

立法會
Legislative Council

LC Paper No. CB(1) 434/02-03

Ref : CB1/HS/1/01

**Paper for the House Committee meeting
on 6 December 2002**

**Report of the Subcommittee on Draft Subsidiary Legislation
to be made under the Securities and Futures Ordinance**

Purpose

This paper reports on the deliberations of the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (SFO) (Cap. 571).

Background

2. The SFO was enacted by the Legislative Council (the Council) on 13 March 2002 to consolidate ten existing Ordinances⁽¹⁾ regulating the securities and futures market into one single ordinance with the aim to enhance Hong Kong's competitiveness as an international financial centre. While the SFO prescribes the necessary regulatory regime for the development of an efficient, fair, orderly and transparent market, it does not contain detailed requirements and regulations. The SFO provides the relevant authorities, including the Chief Executive (CE) in Council, the Chief Justice (CJ), and the Financial Secretary (FS) and the Securities and Futures Commission (SFC) with rule-making power to stipulate detailed and technical requirements and

⁽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).

regulations for the market and practitioners through subsidiary legislation⁽²⁾. The requirement that the rules be made under the Interpretation and General Clauses Ordinance (Cap. 1) (i.e. subject to the negative vetting of the Council) is consistent with the current arrangement under the ten Ordinances. It is noted that the inclusion of technical regulatory details in subsidiary legislation is in line with the approach adopted by modern securities legislation in other jurisdictions to enable regulators to respond efficiently to changing market practices and global conditions by proposing amendments to rules rather than amendments to the primary legislation.

3. A total of 39 sets of subsidiary legislation (including the Notices to commence the SFO and to repeal existing Ordinances) will need to be made for commencing the SFO. They will be brought into operation concurrently with the SFO. The Administration expects this to take place shortly, after completion of the negative vetting procedure through the Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. The Administration aims to announce the target commencement date by the end of 2002.

The Subcommittee

4. Given the complexity and the volume of subsidiary legislation to be made under the SFO, the Bills Committee on the Securities and Futures Bill and the Banking (Amendment) Bill 2000 recommended that in order to allow sufficient time for scrutiny, the subsidiary legislation should be studied in draft form before they are formally tabled before the Council. On 22 February 2002, the House Committee agreed to form a subcommittee for the purpose. The Subcommittee on Draft Subsidiary Legislation to be made under the SFO (the Subcommittee), under the chairmanship of Hon SIN Chung-kai, held 12 meetings from March to October 2002. The membership list of the Subcommittee is in **Appendix I**.

5. The Subcommittee studied the draft subsidiary legislation and related legislative proposals put forward by the Administration as listed in **Appendix II**. To solicit views of market players and to facilitate their compliance with the subsidiary legislation, SFC consulted, where appropriate, the market and the public on the draft subsidiary legislation. The drafts were then submitted to the Subcommittee for scrutiny in batches based on the progress of the consultation exercises on individual drafts. For each set of draft subsidiary legislation, SFC set out the views it received from interested parties as well as its responses.

⁽²⁾ All “rules”, “regulations”, “orders”, and “notices”, unless expressly provided otherwise, made by the SFC, CE in Council, CJ or FS will be subsidiary legislation under the SFO.

Deliberations of the Subcommittee

6. This report summarizes the Subcommittee's deliberations on the draft subsidiary legislation to be made under the SFO which will come into effect upon its commencement. In scrutinizing the draft subsidiary legislation, the Subcommittee has examined the drafts against the regulatory objectives⁽³⁾ of SFC including its objectives to maintain and promote a transparent and orderly market, and to provide protection to the investing public. It has considered comments made by interested parties during the consultation exercises and the responses of the Administration or SFC. The Subcommittee has also discussed the policy issues relating to the draft subsidiary legislation, reviewed the proposals made by the market and suggested amendments to improve the drafting. To facilitate members in perusing the report, **Appendix II** summarizes the draft subsidiary legislation and provides the relevant paragraph number in the report cross referencing each set of draft Rules in the report.

