly include the obligation in the SFB (new clause 186(3)).

*Disciplinary fines*

86. As regards disciplinary fines, the Bills Committee is aware that some market practitioners have submitted that fines should be imposed according to a pre-defined tariff. The Administration however considers it artificial and difficult to provide a pre-defined tariff, given the need to deal with the large variety of misconduct committed in different circumstances. Neither the US nor the UK regulators have adopted a strict tariff schedule of fines.

87. Regarding the level of fines to be imposed, the Administration takes the view that the maximum fines set out in the SFB serves the purpose as an intermediate disciplinary sanction and is appropriate having regard to the practices in other leading jurisdictions. However, having regard to the views expressed by members on the need to enhance transparency in determining the level of fines to be imposed, the Administration agrees to add the new clause 191A to provide for "fining guidelines" for application both to a licensed corporation and an exempt AI. The provision states expressly that SFC shall have regard to factors including impact of the conduct on integrity of financial market, the level of intent, the loss to the affected parties, and the benefit to the party responsible for the conduct, in considering the amount of fines to be imposed. The Bills Committee welcomes the proposed amendment.

*Information to be relied on for the purpose of disciplinary action*

88. Members are aware of a market comment that SFC should not rely on illegally obtained information which comes to its possession in coming to a disciplinary decision (clause 193). SFC holds a different view and points out that illegally obtained evidence may be admissible for the purpose of criminal proceedings. The overriding principle is that the disciplinary proceedings should observe the rules of natural justice. As disciplinary decisions are of an administrative nature, evidence capable of logical proof may be used. SFC would judge whether the information is trustworthy and whether it is fair to use the information. SFC is obliged to give the concerned party an opportunity of

being heard, and to disclose the information that it relies upon in disciplinary proceedings. The various appeal channels are also available for any party aggrieved by the decision of SFC made against him. Hence, the Administration maintains that SFC should be allowed to make use in its disciplinary proceedings any information it has obtained.

Intervention powers

89. Part X of the SFB empowers SFC to protect the assets of the clients of a licensed corporation when there is a risk that the assets may be dissipated, misappropriated or improperly dealt with. These powers enable SFC to intervene in the business and operations of licensed persons (clauses 196 to 204), to apply to the Court for a range of orders and other reliefs against licensed persons, listed corporations and certain other persons (clauses 205 to 207).

90. Members note the concern expressed by some deputations, in particular HKSbA, about clause 197 which imposes restriction on a licensed corporation dealing with client's property to preserve the property, and clause 199 which requires the corporation to transfer custody of the property to SFC before the latter applying for Court orders. Some members consider that the power to issue restriction notices should not extend to property owned by persons other than a licensed person as it is difficult to understand how the corporation can deal with property not owned by it. It is also not clear how clause 199 can be applied to "any other person". The term "any other person" is not defined and there seems to be no link with the licensed corporation. Moreover, only the title deeds but not the immovable assets, such as land can be transferred.

91. The Administration maintains that from practical experience in protecting investors, it is important for SFC to be able to impose restrictions on dealings with property which may be connected with the business of the licensed corporation but which may not be under the control of the licensed corporation, e.g. under the control of another corporation which may be related to the licensed corporation such as a nominee or custodian. Nevertheless, in the light of the comments received, the Administration agrees to propose CSA to restrict the definition of "relevant property" in clause 197. The Administration also takes note of the concerns about the practical application of clause 199 and the extent of the powers conferred on SFC. Having considered the fact that clause 206, which enables SFC to apply for Court orders and injunctions with respect to client property, already achieves the objective behind clause 199 (i.e. to take urgent action to prevent the dissipation of relevant property), the Administration will move CSA to delete clause 199 and invite SFC to rely on clause 206 to protect client property. The Bills Committee welcomes these proposals.

**(F) Checks and Balances on Powers of SFC**

92. In the course of examining the various powers conferred on SFC under the SFB, some members have expressed grave concern about the extent of the powers of SFC and whether SFB has incorporated adequate checks and balances to guard against any abuse of such powers. According to the Administration, in exercising its powers and performing its functions, SFC is expected to be both transparent and accountable. For example, the intervention powers can only be exercised by the full board of directors of SFC, written notice with reasons must be given, there is a right of appeal to SFAT, the power is subject to judicial review and complaint to the Ombudsman, etc.

93. The Bills Committee however has considered it necessary to also study the entire checks and balances mechanism in the new regulatory regime in addition to looking at safeguards against abuse of individual powers of SFC. According to the Administration, the SFB has preserved all existing accountability arrangements (refer to para. 19 for details). In addition, subjects of the decisions and actions by SFC have the right to appeal to SFAT in respect of most SFC decisions and can resort to judicial review. There are also checks by the Ombudsman and ICAC as well as reviews by PRP.

Process Review Panel

94. The Bills Committee notes that in order to enhance the transparency of SFC and to make sure that its internal procedures are fair and reasonable, the Administration has established PRP to serve as an additional check on the exercise of its powers. Some members however have reservation about the effectiveness of PRP. They find that PRP is an administrative arrangement with no statutory power. The scope of its functions is also limited. They opine that if PRP is to be a part of the checks and balances mechanism, it should be included in the SFB as one of the statutory bodies with clearly defined roles and functions. This arrangement will also enhance its transparency and credibility.

95. The Administration maintains that PRP should remain an independent and non-statutory body to review the fairness and reasonableness of SFC's operational procedures on an ongoing basis and to ensure that those procedures are consistently adhered to. It further stresses that the establishment of PRP ahead of the enactment of the SFB demonstrates the Administration's resolve to enhance the accountability and transparency of SFC's operations, as well as SFC's determination to win public confidence and trust. This is ground breaking for SFC, as a similar set-up is not found among its counterparts in overseas jurisdictions. The Administration sees no added benefits for making PRP statutory. The experience of PRP since its establishment in November 2000 demonstrates that a high degree of flexibility is important for the Panel to develop its work. The Administration considers that effectiveness is not hinged

on whether it is statutory or not. Similar set-ups in the Government, such as the Education Commission and the Transport Advisory Committee, have functioned effectively although they are not statutory bodies. The Administration believes that through its regular reports to FS on its review findings and recommendations, and publication of these reports to the fullest extent permitted within the statutory constraints of secrecy and confidentiality, the public will be better able to judge the performance of SFC in conducting its regulatory functions.

Securities and Futures Appeals Tribunal

96. As an improvement to the mechanism of checks and balances to the various powers of SFC, Part XI of SFB establishes an independent statutory SFAT to provide an appeal channel for aggrieved parties to decisions made by SFC. The SFAT will conduct hearings to review the merits of important SFC decisions. Members note from the Administration that SFAT is comparable with the merit review regimes in the US, the UK and Australia.

*Establishment of SFAT and its procedures and powers*

97. The SFAT will be chaired by a full time judge with a panel of members who are experienced and respectable members in the market, business and legal and accounting professions. The Chairman and the panel of members of SFAT will be appointed by CE. The appointment of the Chairman will be made on the recommendation of the Chief Justice. For the hearing of each case, the Chairman will sit with two lay members appointed by the Secretary for Financial Services (SFS) from the panel. The SFC decisions, except those required to be urgently effected for investor protection such as the decision to impose condition in case of non-compliance with the FRR, will not take immediate effect until the time for appeal has lapsed. There is a safeguard whereby a person may apply for a stay of execution of such SFC decisions pending determination of the appeal. The SFAT must hear such an application as soon as practicable and a stay may be granted upon conditions which SFAT considers appropriate.

98. To ensure fairness to the aggrieved party, SFAT must give the party a reasonable opportunity of being heard and make its findings on standards applicable to civil proceedings in a court of law. The aggrieved party is also conferred with a right of appeal on a point of law to the Court of Appeal (CA) with respect to the determination of SFAT. The CA may allow or dismiss the appeal, vary or substitute the decision or remit the matter to SFAT with such directions as it considers appropriate.

99. In response to suggestions of market practitioners and members, the Administration will introduce a number of improvements regarding the operation of SFAT. These include:

(a) to clarify that more than one tribunal may be established to hear more than one review at a time so as to clear backlog of appeal cases. Each tribunal will operate independently as a separate tribunal with same powers and functions and has its own chairman and members (revised clause 210(5));

(b) to delete the provision for "temporary members" (clauses 1, 16 and 20 in Schedule 7) intended to replace ordinary members who becomes incapacitated in the course of a tribunal proceedings. By virtue of the amendment, a new tribunal will have to be appointed to hear the appeal under such circumstances. This will ensure a fair hearing for the aggrieved party;

(c) to put a statutory requirement for CE to consult the Chief Justice before he may remove the Tribunal Chairman from office (revised clause 5 of Schedule 7), and for SFS to seek the Tribunal Chairman's recommendation on appointment of panel members to hear a review (revised clause 11 of Schedule 7);

(d) to empower SFAT to extend the appeal period of 21 days to permit late appeal for good cause, such as genuine hardship on the part of the appellant (new clauses 211(3A) and (3B)); and

(e) to empower SFAT to stay the execution of its own decisions after the determination of the review if it is likely that an appeal against its decision will be lodged and if SFAT considers a stay appropriate (new clause 220A).

