

For discussion
on 18 December 2003

Paper No. CA1-9/03

Bills Committee on Companies (Amendment) Bill 2003

Schedule 1 – Amendments to the Companies Ordinance relating to prospectuses

Securities and Futures Commission's statutory power to make rules and statutory duty to conduct consultation

BACKGROUND

When the Bills Committee considered at its meeting on 9 December 2003 Clause 3 concerning the proposal for empowering the Securities and Futures Commission (SFC) to issue class exemption notice (which is a piece of subsidiary legislation subject to negative vetting by the Legislative Council (LegCo)) and requiring the Commission to consult the public on the draft notice, a Member asked the Administration to consider whether it should be the Administration, instead of SFC, to make subsidiary legislation and to conduct prior consultation on the draft legislation. This paper sets out our response to the Member's comments.

POWER FOR SFC TO MAKE RULES

Effective performance of SFC's regulatory functions

2. Under the regulatory structure enshrined in the recently commenced Securities and Futures Ordinance (SFO), SFC is an independent statutory regulator responsible for, inter alia, maintaining and promoting the fairness and efficiency of the securities industry. It is vested with the power to make subsidiary legislation which –

- (a) is in line with the primary legislation; and
- (b) seeks to enable the Commission to implement the primary legislation in accordance with its regulatory objectives.

3. Effective regulation requires the regulator to exercise reasonable flexibility in adjusting the regulatory requirements to meet

changing market needs. This can be achieved by making timely amendments to subsidiary legislation (“rules”) which prescribes detailed and technical requirements. Hence, such rule-making power is necessary for SFC to be able to respond to changing market needs in a timely manner.

Regulatory independence

4. Under the regulatory structure enshrined in SFO, the Administration does not, and should not, interfere in SFC’s performance of day-to-day regulatory functions. This is important for maintaining the regulatory independence of SFC. Practical experience indicates that SFC’s power to make rules prescribing technical and detailed requirements is part and parcel of its performance of day-to-day regulatory functions.

5. This subject was thoroughly debated during the passage of the Securities and Futures Bill through the legislature. The Bills Committee then was particularly conscious of the need to preserve the regulatory independence of SFC, including the way in which it implemented SFO in accordance with the powers, functions and duties stipulated therein. Hence, any arrangement that may undermine SFC’s regulatory independence should be carefully deliberated.

Existing practice

6. Under the existing Companies Ordinance (CO), SFC is empowered to issue class exemption notice. SFC is also empowered by SFO to make certain rules which are subsidiary legislation. No complaints or adverse comments about the existing arrangement have been received from market users and the general public. Indeed SFC, in exercising its powers and performing its functions, is subject to a number of checks and balances at **Annex A**. These have been modernized during the SFO exercise and can be said to be the most comprehensive safeguards to ensure proper use of powers by financial service regulators in our statute.

Overseas experience

7. It is international trend that rules prescribing detailed and technical requirements for conducting financial services are made by the relevant market regulators. Our approach is in line with international practice.

United Kingdom (UK)

8. In UK, the Financial Services Authority (FSA) is empowered by the Financial Services and the Markets Act (FSMA) to make rules, including amendments to these rules. They are extra-parliamentary i.e. they are not subject to any form of scrutiny or vetting by the Parliament before they become effective. The making of these rules do not require approval from the Treasury.

Singapore

9. In Singapore, the Monetary Authority of Singapore (MAS) may make regulations under a number of statutes for the better carrying out of the objects and purposes of the legislation. Moreover, listing rules and amendments, which carry legislative effect, made by a securities exchange are not subject to any form of scrutiny or vetting by the Parliament. MAS may disallow or alter the amendments within 21 days, and prior approval from the Minister for Finance is not necessary.