Securities and Futures (Recognized Counterparty) Rules

7. The term "recognized counterparty" is defined in section 1 of Part 1 of Schedule 1 to the SFO to include, among others, an institution prescribed by rules made under section 397 of the SFO. The captioned draft Rules prescribe institutions which will qualify as recognized counterparties. An institution prescribed as a "recognized counterparty" will not be regarded as a client of a leveraged foreign exchange trader, hence the regulatory requirements in relation to the trader's clients (e.g. issuance of contract notes and statement of accounts) will not apply to "recognized counterparties". In addition, certain requirements under the Securities and Futures (Financial Resources) Rules will not be applicable to such recognized counterparties. The captioned draft Rules basically preserves the existing criteria adopted by SFC to designate recognized counterparties under section 2 of the Leveraged Foreign Exchange Trading Ordinance (Cap. 451). The draft Rules prescribe five types of institutions as recognized counterparties (clauses 3(a) to (e)). Under clause 3(e), SFC may recognize certain institutions if it is satisfied that the recognition is appropriate and would not prejudice the interest of the investing public and which is specified in Schedule 2 to the Rules. These are basically institutions that do not fit into any of the other four prescribed types of institutions and are drawn up by SFC with reference to the existing list of recognized counterparties.

8. The Subcommittee supports the draft Rules in general. Members consider that allowing leveraged foreign exchange traders to treat their institutional clients as recognized counterparties will facilitate the conduct of traders' business and reduce their compliance cost. As the types of

⁽³⁾ The regulatory activities of SFC are stipulated in section 4 of the SFO.

institutions specified in the draft Rules are subject to stringent criteria such as, regulated by specified jurisdictions (listed in Schedule 1 to the draft Rules), and having issued debt instruments that continue to attract a qualifying credit rating, only institutions that are familiar and qualified for the wholesale end of leveraged foreign exchange trading may qualify.

9. However, members note a market suggestion that SFC should publish the list of qualified recognized counterparties in order to facilitate the operation of leveraged foreign exchange traders. The SFC explains that institutions which meet the qualifying criteria will automatically become recognized counterparties. Institutions recognized by SFC under clause 3(e) will be listed in Schedule 2 to the draft Rules and published in the Gazette.

10. Regarding members' enquiry on the bases for selecting the specified jurisdictions listed in Schedule 1, SFC explains that the specified jurisdictions cover all major jurisdictions in which existing recognized counterparties are incorporated.

Securities and Futures (Stock Market Listing) Rules

11. The captioned draft Rules are to be made by SFC under section 36(1) of the SFO, which empowers SFC to make rules in respect of the listing of securities, such as the requirements to be met before securities may be listed, the procedure for dealing with listing applications, the cancellation of the listing of any specified securities, conditions for suspension or re-commencement of dealings, etc. Provisions are largely based on existing subsidiary legislation currently in force. Yet, there are new elements in the draft Rules. Firstly, a company applying for listing (the applicant) will be required to submit copies of its listing application to SFC within one business day after the same is submitted to the exchange company (clause 5). The SFC may require the applicant to supply further information within ten business days (clause 6). The SFC may object to the listing if the applicant fails to comply with such a requirement, or if it appears to SFC that the applicant has supplied false or misleading information in its application, or if it is not in the public interest or in the interest of the investing public to approve the application. Secondly, the same dual-filing requirement will also be applicable to public statements and other disclosure of information by listed corporations as required by rules made by the exchange company or other applicable laws (clause 7).

12. Members of the Subcommittee support the new dual-filing arrangement. By requiring additional information from listing applicants or listed corporations, SFC is able to exercise its investigatory powers in gathering evidence and establishing the facts (e.g. section 182 of the SFO). Where appropriate, SFC may bring offenders of the provision for false or misleading information to prosecution (section 384 of the SFO). The Subcommittee

accepts that the new dual-filing requirement will act as an effective deterrent against disclosure of false or misleading information, and is a positive move to improve the quality of corporate information disclosure as well as to enhance credibility and competitiveness of the Hong Kong market.