*Scope of appealable decisions*

100. Compared with the existing appeal system, the number of appealable SFC decisions has been increased significantly to 64 (now 72 with the decisions made in respect of exempt persons also appealable to SFAT) covering a wide range of matters including disciplinary decisions against licensees. The Bills Committee however notes a market comment that it will be a more open and clearer arrangement to make all decisions of SFC appealable to SFAT subject to the general criteria excluding those that cannot be appealed to SFAT and some specified exceptions. The Administration maintains that the present approach of itemizing all appealable SFC decisions in Schedule 7 is more practical and provides greater certainty, and will eliminate scope for tactical appeals aimed at delaying timely regulatory actions taken by SFC. This is also the approach adopted in various appellate regimes in existing legislation such as the appeal mechanism under the Education Ordinance (Cap. 279). Clause 227 has empowered CE in Council to amend the list of appealable decisions by way of subsidiary legislation to cater for inclusion of any additional appealable matters in future. The Administration also explains that not all SFC decisions are

suitable for appeal to SFAT. These include intermediate decisions with no substantial conclusive effect on the rights or interests of persons, decisions followed by application to the Court, decisions involving broad policy, and decisions subject to other specialized merits review appeal mechanism such as the Takeovers and Mergers Panel established under the SFCO.

101. As explained in paragraph 80, SFAT will handle appeals against decisions in respect of intermediaries, whether licensed persons or exempt persons. This amendment is to address the concern of the brokerage industry and members about the discrepancy in appeal mechanism for licensed persons and exempt persons and their securities staff. The SFAT being the single appellate body will have at its disposal the full range of disciplinary sanctions administered by both SFC and HKMA in considering an appeal by an exempt AI or its securities staff. On compensation decisions made by SFC or ICC in the future, the Administration has also taken on board members' view that these decisions should also be appealable to SFAT and will introduce CSA to this effect accordingly. All decisions appealable to SFAT will be defined collectively as "specified decisions" and itemized in Part 2 of Schedule 7.

**(G) Combating Market Misconduct**

Dual civil and criminal regimes to deal with market misconduct

102. Under the existing regulatory regime, acts of market misconduct which are criminal offences only include false markets and trading, restrictions on fixing prices for securities, and false or misleading statements. These offences are limited in scope and have proven inadequate in effectively deterring market misconduct that are prejudicial to the interest of investing public. For instance, the criminal standard of proof (i.e. to prove the commission of a crime beyond reasonable doubt) and the restrictive rules of criminal evidence have inhibited successful criminal prosecutions of blatant acts of market manipulation. On the contrary, the existing civil regime for dealing with insider dealing under the Insider Dealing Tribunal (IDT) has been relatively successful since civil procedures are adopted in determining whether insider dealing activities have taken place and the Tribunal is not bound by the civil or criminal laws of evidence. Most importantly, IDT is empowered to make pecuniary fine orders of an amount up to three times the profit made or loss avoided as a result of the insider dealing. Thus, the Administration proposes to establish a civil system in Part XIII of the SFB to address market misconduct by extending the current civil tribunal system of IDT and setting up a Market Misconduct Tribunal (MMT) to cover six types of market misconduct, namely insider dealing, false trading, price rigging, stock market manipulation, disclosing information about prohibited transactions in securities and futures contracts, and disclosing false or misleading information about securities or futures contracts inducing transactions in those products.

103. Nevertheless, in the course of developing this proposal, the Administration has been advised that the jurisprudence developing before the European Court of Human Rights involving human rights protections similar to those under the Basic Law and the Hong Kong Bill of Rights Ordinance cautions that pecuniary fine orders could, in certain cases, be reckoned as "criminal" for purpose of human rights legislation. In the light of such advice, the Administration has decided that, while continuing with extending the effective civil tribunal system beyond insider dealing to other types of market misconduct, MMT will no longer make heavy pecuniary fine orders. Instead, the range of civil sanctions available to MMT will be expanded (refer to para. 106 for details). These sanctions, which have been carefully considered both for compliance with human rights protection and for their credibility as sanctions, will enable MMT to deal appropriately and flexibly with those who engaged in market misconduct.

104. Members share the Administration's view that reliance on civil sanctions is inadequate to deter and punish market misconduct. They support its proposal to modernize and expand the existing criminal regime to make the six types of market misconduct criminal offences under Part XIV of the SFB. It is noted that the criminal route will be pursued for a market misconduct offence where there is sufficient evidence, reasonable prospect of a conviction, and it is in the public interest to bring a prosecution. Besides, acts of fraud or deception, and disclosure of false or misleading information relating to leveraged foreign exchange transactions, which are criminal offences under existing legislation will be re-enacted and a new offence of "bucketing" (i.e. falsely representing that futures contracts have been executed) will be created under Part XIV. The maximum criminal sanction is increased to 10 years' imprisonment and/or fines of $10 million to strengthen the deterrent and punitive effect.

105. The Administration explains that the approach of providing for parallel civil and criminal regimes to deal with market misconduct activities has been adopted by the US, the UK and Australia. The market misconduct provisions in Parts XIII and XIV are largely mirroring each other and modelled on the well established Australian Corporations Law. To avoid a person being subject to dual punishment under the civil and criminal regimes in relation to the same conduct, clauses 274 and 298 clearly provide that the person who has been subject to MMT proceedings may not be subject to criminal proceedings for the same conduct and vice versa.

Market Misconduct Tribunal

106. The MMT, which is modelled on IDT, comprises a Chairman (who must be a judge) and two other members from the market to be appointed by CE, will conduct hearings to determine whether market misconduct has taken place and to identify the persons committing the misconduct by adopting the civil standard of proof and using civil procedures. The range of civil sanctions (clause 249) available to MMT is expanded to include "disgorgement order" (to demand

payment to the Government the amount of the profit gained or loss avoided as a result of the misconduct engaged by a person), "cold shoulder order" (to restrict a person's access to the market), "disqualification order" (to disqualify a person from being a director or other officer of any corporation), "cease and desist order" (to order a person not to engage in any specified form of market misconduct), "Government and SFC cost orders" (to demand the person to pay the costs incurred by the Government and SFC in investigating his market misconduct), and "disciplinary referral order" (to recommend to any body to commence disciplinary action against the person who is one of its members).

*FS to commence MMT proceedings*

107. Under the proposed civil regime, initial reports of suspected market misconduct will be made by SFC following an SFC investigation under clauses 175 and 176. The SFC may refer such a report to FS to consider the institution of civil proceedings before MMT or to the Secretary for Justice (SJ) to consider the institution of criminal proceedings (clause 244). The SFC will also have the residual capacity to institute in its own name summary criminal proceedings for less serious criminal market misconduct offences. It is expressly provided that the powers of SJ in respect of the prosecution of criminal offences under the Basic Law are not affected (clause 376(3)). The decision as to whether to commence criminal proceedings in relation to suspected market misconduct will be made by SJ in accordance with the Department of Justice's Prosecution Policy. Following a report of suspected market misconduct by SFC or a referral from SJ, FS will institute proceedings before MMT.

108. Some members have questioned the rationale for requiring FS to initiate proceedings before MMT. There is concern that the proposed procedures would undermine the independence of SFC to institute proceedings in respect of civil wrongs. The Administration points out that the procedures to be followed by MMT are modelled on the modus operandi of IDT which has been adopted since 1993 and has been working effectively. The proposed procedures in the SFB represent a reasonable allocation of roles in commencing proceedings. In brief, SFC will conduct an independent investigation and refer cases to FS if it is satisfied that there is "reasonable suspicion". The SJ will tender independent legal advice to FS on "chance to win". The FS will institute MMT proceedings having regard to the legal advice and broader considerations in relation to the regulation of financial market in Hong Kong. The Administration also points out that it is appropriate for FS to institute the proceedings as the investigation concerned may go beyond SFC's "regulated class", for example, persons related to a listed company.

*Bringing additional persons to MMT proceedings*

109. The Administration explains that persons who have not been specified in the initial written statement instituting an MMT inquiry may be identified in

the course of proceedings as being possibly guilty of market misconduct. In order to include such persons in MMT inquiry, the Administration proposes to empower MMT to identify such persons (in relation to the same market misconduct) to be covered in MMT proceedings (clause 16 of Schedule 8). However, members are concerned that the proposal to bring in additional persons in the middle of MMT proceedings may not ensure fair hearing. After deliberation, the Administration agrees not to pursue the proposal. In the event that MMT considers it appropriate to institute MMT inquiry against any additional persons identified in the course of the proceedings, it may make a recommendation to FS to do so in MMT's report issued at the end of the proceedings. The FS may make a decision to start new MMT proceedings in relation to such a person just as he does on receiving a report from SFC or a referral from SJ (new clause 19A in Schedule 8).