DUTY FOR SFC TO CONSULT

Integrity of the rule-making process

10. Since the subsidiary legislation is prepared and made by SFC, it is logical for SFC to conduct public consultation on the draft subsidiary legislation before making it. Consultation on the contents of such subsidiary legislation is an integral part of the rule-making process. It would be illogical to vest the rule-making power in SFC; and impose the duty to consult on draft rules on the Administration, or indeed any other party who is not the owner of such rules.

Regulatory expertise

11. SFC has the regulatory expertise and a well-established mechanism, e.g. its Advisory Committee, Shareholders Group and focus groups, to gauge the views of stakeholders in a professional manner. It is well-placed to conduct public consultation on the draft subsidiary legislation to be made by it under CO.

12. In fact since commencement of SFO, SFC has been adhering to the new mandatory consultation requirement in section 398 of SFO, on which Clauses 3, 16 and 24 are modelled, and conducted two consultation exercises on its proposals for new subsidiary legislation. The market is positive towards such engagement efforts made by SFC.

Regulatory independence

13. Consultation on the draft subsidiary legislation to be made by SFC forms part of its day-to-day regulatory functions. SFC will be answerable to the market users who will be affected by the draft subsidiary legislation and in a position to explain the rationale behind the proposal. It will also benefit from the public comments so received in shaping the final product to be tabled at LegCo. The Administration's involvement in the consultation will inevitably undermine the regulatory independence of SFC, and may be misconstrued as interfering into the way in which SFC is performing its regulatory functions.

Overseas experience

14. The arrangement for the regulator, i.e. SFC, to conduct consultation on the draft subsidiary legislation to be made by it is consistent with modern securities legislation such as UK's FSMA. Under FSMA, FSA must make and maintain effective arrangements for consulting stakeholders on the extent to which its general policies and practices are consistent with its general duties. FSMA provides that FSA has, subject to certain exception, the statutory duty to conduct consultation before making any rules. This is emulated in section 398 of SFO, in response to the request of Members during the passage of the Securities and Futures Bill through the legislature. Relevant extracts from SFO are at **Annex B**. The implementation of this particular section of SFO has been well received by the market and the general public. For consistent treatment, this arrangement has been replicated in Clauses 3, 16 and 24 of the Bill.

CONCLUSION

15. The success of Hong Kong as an international financial centre is predicated on our ability to devise and maintain a modern regulatory regime which is responsive to market changes and capable of timely adjustment. Regulatory experience indicates that there is a practical need for SFC to be vested with the power to make subsidiary legislation prescribing detailed and technical requirements, and to perform the duty to consult on the contents of the draft subsidiary legislation so made. This arrangement is in line with public expectation and international practices. By making the consultation arrangement statutory, the market and the general public are reassured. In order to maintain and modernise the regulatory regime, the Administration believes that SFC should continue to be vested with the power to make subsidiary legislation and to perform the duty to consult on the contents

of the draft subsidiary legislation to be made by it. It would not be appropriate for the Administration to take over these roles from SFC which possesses the relevant knowledge and expertise.

Financial Services and the Treasury Bureau
Securities and Futures Commission
15 December 2003

Checks and Balances over SFC's Exercise of Functions and Powers

1. The Chief Executive (CE) appoints all the SFC directors; the majority of the members of the Commission shall be non-executive directors.
2. CE may give SFC directions regarding the performance of its duties and functions.
3. CE approves estimates of SFC's income and expenditure and the Financial Secretary (FS) causes the approved estimates to be laid before LegCo.
4. SFC must prepare annual report and send a copy to FS who shall cause a copy to be laid before LegCo.
5. SFC must furnish such information to FS as he may specify.
6. An independent Securities and Futures Appeals Tribunal, which has judicial status, hears appeals against certain decisions made by SFC.
7. Any SFC's decisions concerning the recognition and closure of exchanges (and clearing houses) and the issuance of restriction notice and suspension order in respect of exchanges (and clearing houses) may be appealed to CE in Council.
8. SFC must consult the public on draft subsidiary legislation to be made by it.
9. An independent Process Review Panel established by CE reviews SFC's internal operating procedures, including those for ensuring consistency and fairness.
10. Complaints against the actions of SFC or any of its staff may be lodged with the Office of the Ombudsman.
11. Judicial review by the Court of First Instance of relevant SFC decisions is available.
12. Director of Audit may examine records of SFC.