Dual-filing of information to SFC

13. However, the Subcommittee is aware of the concerns raised by market practitioners over the dual-filing and vetting procedure as it may unnecessarily delay the listing process. Their concerns are two-fold: the time and cost in submitting copies of applications to SFC and the ten-day period for SFC to require additional information. In this respect, SFC stresses that the draft Rules have been formulated in such a way that the listing process is not burdened with additional red tapes. To facilitate compliance, the listing applicant is deemed to have fulfilled its filing obligation to SFC by authorizing the exchange company to file a copy with SFC on its behalf. As the exchange and SFC are already moving towards electronic filing of applications and dissemination of disclosure documents, forwarding of information can be done almost automatically. Hence, there should not be any additional compliance burden on the part of the applicant. As to some comments that the ten-day period to allow SFC to request additional information from listing applicant is too long, the Subcommittee notes that the ten-day period will run concurrently with the exchange's vetting timetable, which usually takes a minimum of 25 clear business days. The ten-day period therefore will not prolong the listing approval process. However, the Subcommittee suggests, and SFC agrees, to take into account the complexity and nature of different applications and confirms its "no objection" to the listing as soon as possible.

14. The Subcommittee has also examined whether the dual vetting of listing documents will result in duplication of effort between SFC and the exchange, and create uncertainty over the regulatory roles of the two bodies. The SFC assures the Subcommittee that the exchange will remain the point of contact with listing applicants and will conduct the frontline review. The SFC will not attempt to vet the commercial merits of each listing application. The SFC however will ensure that the public receives timely, accurate and full disclosure to make informed decisions. The SFC further advises that before the commencement of the SFO and the draft Rules, SFC and the exchange will revise their Memorandum of Understanding (MOU), where the related administrative arrangements concerning the new dual-filing requirements will be laid down. The new MOU will be published as soon as it is ready.

Approval of listing applications

15. As regards SFC's discretion to object to listing applications, SFC explains that the decision will mainly be based on grounds that the applicant has provided false or misleading information, or on public interest

considerations. The applicant will have a right of appeal to the independent Securities and Futures Appeals Tribunal (SFAT) for a review on the objection.

16. The Subcommittee shares the view of some market practitioners that the Penny Stocks Incident in July 2002 has necessitated a review of the functions and responsibilities of relevant authorities for approving listing applications and subsequent surveillance of the performance of listed companies. In this respect, the Subcommittee notes that the dual-filing proposals are targetted for commencement of the SFO, and that the Administration will review and formulate long term measures concerning listing matters, after commencement of the SFO, in the light of the forthcoming recommendations of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure due in March 2003.

Securities and Futures (Transfer of Functions - Stock Exchange Company) Order

17. Apart from the functions of SFC specified in the SFO, certain provisions under Parts II and XII of the Companies Ordinance (Cap. 32) also confer functions upon SFC relating to the vetting and authorization of prospectuses concerning shares in or debentures of a corporation. Under section 25 of the SFO, SFC may request the CE in Council to make a transfer order transferring certain functions of SFC to a recognized exchange company, if SFC is satisfied that the designated exchange company is willing and able to perform the functions. The captioned draft Order, which specify these matters, is substantially the same as the present Securities (Transfer of Functions) Order (Cap. 24, Sub. Leg. H). To preserve the existing arrangements under which prospectuses of mutual funds corporations are authorized by SFC, the draft Order has carved out collective investment schemes (the term as defined in the SFO includes mutual funds and other pooled investment products) from the scope of transfer so that collective investment schemes will remain subject to SFC's authorization for marketing to the public.