*MMT's power to compel the giving of evidence*

110. Members share the view of the legal profession and market players that clause 246 has conferred wide powers on MMT to ask for provision of records, information or explanations where the threshold is only "reasonable grounds to believe or suspect" the information required is relevant to MMT proceedings. There is further concern about self-incrimination as MMT evidence could be admissible in other proceedings as provided in clause 247.

111. The Administration maintains that MMT's powers to receive any evidence, to compel the giving of evidence, and to direct SFC to make further investigation are important for its success as an effective civil tribunal. Members are assured that there are safeguards against the abuse of these powers, including parties will be granted a reasonable opportunity to be heard and comment on the evidence come to light, and MMT is bound by the principle of fairness and will give any evidence appropriate weight depending on its reliability. The Administration further confirms that safeguards have been incorporated in clause 247 to protect right of individuals in giving evidence and undertakes to introduce amendments to the effect that evidence admitted before MMT will not be admissible in any other civil or criminal proceedings except in well accepted circumstances specified in the provision, e.g. perjury, giving of false or misleading information, civil or criminal proceedings under Part XIII, and civil proceedings under Part XIV (clause 296).

*"Cost orders" imposed by MMT*

112. Some members are concerned that huge costs and expenses may be incurred by SFC (clause 249) in conducting an investigation relating to a MMT proceedings and imposing "cost order" on a person will be considered "punitive". The Administration explains that the person will be given an opportunity of being heard before MMT makes the order and the person can also appeal to CA against the order, or seek judicial review as appropriate. According to

information provided by SFC, the maximum cost per case awarded by the Court to the Commission for investigating a market misconduct offence in the past three years has not exceeded $260,000.

*Stay of execution of MMT order upon appeal*

113. The Bills Committee notes that clause 259 provides that an application for a stay of execution of a MMT order must be made to CA. Some members consider that as MMT is familiar with the case, it can consider the application for stay of execution more expeditiously. While considering that CA will deal with an application efficiently, the Administration agrees to add a new clause 256A to provide MMT with the flexibility to stay execution of its own orders where it considers appropriate.

*Membership of MMT*

114 Some members suggest that there should be a panel of members for appointment as ordinary members of MMT as the arrangement will enhance credibility and transparency of the tribunal. The Administration maintains that the present proposal for CE to appoint two ordinary members to a tribunal hearing on a case-by-case basis will allow greater flexibility and better ensure persons with the expertise required for a specific market misconduct will be appointed to hear a particular case.

115. While members note that the proposal to appoint "temporary members" to MMT (clauses 9 to 13 of Schedule 8), which is adopted from the existing arrangements for IDT, to replace incapacitated members after proceedings have started will save cost and time for the parties concerned, there is concern that the arrangement will not ensure fair hearing. To address members' concern, the Administration will delete the reference to "temporary members" and add safeguards that CE may appoint a person to replace an ordinary member on the recommendation of MMT Chairman having regard to the interest of justices, and the parties concerned must be given an opportunity of being heard before such appointment is made. When a MMT Chairman becomes incapacitated, a new tribunal will have to be appointed and MMT proceedings will start afresh.

<u>Concern about overlap in the types of market misconduct</u>

116. Members note that some deputations, including HKAB and the Group of nine investments bankers comment that there is significant overlap between the three categories of market misconduct i.e. false trading, price rigging and stock market manipulation. The Administration points out that similar provisions in the US, Australia and many other jurisdictions also overlap so as to avoid regulatory gaps. The provisions are generally designed to identify specific types of manipulative conduct so that certain misconduct may be more readily

prosecuted in those instances. This approach will also help market participants understand clearly specific types of activities which are prohibited. In the light of market comments, the Administration has made careful efforts to minimize that any overlap.

Conduct not to constitute market misconduct

117. The Bills Committee notes that clauses 273 and 297 empower SFC, after consulting FS, to make rules to create "safe harbour" for the market misconduct civil and criminal provisions. Members and the market support this flexible approach as it will provide greater certainty on what is and what is not acceptable conduct to cater for market development. However, there is doubt that such rules which seek to modify the law quickly may override the principal legislation. The Administration stresses that the purpose of the rules is to provide defences to market players so as not to outlaw legitimate market activities. It assures members that the rules will not broaden the scope of market misconduct provisions. Like other rules under the SFB, they will be subsidiary legislation subject to negative vetting of the Council and the statutory public consultation requirement under new clause 384A. SFC is preparing the draft rules based on the UK model and will consult the market in anticipation of the commencement of the Bill. Legitimate activities to be stipulated in the rules will include price stabilization activities in an initial public offering.

Burden of proof on charge of criminal offences

118. Noting that the criminal regime for dealing with market misconduct has been expanded to cover a wider range of misconduct activities and that the maximum penalties for offences have increased to fines of $10 million and/or 10 years' imprisonment, members are keen to ensure that the legislation adopts the proper standard and burden of proof for criminal offences.

119. The Bills Committee has made reference to the findings of the overseas duty visit delegation on the application of standard of proof for prosecution of criminal offences in the UK and the US. The delegation notes that both jurisdictions have adopted dual civil and criminal regimes for dealing with market misconduct activities. On the criminal side, criminal penalties for market misconduct acts are provided in the principal securities legislation of the US and the UK. The prosecutions have applied the criminal standard of proof for dealing with criminal offences such as the proof beyond reasonable doubt, establishment of "intentional" or "reckless" mental element for offences, and provision of adequate defences. The Bills Committee affirms that it is imperative for the Hong Kong regime be comparable with those of foreign jurisdictions.

120. Members note that the Administration has taken on board comments from deputations including the Group of nine investment bankers about the strict

liability provision of some market misconduct offences under Part XIV. The Administration further clarifies that in prosecuting market players for market misconduct, the onus of proving the offence according to a criminal standard of proof will be on the prosecution. This is both a principle of common law and generally required by the human rights provisions of the Basic Law. Most of the offences under Part XIV will require the prosecution to establish an "intentional" or "reckless" mental element. Defences for "mere conduit" (i.e. passively pass on false information for the offence of disclosure of false or misleading information under clause 290) are also provided.

121. However, members are aware that there is still market concern that in the prosecution of illegal acts of "wash sales" and "matched orders" under false trading, the prosecution is not required to establish the "criminal intent" and the defendants will be required to explain the reasons for their acts (clauses 265(6) and 287(7)). They consider that this will put the onus of proving one's innocence on the defendant. The Administration explains that "criminal intention" for acts of "wash sales" and "matched orders" is very difficult to establish. Nonetheless, these acts are common manipulative devices with relatively few innocent explanations. The person, who has engaged in such acts, is best placed to explain if he engaged in those behaviours for only legitimate reasons. They will have a defence if they prove, on the lower standard of balance of probabilities, that none of the purpose for which they engaged in these acts is to create a false or misleading appearance of active trading in the market. The provisions are based on the Australian Corporations Law which has not caused complaints from market practitioners in their implementation. Hence, the Administration considers that it is reasonable to require the defendant to explain that their acts are innocent.

**(H) Investor Protection and Enhancing Market Transparency**

122. "To provide protection to members of the public investing in or holding financial products" has become one of the regulatory objectives of SFC in the SFB. The Bills Committee notes that a number of provisions in the SFB are designed for enhancing protection of investors. Some of them are built upon provisions in the existing Protection of Investors Ordinance (Cap. 335) and the Securities Ordinance (Cap. 333), while some are new initiatives. It is also one of the emphases of the SFB to enhance market transparency for the protection of the investing public.

<u>Making non-exempted advertising and invitation relating to investments an offence</u>

123. Clause 102 imposes a general prohibition on the issue of marketing materials for investment products. A breach to the prohibition will be an offence subject to a number of exemptions, e.g. materials authorized by SFC, or issued by specific categories of persons such as printers, broadcasters, licensed or

exempt persons in their normal course of business. The main objective is to ensure protection for investors while allowing room for market development through the provision of a wider range of investment products.

*Liability for inducing others to invest money*

124. For the protection of investors, clause 106 prohibits and makes it an offence for a person to induce another, by any fraudulent or reckless misrepresentation, to invest money. The Bills Committee accepts that misrepresentation should include false or misleading statements or promises. However, some members have reservation over the scope to cover "forecast" and are concerned that this will make a lot people liable, in particular, financial analysts or columnists who often make forecasts on the performance of the market or investment products. The Administration explains that the coverage of "forecast" is already in existing legislation and has worked well. Moreover, an offence for making a fraudulent or reckless forecast will only be committed if the prosecution establishes that the forecast was made for the purpose of inducement and with fraudulent intent or recklessly. The Administration will propose CSA to make clearer the mental element by adding "for the purpose of inducing" in clause 106(1).