398. General provisions for rules by Commission

(1) Notwithstanding any other provisions of this Ordinance but subject to subsection (3), where the Commission proposes to make rules under any provision of this Ordinance, it shall publish a draft of the proposed rules, in such manner as it considers appropriate, for the purpose of inviting representations on the proposed rules by the public.

(2) Where the Commission makes any rules under any provision of this Ordinance after a draft is published under subsection (1) in relation to the rules, it shall—

- (a) publish, in such manner as it considers appropriate, an account setting out in general terms—
 - (i) the representations made on the draft; and
 - (ii) the response of the Commission to the representations; and
- (b) where the rules are made with modifications which in the opinion of the Commission result in the rules being significantly different from the draft, publish, in such manner as it considers appropriate, details of the difference.

(3) Subsections (1) and (2) do not apply if the Commission considers, in the circumstances of the case, that—

- (a) it is inappropriate or unnecessary that such subsections should apply; or
- (b) any delay involved in complying with such subsections would not be—
 - (i) in the interest of the investing public; or
 - (ii) in the public interest.

(4) Notwithstanding any other provisions of this Ordinance, the Commission shall consult the Monetary Authority regarding rules it proposes to make under any provision of this Ordinance in so far as such rules apply to authorized financial institutions by reason of their being registered institutions, or associated entities of intermediaries.

(5) For the avoidance of doubt, nothing in subsections (1) to (4) affects any other requirements which, apart from such subsections, apply to the making of any rules under any provision of this Ordinance.

(6) Where rules are made by the Commission under any provision of this Ordinance and it has not been provided in this Ordinance that the rules may provide that a contravention of any specified provision of the rules constitutes an offence, the Chief Executive in Council may make regulations to provide that a person who contravenes any specified provision of the rules that applies to him commits an offence and is liable to a specified penalty not exceeding—

- (a) on conviction on indictment a fine of \$500,000 and a term of imprisonment of 2 years;
- (b) on summary conviction a fine at level 6 and a term of imprisonment of 6 months.

(7) Except as otherwise provided in this Ordinance, rules made by the Commission under any provision of this Ordinance may provide that, subject to the terms and conditions specified in the rules, the provisions of this Ordinance specified in the rules—

- (a) shall not have effect, or shall only have effect to a specified extent, in relation to any specified person or to members of a specified class of persons—
 - (i) who is or are or may be required to be licensed by reason only of his or their doing anything that is incidental to another business;
 - (ii) who does not or do not, on behalf of any other person, deal in securities or futures contracts or trade in interests in collective investment schemes or leveraged foreign exchange contracts; or
 - (iii) who is or are or may be required to be licensed by reason only of his or their entering into a specified class of transactions;

- (b) shall not have effect in relation to any specified transaction or class of transactions entered into by any specified person or class of persons;
 - (c) shall, where they require any application, statement, notice or other document (however described) to be lodged or filed with or submitted to the Commission, be regarded as having been complied with if the application, statement, notice or other document (as the case may be) is lodged or filed with or submitted to any other specified person.
- (8) Except as otherwise provided in this Ordinance, rules made by the Commission under any provision of this Ordinance—
- (a) may be of general or special application and may be made so as to apply only in specified circumstances;
 - (b) may make different provisions for different circumstances and provide for different cases or classes of cases;
 - (c) may authorize any matter or thing to be determined, applied or regulated by any specified person;
 - (d) may provide for the exercise of discretion in specified cases;
 - (e) may, for the better and more effectual carrying into effect of any provision of this Ordinance or the rules, include any savings, transitional, incidental, supplemental, evidential and consequential provisions (whether involving the provisions of any principal legislation or the provisions of any subsidiary legislation).