18. The Subcommittee notes that there is no comment on the draft Order from the market. It is also noted that SFC may perform the transferred functions concurrently with the exchange company as provided under clause 3 of the draft Order to provide a firm legal basis for SFC to consider listing applications as necessary.

Securities and Futures (Contracts Limits and Reportable Positions) Rules

19. The SFC is empowered under section 35(1) of the SFO to prescribe the limits on the number of specified futures contracts and options contracts which may be held or controlled by any person in any one contract month or expiry month, and the related reporting requirements. The relevant limits and reportable positions for futures contracts and stock options contracts are set out

in Schedules 1 and 2 to the captioned draft Rules respectively, and will be updated from time to time when new products are launched on the exchange. The draft Rules also provide that a person authorized under the rules of a recognized exchange company may hold or control such contracts in excess of the limits. Persons who may be authorized include registered market-makers, and issuers of structured products like derivative warrants and equity linked instruments. The SFC may also allow certain persons to hold or control contracts in excess of the limits in special circumstances. Persons holding or controlling a reportable position are required to notify the exchange company concerned within one trading day of the reportable position and provide the information required.

20. The Subcommittee agrees with the objective of the draft Rules, which seek to prevent the holding or controlling of large concentrations of contracts by one person without the recognized exchange company being notified, hence minimizing systemic risks and promoting transparency of the market. Members note that the market is generally in support of the draft Rules which are based on the existing Securities (Exchange - Traded Stock Options) Rules (Cap. 333 Sub. Leg. K) and the Commodities Trading (Trading Limits and Position Limits) Rules (Cap. 250 Sub. Leg. E). No new policy has been introduced.

21. Members further welcome the initiative of the exchange to explore with the industry the feasibility of notifying the exchange through electronic means to facilitate compliance of the reporting requirement within one trading day.

Securities and Futures (Professional Investor) Rules

22. The SFO has incorporated the concept of a “professional investor” who is a sophisticated individual or institution capable of protecting his/its own interests so that certain investor protection measures (e.g. prescribed in sections 103, 174 and 175 of the SFO and those provisions in the subsidiary legislation to be made that refer to “professional investor”) can be dispensed with or modified when the relevant activities are targeted at them. By disapplying these protection measures in relation to professional investors, the compliance cost to the market intermediaries can be reduced without compromising investor protection.

23. The term “professional investor” is defined in section 1 of Part 1 of Schedule 1 to the SFO to include various classes of persons, such as intermediaries, authorized financial institutions (AIs), insurance companies and recognized exchange companies. Paragraph (j) of the definition provides that other persons prescribed by SFC in rules made under section 397 will also qualify as “professional investor”. This will provide flexibility to develop the definition further to meet emerging market needs. This extended definition of

“professional investor” applies throughout the SFO and its subsidiary legislation, except Schedule 5 to the SFO.

24. The captioned draft Rules prescribe additional classes of persons as “professional investor” including trust companies, corporations/partnerships, and individuals (either alone or with his associates on a joint account), with total assets or investment portfolios meeting certain threshold levels in Hong Kong dollars or equivalent amount of foreign currency.

25. Members note the industry's comment that the portfolio size of an investor should not be the sole criterion for determining the professional investor status and other factors, such as the investors' investment experience and trading pattern, should also be taken into account. The SFC explains that the asset threshold requirement will provide a more objective definition for “professional investor” and ensure investors have sufficient financial resources to protect their own interests. This approach is also broadly in line with that of other major jurisdictions, like the United States (US) and the United Kingdom (UK).

26. On the asset requirements for “professional investor”, while members note the proposed threshold of HK\$ 40 million in total assets for trust companies and corporations, they support SFC’s revised proposal in response to industry’s request to reduce the portfolio threshold in respect of individual, corporation or partnership from the original proposed HK\$16 million to HK\$8 million to make it in line with the existing requirement in the Code of Conduct applicable to intermediaries. They also note that the reduced threshold is comparable to that of US and UK.