125. Regarding clause 107, while members support the provision as it preserves the private cause of action for investors to claim damages in relation to fraudulent, reckless, or negligent misrepresentation as provided in existing law, they note the market concern that the provision may go beyond the common law requirement on the maker of a misstatement to compensate an investor and the suggestion that the test of "fair, just and reasonable" should be added for determining the compensation. The Administration maintains that it is most appropriate for the Court to decide on and apply the relevant test including the test for measure of damages taking into account the nature of the misrepresentation and the relationship between the plaintiff and the defendant, etc. Thus, it is not necessary nor appropriate to add the "fair, just and reasonable" test.

*Disclosure by intermediaries on offers of investment*

126. Members note that clause 108 aims to impose certain disclosure requirements on intermediaries when they communicate an offer to acquire or dispose of securities and also provides investors with rights to rescind transactions. As the provision deals with business conduct of intermediaries, the Administration has taken on board market comment to relocate the provision to Part VII as new clause 169A for the sake of tidiness and easy reference. In order not to unduly affect the rights of intermediaries, the Administration accepts the views of the Group of nine investment bankers and will make amendment to shorten the period allowed for an investor to rescind transaction to seven days after he/she becomes aware the offer has breached clause 108.

Rules governing cold calls

127. Members note that clause 169 intends to prohibit cold calling by market intermediaries. While they share the concern of some deputations about the wide scope of the provision, they agree that there is a need to restrict high-pressure sales techniques to protect the interests of the investing public and support that definition on "call" should be sufficiently broad to cater for development in communication technology. The Administration explains that SFC is empowered to make rules to exclude certain types of calls or modify the strict application of the clause to facilitate market development.

Criminal liability for disclosure of false or misleading information inducing transactions

128. The Bills Committee notes that clauses 268 and 290 of the SFB respectively prohibit a person under the civil and criminal regimes from knowingly, recklessly or negligently disclosing in Hong Kong or elsewhere false or misleading information about securities or futures contracts that is likely to induce investment decisions or have a material price effect. They note that the market practitioners and the news media industry have raised serious concerns over the two clauses. They consider that the provisions may discourage robust dissemination of information to investors and the market. There would also be adverse impact on the operation of the media.

129. The Administration maintains that false or misleading information has a very serious effect on the price of securities or futures contracts which may cause immediate harm to a large number of investors and disruption in the market. The provisions are intended to protect the interests of investors and to maintain an orderly market. The Administration is of the view that it is reasonable to impose on those involved in disclosing information that might have an effect on investment decisions a duty to take reasonable steps to ensure that such information is true and not misleading. It does not anticipate that these provisions will have any "chilling" effect on the dissemination of reliable information. Moreover, defences are available under the two clauses for those who may passively disseminate false or misleading information owing to the nature or an aspect of their business, which involves disseminating information received from others and who are not in a position to check the accuracy of such information. These defences are intended for persons including printers and publishers, live broadcasters, and internet website operators who provide access to third party information.

130. Market practitioners are also concerned about the heavy criminal sanctions imposed on "negligent" behaviours under clause 290. Some members consider that the mental element of "negligence" is acceptable as a threshold for acts of market misconduct under clause 268 of the civil regime since only civil sanctions will be imposed against such misconduct. However, they share the

industry's concern that imposing criminal liability under clause 290 (equivalent of clause 268 in the criminal regime) for "negligently" disseminating false or misleading information is too harsh. "Negligence" as a mental element for criminal offences is inappropriate. Members consider that criminal liability should only be attached to "knowingly" or "recklessly" disseminating false or misleading information. The Administration explains that for a person to be convicted under clause 290, the prosecution must prove beyond reasonable doubt that the accused knows that the information disclosed is materially false or misleading or is reckless or negligent as to whether it is so. Furthermore, the provision already contains defences for those who merely disseminate the false or misleading information. Nonetheless, having considered the views of members and the media, the Administration agrees to propose CSAs to delete the reference to "negligent" in clause 290. The "negligent standard" will only be applicable to clause 268. The Bills Committee welcomes this move.

Civil liability for false or misleading public communications

131. Clause 208 imposes civil liability on person who discloses to the public false or misleading information concerning securities or futures contracts, or that might affect their market prices. Any person who has suffered loss as a result of relying on such disclosure may claim damages through a private cause of action. There is concern from members that the scope of liability under the provision is unclear. The Administration maintains that the provision has expressly included the common law principles of "fair, just and reasonable" as to facilitate establishment of liability and the extent thereof. These principles are also adopted in comparable law in overseas jurisdictions. After deliberation, the Administration proposes to relocate clause 208 to Part XVI to make it new clause 378A as its application is not restricted to Part X.

Civil liability for market misconduct

132. Members note that to make it procedurally easier for an investor who suffer pecuniary loss as a result of a person's market misconduct to bring a civil action, clauses 272 (Part XIII) and 296 (Part XIV) expressly provide the rights of civil action for the investor to seek compensation for losses suffered as a result of market misconduct, and make the person liable to pay damages to the investor. The MMT findings will be admissible in evidence in such civil proceedings. This will enhance the deterrent effect of the proposed regime. The Bills Committee notes the Administration's explanation that making MMT findings admissible in evidence for the purposes of these two clauses will not affect the reception of other admissible evidence in such civil proceedings. MMT findings admitted as evidence, if not balanced or out-weighed by other evidence, will suffice to establish a particular contention. The Administration maintains that the two clauses will assist an investor who initiated civil action to substantiate his action and he will not have to prove the same facts from scratch.

133. Noting that similar provisions in the Australian Corporations Law have spelt out the scope of civil liability, some members are concerned about the undefined scope of these clauses. The Administration re-iterates that the court will rely on the common law principles of "fair, just and reasonable" set out in the provisions in determining the liability of a person. This will strike a proper balance between the interest of investors and those of other market players.

134. On some members' concern that the new clause 378A (original clause 208) will overlap with clauses 272 and 296, the Administration notes that the clauses may overlap slightly with each other, but maintains that the clauses have different policy intent. Clause 378A intends to send a signal to the market that any person responsible for issuing public communications concerning securities or futures contracts or which are price sensitive, has the duty to ensure that the communications are not false or misleading. The provision serves to empower investors further in advancing their rights for compensation through civil actions. The Administration maintains that it will be desirable to spell out the various private rights of action in individual provisions to facilitate investors' understanding of their rights under different circumstances.

The term "professional investors"

135. The Bills Committee notes the suggestion made by market participants, e.g. the Group of nine investment bankers and HKAB, for a wider "professional investor" safe harbour. The Administration has developed the concept of a "professional investor" (definition in Schedule 1), who are sophisticated individuals or institutions capable of protecting their own interests. Transactions with these persons or corporations, and the issue of marketing and other protection to them will be subject to a lighter regulatory approach. The SFC is empowered to make subsidiary legislation to develop further the definition to meet emerging market needs and is consulting the public on draft rules in anticipation of commencement of the SFB. Members agree that the exemptions or relaxation in relation to dealings with "professional investors" will effectively reduce regulatory burden on some market intermediaries without compromising investor protection.

The new disclosure regime

136. The Bills Committee notes that Part XV of the SFB seeks to modernize the existing regime for the disclosure of interests in securities with a view to minimizing compliance burden on market practitioners, enhancing market transparency to provide investors with more complete information facilitating their investment decisions, and bring Hong Kong in line with international standards. Major changes proposed in the SFB include:

(a) improving disclosure of interests in securities by lowering the initial shareholding disclosure threshold for persons other than

directors and chief executives from 10% to 5% (clause 306) while exempting substantial shareholders from disclosing small changes in their interests in shares (clause 304);

(b) streamlining the submission procedures and standardizing disclosure forms (clause 315 & 338); and

(c) extending certain disclosure requirements to short positions, unissued shares and cash-settled derivatives products and shortening the disclosure notification period for most cases from five days to three business days (clauses 316 and 339).

Investigative powers of listed corporation on disclosure of interests

137. The Bills Committee notes HKSbA's concern over clause 320 which empowers a listed corporation to commence an investigation to discover the true identity of persons having an interest in its shares and to require intermediaries to furnish information within short notice. The HKSbA considers it unfair to impose criminal sanction on intermediaries for failure to comply with request from corporations (clause 325) and further suggests that listed corporations should be required to reimburse the intermediaries for the expenses incurred.

138. Some members question the rationale for providing a listed corporation with such powers. According to the Administration, the provision is derived from the existing law. Similar provisions providing for investigation by listed corporations are found in legislation in the UK, Australia and Singapore. The powers are necessary because blocks of shares are often held in the names of nominee companies, so that the identity of the persons having an interest in the shares of a listed corporation is concealed. The aims of the parties may be to influence company policy or to build up a substantial holding in a corporation prior to making a takeover bid.

139. Moreover, members are concerned about possible abuse of the investigative powers by a listed corporation. The Administration points out that there are already safeguards in the SFB. Firstly, the corporation has to apply to the Court for restrictions to be imposed on the relevant shares in the event that the intermediary does not comply with the request to provide the information. The Court will not impose restrictions unless it is satisfied that the request is appropriate and that a reasonable period had been given to comply with such request. Secondly, a person commits an offence only if he fails to comply with a request without reasonable excuse. It should also be noted that it will be SFC and not the listed corporation which will prosecute the intermediary concerned for non-compliance with requests.

140. On HKSbA's proposal for reimbursement of cost, members note that there is no provision in the existing legislation or those in the UK and Singapore

for reimbursement of cost. They note that although the regulator in Australia is provided with a statutory power to make regulations to prescribe fees to be recovered from listed corporations, no such regulations have been made so far, indicating that there has not been any practical concern about cost. After deliberation, the Bills Committee accepts the Administration's explanation and does not propose any change to the provisions.

FS's power to investigate ownership of listed corporation

141. The Bills Committee notes that clause 347 empowers FS to commence an investigation into the ownership of a listed corporation on his own initiative or upon application of members of the corporation, for the purpose of protecting its shareholders. As a safeguard to frivolous applications by members of the corporation, FS may recover the cost of investigation from an applicant (clause 354). Some members are of the view that if the applicant is liable to pay the concerned cost, he must be informed of the estimated amount prior to the commencement of the investigation and should not be required to pay an amount more than the estimate. The Administration has taken on board members' comment and will propose CSA to clauses 347(5) and 354(1)(e) accordingly.

142. Members are also concerned about whether it is appropriate to require a person convicted as a result of the investigation under clause 347 to indemnify other affected parties as stated in clause 354(5). In response, the Administration agrees to propose CSA to delete clause 354(5) and leave it to the Court to determine whether such liability on the convicted person should be imposed.

143. As regards members' concern over the power conferred on FS to require information relating to shares from persons on "reasonable grounds" (clause 356), the Administration explains that the grounds pertaining to such requests are numerous and impossible to be listed exhaustively in the provision. The FS is committed to making his reasons transparent. As a further safeguard, the Administration agrees to include a reasonable excuse defence in clause 356(4) so that non-compliance with the request will not become a strict liability offence.

Disclosure regime as compared to those of overseas jurisdictions

144. The Bills Committee shares the concern of market practitioners, in particular, international brokerage houses and the Group of nine investment bankers, that by extending disclosure requirements to short positions, unissued shares and cash-settled derivatives, etc, the proposed disclosure regime may go considerably beyond those of other international markets. A number of new requirements are complex and costly to comply with, hence leading to compliance problems and adversely affecting Hong Kong's competitiveness as an international financial centre. Members also note at the same time that the Administration has to take into account requests from others like the Hong Kong General Chamber of Commerce and smaller market players for greater

transparency of market activities in derivatives etc. These organizations are concerned about improper market practices through the use of derivatives.

145. The Administration confirms that the proposed disclosure regime seeks to bring the level of transparency in Hong Kong in line with international and regional standards, taking into account the local market characteristics. Regarding some of the new requirements under the disclosure regime, the Administration explains that they are intended to close an information gap for investors and to address a unique Hong Kong problem in that the market capitalization and the public float of most listed corporations are relatively small thus incomplete information on shareholding positions may easily distort market prices. The Administration is aware of genuine market concerns. Working closely with concerned market practitioners, in particular the large international investment bankers, the Administration has identified a number of disclosure requirements which can be further relaxed or modified to facilitate certain market activities without substantially compromising market transparency. For instance, the Administration has already removed from the SFB the requirement for substantial shareholders to disclose certain commercially sensitive information and extended the exemption for reporting "exempt security interests" (clause 314(5)) to overseas corporations. Nonetheless, the Administration will propose amendments to relevant clauses (e.g. clauses 304, 317, 332 and 335) to facilitate compliance by market players while preserving the essential aggregate data for investors' information. For example, new clause 365A will be introduced to provide SFC with the power to make rules to prescribe detailed disclosure exemptions relating to stock borrowing and lending activities in order to cater for market developments. Such rules are subsidiary legislation and also subject to the market consultation requirement (new clause 384A). Members note the Administration's undertaking to work closely with the market to address concerns on the new requirements and welcome amendments to the provision to solve compliance problems. The Administration also assures members that the new regime will be reviewed at appropriate time in the light of its actual implementation in consultation with the LegCo Panel on Financial Affairs.

**(I) Investor Compensation Scheme**

146. The existing compensation funds namely, Unified Exchange Compensation Fund (UECF) and the Futures Exchange Compensation Fund (FECF), for both SEHK and the Hong Kong Futures Exchange (HKFE) are derived partly from deposits paid by the exchange participants and partly from statutory transaction levies. The compensation ceilings are respectively $8 million per stockbroker and $2 million per futures broker, but SFC may allow a higher level of compensation. The per broker ceilings give an uncertain level of investor protection, as they do not communicate to investors the amount of coverage available to them individually.

147. Part XII of the SFB sets out the legal framework for the new investor compensation arrangements to provide compensation to investors in the event of defaults of market intermediaries. Members note that SFC conducted a public consultation on the proposed new investor compensation arrangements in March 2001. There is public support in general for the proposals including establishing a new single investor compensation fund (the new fund) to replace the existing UECF and FECF (clause 229) which will eventually be dissolved (transitional arrangements for the old funds are provided in Schedule 9). Initial funding for the new fund will mainly come from the transfer of assets (estimated to be about $655.8 million) from UECF and FECF (clause 230). SFC recommends that the new fund should build up its reserves to $1 billion via a 0.002% levy on stock trading and $0.5 levy for each side per futures contract made.

148. Members note SFC's undertaking to review the funding need of the new scheme when the fund has accumulated to the target level of $1 billion. However, to address the concern about the risk of cross-subsidization in contributions by different sectors of the industry, SFC undertakes to monitor the situation and will consider adjusting the levies for different sectors to address the imbalance if necessary. SFC will also take into account the view of HKEx on a need to make special funding arrangements in relation to ATS trading that is not done through SEHK to ensure a fair and level playing field in making the subsidiary legislation.

149. Members share the market views that major elements of the new compensation scheme such as its funding, coverage and compensation limit should be specified in provisions of the SFB. The Administration maintains that it is more flexible to prescribe arrangements in subsidiary legislation. As such, CE in Council is empowered under clause 236 to make rules on means of funding for the new scheme, the limit of compensation per investor and the maintenance of sub-accounts, etc. According to the Administration, the compensation limit will initially be set at $150,000 and will be reviewed as necessary. On the other hand, the coverage of the new fund will be expanded to include all intermediaries licensed or registered under SFB for dealing in securities, futures contracts and provision of securities margin financing in relation to products traded on HKEx. This arrangement will be stipulated by rules made by SFC under clause 236 after consultation with FS. Other rules to be made by SFC under clause 236 will include entitlements of claims, the manner in which a claim is to be made, the information or documents to be supplied for making claims, etc.

150. Nonetheless, the Administration notes the Bills Committee's concern and will move the following CSAs:

(a) to amend clause 229 to stipulate clearly that the overall purpose of the investor compensation fund is to provide a measure of compensation to clients who suffer a loss due to a default

committed by a specified person, and to subject any rules made under clause 236 to this overall purpose; and

(b) to add new clause 236(4) to stipulate that funds of the compensation scheme should as far as practicable come from the market in order to uphold the user-pays principle.

## (J) Miscellaneous Provisions under Part XVI of the SFB

151. The Bills Committee notes that Part XVI of the SFB contains miscellaneous provisions which either have common application to the regulatory powers and statutory requirements in various parts, or do not logically belong to any of the preceding 15 Parts of the Bill. Those clauses on which the Bills Committee raises concerns are summarized below.

Preservation of secrecy

152. Clause 366 preserves the secrecy of information gathered by SFC in the course of performing its statutory functions by permitting the disclosure of information to designated parties when certain conditions are satisfied. The provision further prohibits onward transmission of the information by the parties by making the contravention a criminal offence. Some members express concern about the wide scope of exceptions to the secrecy provision, in particular, where SFC may disclose information to overseas regulatory authorities (clause 366(3)(h)(i)). The Administration explains that there are built-in safeguards in the clause where SFC must be satisfied that the disclosure is in the public interest, the overseas authority performs a financial market regulatory function and is subject to adequate secrecy provisions (clauses 366(5) and (6)).