27. As regards assets jointly held by an individual with his “associate”, while some members share the view from the Hong Kong Stockbrokers Association (HKSbA) that limiting “associate” to spouse and children of the individual will exclude joint assets held with parents and siblings from the calculation of asset threshold requirement and prevent “family investment” from meeting the “professional investor” definition, they note SFC's view that as the modern concept of family only includes spouse and children, it is appropriate to exclude parents and siblings from the definition of “associate”. Moreover, the extension proposed by the industry may lead to abuse whereby resources from a large group of people could be pooled together for meeting the threshold requirement for “professional investor” to circumvent the investor protection measures.

28. On the tests for ascertaining whether a person or an institution will qualify as a “professional investor”, members agree that the asset evaluation process should be simple and straight forward to reduce compliance burden on investors and intermediaries. They support SFC's amendments so that verification can now be done by referring to the audited financial statements,

custodian statements or certificates issued by auditors or accountants. The definition of “custodian” is also revised to include AIs, licensed corporations and their overseas equivalents. However, SFC considers that it is unnecessary to specify the “relevant date” for calculating assets in foreign currency in the draft Rules as documents from banks or custodians will contain valuation of assets as at a specific date.

29. In order to facilitate the awareness of investors of their “professional investor” status, members note that the intermediaries are obliged under the Code of Conduct applicable for intermediaries to take necessary steps to verify whether their clients are eligible for such status and advise them of their rights accordingly.

Securities and Futures (Exempted Instruments - Information) Rules

30. While section 103 of the SFO imposes a general prohibition on the issue of marketing materials for investment products, section 103(3)(e), (f) and (g) provides exemption for documentation in relation to certificates of deposit or commercial papers provided that certain minimum denomination and capitalization requirements are met. Section 110 requires the relevant issuers of the exempted instruments to file with SFC certain information within ten business days after issue of the relevant marketing materials. The captioned draft Rules specify the information required. The draft Rules are to be made by SFC under section 397(1) of the SFO. The intention is to enhance transparency and allow the relevant regulatory authorities to monitor the development of capital markets in Hong Kong.

31. Members note that the industry is generally content with the information requirements specified in the draft Rules, which basically replicate the existing requirements under the Protection of Investors Ordinance (PIO) (Cap. 335).

Securities and Futures (Collective Investment Schemes) Notice

32. For the sake of protection of investors, section 103 of the SFO imposes a general prohibition on the issue to the public of advertisements, invitations and documents relating to a wide range of investments mainly falling into a category described as “collective investment schemes” in the SFO. Section 104 further requires the advertisements, etc. and the schemes themselves to be authorized by SFC. With a view to providing adequate flexibility to address changing market conditions, the term “collective investment schemes” is not exhaustively defined in the SFO. The definition in section 1 of Part 1 of Schedule 1 to the SFO provides that the scope of the term can be enlarged or limited from time to time by a notice made by FS published in the Gazette under section 393 to prescribe arrangements with certain characteristics as “collective investment schemes”.

33. The captioned draft Notice prescribes that the arrangements for the purchase of gold coin or gold bullion which have the characteristics, namely to obtain ownership of the coin or bullion for valuable consideration, to defer taking possession of the coin or bullion, and to transfer or retransfer the ownership of the coins or bullion to specified persons, are to be regarded as “collective investment schemes”.

34. A member expresses the concern of the gold industry that the common practice whereby gold dealers keep safe custody of purchased gold on behalf of their clients may have the effect of enabling the clients to “defer taking possession of the coin or bullion” and that such business would thus fall within the scope of the draft Notice and be subject to the regulation of “collective investment schemes”. The SFC explains that the draft Notice aims to replicate the existing Protection of Investors (Gold Purchase) Order made under the PIO to prescribe “paper gold schemes” as “collective investment schemes” to bring them within the regulatory framework for offering of investment products. The SFC further clarifies that the ordinary sale and purchase of gold products and the business practice mentioned above will not involve the offering of “paper gold schemes”. The SFC assures that the normal business practice of gold dealers will not be affected.