153. On members' concern about difficulties in enforcing statutory prohibition on overseas authorities against onward disclosure of information provided by SFC, the Administration agrees that it may not be appropriate to deal with such enforcement issues under the law. It further considers that as the use of confidential information disclosed to the authority will be subject to the Memorandum of Understanding entered into between SFC and the authority, and any conditions attached therein relating to onward disclosure; it is not necessary to impose restriction on the authority on onward disclosure. Hence amendment will be made to clause 366(7) to this effect.

154. Members note that the Administration has taken on board LSHK's concern that clause 366 will prohibit subjects of investigation or inquiry by SFC or their legal representatives from disclosing SFC information even for exercising their legitimate rights, such as to seek legal or other professional advice on the case, and will move CSA to remove such restriction (new clauses 366(2)(ba), (bb) and (bc)).

Immunity in respect of communication with SFC by auditors of listed corporations

155. The Bills Committee notes that clause 369 provides auditors of listed corporations, who choose to report to the regulatory authority any suspected fraud or misconduct in the management of the corporation, with statutory immunity from civil liability under the common law. Some members opine that in order to enhance protection for shareholders, it should be a statutory duty for auditors to report possible fraud or irregularity of listed corporations to SFC. The Administration clarifies that clause 369 provides auditors with immunity in the event that they choose to make such reports, not to impose upon them any duty to report. HKSA welcomes the Administration's reassurance in this respect and will draw up a practice note in consultation with SFC to assist auditors on the practical application of this provision. As regards some members' view that other professionals such as lawyers, company secretaries, directors, etc, who are accountable to the shareholders should report their concerns to the regulator, the Administration points out that the responsibilities and accountability of these professionals to the shareholders is a separate issue to be dealt with under the on-going review of corporate governance spearheaded by the Standing Committee on Company Law Reform.

Power of SFC to intervene in proceedings

156. The Bills Committee notes that clause 373 is a new provision to give SFC a standing to intervene in proceedings between third parties (other than criminal proceedings) in appropriate cases. Members note that the clause has taken into account views put forward by the LegCo Subcommittee and the HKBA where SFC must consult FS before seeking to intervene in any proceedings and must be satisfied that its intervention is in the public interest or in which SFC has an interest by virtue of its statutory functions. Parties to the litigation will have the right to challenge the intervention and the intervention will be subject to such terms as the Court considers just. Members note that the proposal will enable SFC to provide its regulatory perspective, expert opinion and current practices in the market to assist the Court in making more informed decisions for cases.

Exclusion of provisions of Gambling Ordinance

157. The Bills Committee notes that the original clause 390 provides exemption for transactions or activities in compliance with the SFB from regulation of the Gambling Ordinance (GO) (Cap. 148). However, some members have doubts on the need of the Administration's proposed amendment to add clause 390(2) to provide SFC with the rule-making power to specify that the GO should apply to certain transactions or activities under the SFB. The Administration explains that such a power is to cater for situations where

clarifications are needed in respect of new products which should be more appropriately dealt with under the GO. The amendment will also avoid possible circumvention of the GO by structuring certain gambling products such that it appears that the SFB will apply to them, hence benefiting from the exemption under clause 390(1). Members considered and support the proposed amendment.

**(K) Expanded Function of HKMA under the Banking (Amendment) Bill 2000**

158. Notwithstanding that the Bills Committee welcomes the proposed amendments to BAB to underpin the revised disciplinary regime for exempt AIs and their securities staff and the related appeal mechanism as outlined in paragraphs 79 to 81, some members express concern over clause 3 of BAB. They point out that the amendment, which proposes to add a new paragraph to section 7(2) of the BO to provide that HKMA shall take all reasonable step to ensure "any other business" carried on by AIs are operated in a prudent manner, may unnecessarily expand the powers and functions of HKMA which are unrelated to the regulation of regulated activities conducted by AIs.

159. In response, HKMA clarifies that the regulatory framework promulgated by the BO is intended to allow HKMA to exercise supervisory oversight over all business conducted by an AI. This approach is consistent with the "Core Principles for Effective Banking Supervision" published by the Basle Committee in 1997 - Principle 20 stipulating that an essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis. In practice, the supervisory process of HKMA has already extended beyond banking business and embraced all businesses conducted by an AI, including those conducted through its subsidiaries, to ensure that all businesses are conducted properly to safeguard the overall safety and integrity of individual AIs. The HKMA stresses that clause 3 of the BAB intends merely to clarify that HKMA has an overall supervisory responsibility for all the businesses of AIs. The HKMA has a duty to take all reasonable steps to ensure that any business of AIs is conducted with "integrity, prudence and the appropriate degree of professional competence". According to the legal advisors of HKMA, the proposed amendment is desirable to remove any uncertainty about the scope of HKMA's functions for the effective performance of its front-line regulatory role in respect of "registered institutions" and is consistent with the proposed regulatory regime for market intermediaries enshrined in the Bills.

160. Members accept HKMA's explanation. A member, however, suggests that the Administration should assure the Council in the resumption of the Second Reading debate of the Bills that such an amendment is not intended to expand the powers and functions of HKMA. The Administration agrees to the request.

## (L) Transitional Arrangements

161. Part XVII of and Schedule 9 to the SFB relate to the transitional arrangements and consequential amendments of the Bill. The provisions are mainly to ensure the continued operation of SFC, existing market operators, and smooth migration of existing registrants into the new licensing regime. In the light of the suggestions made by members and the LegCo Legal Service Division, the Administration undertakes to introduce a number of technical amendments to the clauses.

162. The Bills Committee notes the Administration's proposal to allow a two-year transitional period after the commencement of the SFB for existing SFC registrants and exempt persons to transit to the new regime. During the period they can continue with their business but are required to comply with provisions of the SFB with necessary modifications granted by SFC. Registrants who wish to carry on a regulated activity must apply for a licence or registration to SFC before the expiry of the two-year period. The Administration points out that this approach is preferred to grandfathering the existing registrants for the purpose of investor protection and has been generally accepted by the industry. However, the Bills Committee notes the concern of the brokerage industry that existing registrants may not be able to meet enhanced entry requirements to the securities and futures industry within the two-year period. The Administration stresses that existing registrants will have to satisfy SFC of their fitness and properness under the new regime. The two-year transitional arrangement is to allow them to adjust to the new regime. Following discussion with the Administration, it is noted that SFC shall have regard to the experience and ability of the applicants under the existing regime in considering their applications and will not require existing practitioners to take fresh examinations. It is therefore envisaged that the majority of such applications will be approved within a short period of time. In order to prevent a rush in applications close to expiry of the transitional period, SFC will provide incentives to encourage existing registrants to hand in their applications at an earlier time. Those who have submitted applications prior to the expiry of the transitional period will be able to continue their regulated activities pending the decision on their applications.

## COMMITTEE STAGE AMENDMENTS

163. To facilitate the Bills Committee in scrutinizing its proposed CSAs, the Administration has provided these CSAs in marked-up versions against the Blue Bills with footnotes explaining the various amendments. It has also provided a copy of the draft CSAs to be moved. Due to the huge contents (over 1,000 pages) of the marked-up versions and the draft CSAs, they are not attached to this report but separately provided in **Volumes II** and **III** of this report. To

facilitate easy retrieval, Volumes II and III are available at the LegCo website (http://www.legco.gov.hk).

## RECOMMENDATION

### Resumption of Second Reading debate

164. Subject to the moving of the proposed CSAs by the Administration, the Bills Committee supports the resumption of the Second Reading debate on the Bills on 13 March 2002.

### Formation of a subcommittee to study draft subsidiary legislation

165. According to the Administration, there will be about 39 sets of subsidiary legislation (as referred to in para. 64) to be made under the Securities and Futures Ordinance for the implementation of the Ordinance. These 39 sets of subsidiary legislation, as listed in **Appendix III**, will be subject to the negative vetting of the Council. The Administration is prepared to consult Members on the subsidiary legislation in draft form before they are introduced into the Council. As the subsidiary legislation is numerous and complex, the Bills Committee recommends that to allow sufficient time for scrutiny, a subcommittee should be formed under the House Committee to study the proposed subsidiary legislation.

## CONSULTATION WITH THE HOUSE COMMITTEE

166. The House Committee at the meeting on 22 February 2002 supported the recommendations of the Bills Committee in paragraphs 164 and 165 above.

Council Business Division 1
Legislative Council Secretariat
5 March 2002

**Appendix I**

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

**Membership list**

| | |
|---|---|
| **Chairman** | Hon SIN Chung-kai |
| **Deputy Chairman** | Hon Margaret NG |
| **Members** | Hon Albert HO Chun-yan<br>Hon Eric LI Ka-cheung, JP<br>Dr Hon David LI Kwok-po, GBS, JP<br>Hon NG Leung-sing, JP<br>Hon James TO Kun-sun<br>Hon Bernard CHAN<br>Hon Mrs Sophie LEUNG LAU Yau-fun, SBS, JP<br>Hon Jasper TSANG Yok-sing, JP<br>Hon Ambrose LAU Hon-chuen, GBS, JP<br>Hon Abraham SHEK Lai-him, JP<br>Hon Henry WU King-cheong, BBS<br>Hon Audrey EU Yuet-mee, SC, JP (since 02.01.2001)<br><br>(Total : 14 Members) |
| **Clerk** | Ms Connie SZETO |
| **Legal Adviser** | Mr KAU Kin-wah |
| **Date** | 5 October 2001 |

**Appendix II**

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

**List of organizations/individuals which have given views on the Securities and Futures Bill and Banking (Amendment) Bill 2000**

***Organizations:***

1. Charles Schwab & Co., Inc.
2. Charles Schwab Hong Kong Limited
3. Consumer Council
4. Hong Kong Bar Association
5. Hong Kong Exchanges and Clearing Limited
6. Hong Kong Journalists Association
7. Hong Kong News Executives' Association
8. Hong Kong Society of Accountants
9. Hong Kong Stockbrokers Association
10. International Swaps and Derivatives Association, Inc.
11. KGI Asia Limited
12. Linklaters & Alliance
13. Mandatory Provident Fund Schemes Authority
14. Sing Pao Newspaper Company Limited
15. The Hong Kong Association of Banks
16. The Hong Kong Chinese Press Association
17. The Hong Kong General Chamber of Commerce
18. The Institute of Securities Dealers Limited
19. The Law Society of Hong Kong
20. The Pan Asian Securities Lending Association Limited
21. Wocom Holdings Limited

***Individuals:***

Four individuals

Council Business Division 1
Legislative Council Secretariat
19 February 2002

**Appendix III**

# Securities and Futures Bill
## Subsidiary legislation to be made for commencement of new legislation

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| **Part III** | | | | | |
| 1 | 25(1) | Transfer of Functions – Stock Exchange Company Order | SFCO Sub Leg H | CE in Council | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 2 | 35(1) | Contracts Limits and Reportable Positions Rules | CTO Sub Leg E<br>SO Sub Leg K | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 3 | 36(1) | Stock Market Listing Rules | SO Sub Leg C & F | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 4 | 61(16) | Minority Controllers – Exemptions Rules | New | SFC (after consultation with FS) | Consideration is being given to make rules for granting exemption as an alternative to the present approach of granting approval under section 6 of the ECHMO. |
| 5 | 80(1) | Transfer of Functions – Recognized Investor Compensation Company Order | Based on SFCO Sub Leg H | CE in Council | Provisions transferring certain functions in connection with the Investor Compensation Fund from SFC to a recognized investor compensation company.<br><br>Consultation in 1Q 2002 |
| 6 | 88(1) + 384 | Investor Compensation (Financial Statements) Rules | New | SFC | Technical provisions on the format, substance, manner, etc. of the financial statements which a recognized investor compensation company is required to prepare.<br><br>Consultation in 1Q 2002 |

[1] Current plan is that 39 sets of subsidiary legislation have to be made to bring the Securities and Futures [Ordinance] into operation. The target is to submit the draft subsidiary legislation to the LegCo as and when ready starting from March to May 2002.

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| **Part V** | | | | | |
| 7 | 115(4)/4A | Security Deposits Rules/ Insurance Rules | SO Sub Leg A/ Rule 359 of the Stock Exchange of Hong Kong Rules | SFC | Adapted from existing subsidiary legislation and exchange rules[2], the latter of which concerns the taking out and maintenance of fidelity insurance to cover specified risks, and related specified requirements.<br><br>Consultation in 1Q 2002. |
| 8 | 117(2) | Leveraged Foreign Exchange Trading – Arbitration Rules | LFETO Sub Leg C | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| **Part VI** | | | | | |
| 9 | 141(1) | Financial Resources Rules | SFCO Sub Leg D<br>LFETO Sub Leg G | SFC (after consultation with FS) | Adapted from existing subsidiary legislation.<br><br>Consultation in 2Q 2002. |
| 10 | 144(1) | Client Securities Rules | 81, 81A, 121AB SO | SFC | Technical operational requirements regarding the manner in which intermediaries and their associated entities must treat client securities and securities collateral received or held in Hong Kong. These include a requirement for registration or deposit, circumstances in which withdrawal is permitted and the extent of the right of disposal of such securities and collateral. Most of the requirements are currently in primary legislation. Experience demonstrates that these technical requirements will have to be updated from time to time to meet latest market development.<br><br>Consultation conducted in 2Q 2001. |

[2] After the listing of the Hong Kong Exchange Company, the Stock Exchange of Hong Kong ceased its role in the regulatory supervision of its participants.

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 11 | 145(1) | Client Money Rules | 84, 121AJ-AP SO<br>46 CTO<br>23 LFETO | SFC | Technical operational requirements regarding the manner in which licensed corporations and certain associated entities must treat and deal with client money received or held in Hong Kong. There are provisions for the payment of client money into segregated trust accounts or client accounts, payments out of such accounts and payment of interest. Most of the requirements are now in primary legislation. Experience demonstrates that these technical requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation conducted in 2Q 2001. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 12 | 147(1) | Keeping of Records Rules | 83, 121AG SO<br>45 CTO<br>LFETO Sub Leg D<br>SO Sub Leg M | SFC | Technical operational requirements regarding the accounting and other records that intermediaries and their associated entities must keep e.g. to explain transactions undertaken; account for client assets; reflect their financial positions; enable true and fair profit and loss accounts and balance sheets to be prepared. The requirements are now being treated differently – under primary law primarily in the case of securities and commodities but by way of subsidiary legislation for leveraged foreign exchange trading. Efforts will also be made to streamline the procedures where appropriate. Experience demonstrates that these technical requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation in 1Q 2002. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 13 | 148(1) | Contract Notes, Statements of Account and Receipts Rules | 75 SO<br>45A CTO<br>21,22,73 LFETO | SFC | Technical operational requirements prescribing the manner in which contract notes, statements of account and receipts must be prepared by and delivered to clients by intermediaries or their associated entities. In particular, the rules set out the detailed information that must be included in such documents and the periods within which they must be delivered to clients. The requirements are now in primary legislation. Experience demonstrates that these technical requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation conducted in 4Q 2001. |
| 14 | 152(1) + 384(1) | Accounts and Audit Rules | SO Sub Leg B<br>CTO Sub Leg D<br>LFETO Sub Leg A | SFC | Adapted from existing subsidiary legislation.<br><br>Consultation concluded on 31 January 2002. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 15 | 161(1) + 384(1) | Associated Entities Rules | New | SFC | Technical provisions prescribing the particulars that must be contained in a notice given to the Commission by an associated entity when it becomes such an entity and when it ceases to be one. These technical requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation conducted with the HKMA which regulatees would be most affected, in mid 2001. |
| **Part VII** | | | | | |
| 16 | 165(3)(e) + 384(1) | Short Selling Exemptions Rules | SO Sub Leg A<br>SO Sub Leg K | SFC | Adapted from existing subsidiary legislation.<br><br>Consultation in 2Q 2002. |
| 17 | 169(3)(d) + 384(1) | Unsolicited Calls – Exemption Rules | LFETO Sub Leg H | SFC | Based on new rules on cold calling made by the UK Financial Services Authority.<br><br>Consultation conducted in 4Q 2001. |
| **Part IX** | | | | | |
| 18 | 187(5) + 384(1) | Registration of Disciplinary Orders Rules | Based on SIDO Sub Leg A | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| **Part XI** | | | | | |
| 19 | 226(d) | Appeals Tribunal (Fee) Order | SFCO Sub Leg I | Chief Justice | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 20 | 219 + 226(b) | Appeals Tribunal – Registration of Orders Rules | Based on SIDO Sub Leg A | Chief Justice | Adapted from existing subsidiary legislation – no significant policy change involved. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| **Part XII** | | | | | |
| 21 | 236(1) | Investor Compensation Rules | New | CE in Council | Technical provisions specifying among other matters the maximum amount that can be paid to a claimant and the framework for funding the compensation fund. These requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation in 1Q 2002. |
| 22 | 236(2) | Investor Compensation – Miscellaneous Rules | New | SFC<br>(FS to be consulted on certain items) | Technical provisions specifying among other matters the circumstances where a claim may be made on the compensation fund, those who may not make a claim and the procedure for making a claim by those entitled to do so. These requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation in 1Q 2002. |
| **Part XIII** | | | | | |
| 23 | 256 + 260(b) | Market Misconduct Tribunal – Registration of Orders Rules | SIDO Sub Leg A | Chief Justice | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 24 | 273(1) + 297(1) | Price Stabilization Rules | New | SFC<br>(after consultation with public and FS) | Based on new price stabilization rules made by the UK Financial Services Authority. The provisions define permitted price stabilization activities (to match those adopted internationally). These requirements will have to be updated from time to time to reflect latest market development.<br><br>Consultation in 1Q 2002. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| **Part XV** | | | | | |
| 25 | 365(1)(b) | Disclosure of Interests – Exclusions Regulations | SDIO Sub Leg A | CE in Council | Updated on the basis of existing subsidiary legislation to reflect changes required in the proposed regime for disclosure of securities interests.<br><br>Market consultation started in 1998 and is an on-going process in the context of the overall package of proposals. |
| 26 | 365A | Disclosure of Interests – Securities Borrowing and Lending Rules | New | SFC (after consultation with FS) | Provisions prescribing (a) the circumstances in which persons lending shares are exempt from the duty of disclosure under Divisions 2 to 4 of Part XV of the SF Bill; and (b) interests and short positions, in shares held by regulated persons, that are to be disregarded under clause 314 of the SF Bill. The Rules also provide for approval of custodians and others as approved lending agents; and the keeping of records of dealings in interests in shares that are exempt from the duty of disclosure for the purposes of Divisions 2 to 4 of Part XV or disregarded for the purpose of clause 314.<br><br>Market comments being considered with a view to facilitating stock borrowing and lending as appropriate. |
| **Part XVI** | | | | | |
| 27 | 380 | Gold Purchase Notice | PIO Sub Leg A | FS | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 28 | 381(1) | Levy Order (on levy payable to SFC) | SFCO Sub Leg A & B | CE in Council | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 29 | 381(6) | Levy Rules (on payment, collection etc. of levy in item 28) | SFCO Sub Leg G | CE in Council | Adapted from existing subsidiary legislation – no significant policy change involved. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 30 | 382 | Fees Rules (on payment of fees to SFC) | SFCO Sub Leg C<br>LFETO Sub Leg F | CE in Council | Adapted from existing subsidiary legislation.<br><br>Consultation in 1Q 2002. |
| 31 | 384 | Annual Returns Rules (on timing, particulars, manner, circumstances, etc. of submission of returns to SFC) | SFCO Sub Leg F<br>LFETO Sub Leg B | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 32 | 384 & 168 | Miscellaneous Rules | SO Sub Leg A | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 33 | 384(8) | Offence and Penalty Regulations | SO Sub Leg D<br>CTO Sub Leg B | CE in Council | Adapted from existing subsidiary legislation.<br><br>Consultation in 2Q 2002. |
| 34 | 384(1) | Licensed Persons and Registered Institutions Rules | SO Sub Leg G<br>CTO Sub Leg A | SFC | Adapted from existing subsidiary legislation.<br><br>Consultation conducted in 4Q 2001. |
| 35 | 384(1) | Leveraged Foreign Exchange Trading – Exemption Rules | LFETO Sub Leg E | SFC | Adapted from existing subsidiary legislation – no significant policy change involved. |
| 36 | 384(1) | Professional Investor Rules | New | SFC | Provisions prescribing classes of persons who will be considered as professional investors for the purposes of paragraph (i) of the definition of "professional investor" in Part 1 of Schedule 1 to the SF Bill<br><br>Consultation in 1Q 2002. |

| Serial No. | Clause in SF Bill | Subsidiary legislation | Derivation | Authority to make Sub Leg | Remarks[1] |
|---|---|---|---|---|---|
| 37 | 384(1) | Recognized Counterparty Rules | New | SFC | Provisions prescribing certain institutions as recognized counterparties for the purposes of paragraph (c) of the definition of "recognized counterparty" in Part 1 of Schedule 1 to the SF Bill.<br><br>Consultation conducted in 4Q 2001. |
| 38 | 384(1) | Corporation Rules | Definition of "corporation" in s.2 CTO | SFC | Adapted from existing legislation – no significant policy change involved.<br><br>(This item may be amalgamated with item 32.) |
| 39 | 384(1) | Information Rules | s.7A PIO | SFC | Adapted from existing legislation – no significant policy change involved. |

**Legend**

CTO – Commodity Trading Ordinance (Cap. 250)
ECHMO – Exchanges and Clearing Houses (Merger) Ordinance (Cap.555)
LFETO – Leveraged Foreign Exchange Trading Ordinance (Cap. 451)
PIO – Protection of Investors Ordinance (Cap. 335)
SDIO – Securities (Disclosure of Interests) Ordinance (Cap. 396)
SFCO – Securities and Futures Commission Ordinance (Cap. 24)
SIDO – Securities (Insider Dealing) Ordinance (Cap. 395)
SO – Securities Ordinance (Cap. 333)
Sub Leg – Subsidiary legislation
CE in Council – Chief Executive in Council
FS – Financial Secretary
SFC – Securities and Futures Commission

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**Appendix IV**

## Non-statutory Codes and Guidelines to be made by SFC for commencement of the Securities and Futures Bill

| Serial No. | Clause in SF Bill | Code/Guideline | Derivation |
|---|---|---|---|
| **Part III** | | | |
| 1 | 95(5) | Guidelines for the Regulation of Automated Trading Services | New. Consultation conducted in 2Q 2001. |
| **Part VI** | | | |
| 2 | 164(1) | Code of Conduct for Persons licensed [or registered] by the SFC (including those serving the Professional or Sophisticated Market) | Code of Conduct for Persons Registered with the SFC issued in April 2001 after consultation with the market. This has to be revised to incorporate code of conduct provisions as applicable to leveraged foreign exchange traders after consultation with the market. |
| 3 | 164(1) | Corporate Finance Adviser Code of Conduct | Corporate Finance Adviser Code of Conduct issued in December 2001 after consultation with the market. |
| 4 | 164(1) | Guidance Notes Regarding Money Laundering | Revised Guidance Notes Regarding Money Laundering issued in July 1997 after consultation with market. |
| 5 | 164(1) | Code of Conduct for Fund Managers | Code of Conduct for Fund Managers issued in December 1997 after consultation with market. |
| **Part IX** | | | |
| 6 | 187(7) | SFC Disciplinary Fining Guidelines | New. Consultation conducted in 2Q 2001. |

| Serial No. | Clause in SF Bill | Code/Guideline | Derivation |
|---|---|---|---|
| **Part XV** | | | |
| 7 | 300(1) | Disclosure of Interests Exemption Guidelines | Guidelines for the Exemption of Listed Companies from the Securities (Disclosure of Interests) Ordinance (Cap.396) published in July 1991. |
| **Part XVI** | | | |
| 8 | 385(1) | Fit and Proper Criteria | Fit and Proper Criteria issued in December 2000 after consultation with market. |
| 9 | 385(1) | Guidance Note on Incidental Investment Advice Provided by Solicitors and Accountants | Guidance Note on Incidental Investment Advice Provided by Solicitors and Accountants issued in July 2000 after consultation with market. |
| 10 | 385(1) | Codes on Takeovers and Mergers and Share Repurchases | The Codes on Takeovers and Mergers and Share Repurchases were revised after consultation with the market, and the amendments became effective on 19 October 2001. In addition, consultation on an overall review of the Codes was concluded in June 2001. The revised Code has become effective on 1 February 2002. |
| 11 | 385(1) | Code on Investment-Linked Assurance Schemes | Code on Investment-Linked Assurance Schemes issued in January 1998 after consultation with market. |
| 12 | 385(1) | Code on Pooled Retirement Funds | Code on Pooled Retirement Funds issued in January 1998 after consultation with market. |
| 13 | 385(1) | Code on Collective Investment Schemes | Code on Unit Trusts and Mutual Funds (3rd Edition) issued in December 1997 after consultation with market. |
| 14 | 385(1) | Code on Immigration-Linked Investment Schemes | Code on Immigration-Linked Investment Schemes issued in February 1993 after consultation with market. |
| 15 | 385(1) | Guidance Note on Internet Regulation | Guidance Note on Internet Regulation issued in March 1999 after consultation with market. |
| 16 | 385(1) | Management, Supervision and Internal Control Guidelines for Persons Licensed by the SFC | Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the SFC issued in May 1997 after consultation with market. |

| Serial No. | Clause in SF Bill | Code/Guideline | Derivation |
|---|---|---|---|
| 17 | 385(1) | Guidance Note on Transitional Arrangements | New but based on Schedule 9 provisions in relation to Part V. |
| 18 | 385(1) | Code of Share Registrars | Code of Share Registrars issued in October 2001 after consultation with market. |

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