Securities and Futures (Leveraged Foreign Exchange Trading - Exemption) Rules

35. “Leveraged foreign exchange trading” is one of the regulated activities defined in Part 2 of Schedule 5 to the SFO. The definition in the Schedule is described in broad term. A range of acts and transactions are excluded from the definition. These exclusions include classes of persons, or types of business prescribed by rules made by SFC under section 397(1) of the SFO. This means that these persons or acts need not obtain a licence for carrying on activities that may constitute leveraged foreign exchange trading. The captioned draft Rules prescribe the classes of persons to be excluded from the definition. The classes include corporations with a qualifying credit rating, and either whose principal business is not in leveraged foreign exchange spot transactions, or the average amount of each transaction is not less than \$7.8 million; licensed corporations or their clients; as well as issuers concerned with trading of listed currency warrant.

36. Members agree that as the exempted classes are corporations targetting at non-retail investors, the draft Rules do serve to facilitate market development and reduce compliance cost without compromising investor protection. However, there is concern that without prescribing the procedure for application of exemption but only requiring corporations to notify SFC after each financial year that they satisfy the conditions for exemption, a corporation may not know before the end of a financial year whether it is qualified for

exemption or not. According to SFC, it is easy to establish proof on qualifying crediting rating of a corporation and whether its principal business is in leveraged foreign exchange spot trading. As the \$7.8 million minimum threshold is low in terms of leveraged foreign exchange transactions undertaken in the non-retail market, a corporation will be able to tell from its client base whether it has met the threshold. The SFC points out that the notification requirement has operated for several years and worked well. Nonetheless, if a corporation is in doubt, it should seek to take out a licence rather than relying on the exemption.

Securities and Futures (Leveraged Foreign Exchange Trading) (Arbitration) Rules

37. Part V of the SFO provides for the licensing and registration of individuals and corporations who carry on regulated activities by SFC, including trading in leveraged foreign exchange contracts. Section 118(1)(b) provides that it is a condition of a licence for carrying on trading in leveraged foreign exchange contracts that any dispute between a client and a licensed corporation be arbitrated in accordance with rules made by SFC under section 118(2). The captioned draft Rules provide for the establishment and functions of an arbitration panel for the purposes of section 118(2), the appointment of the chairman and members of the panel and its practice and procedures.

38. The Subcommittee is in support of the draft Rules, which are adapted from the existing Leveraged Foreign Exchange Trading (Arbitration) Rules (Cap. 451 Sub. Leg. C). The Subcommittee also notes that the draft Rules are welcomed by the market. However, during the course of deliberation there is concern on the arbitration cost. According to SFC, representatives from the Hong Kong International Arbitration Centre would provide expert advice on matters relating to the practice and procedure of an arbitration, while members of the arbitration panel, who are expected to be experienced market practitioners of foreign exchange trading, would give expertise advice on the merits of the case. Nonetheless, the Administration agrees to consider appointing members with both knowledge on arbitration and foreign exchange trading to the arbitration panel in future.

Securities and Futures (Licensing and Registration) (Information) Rules

39. Section 128 of the SFO requires applicants making applications under Part V of the SFO to provide SFC with required information to enable it to consider the applications. Section 135 requires a person who has provided SFC with information to give notice in writing of changes to the information. Clause 3 of and Schedule 2 to the captioned draft Rules set out the information required to be provided by applicants (e.g. for corporate or representative licence, for certificate of registration by AIs, and application to become or continued to be a substantial shareholder of a licensed corporation) to enable

SFC to consider their applications. Clause 4 of and Schedule 3 to the draft Rules specify the circumstances in which notification to SFC or the Hong Kong Monetary Authority (HKMA) as appropriate of changes in information must be given within seven business days (e.g. changes in contact details, details relating to corporation's associated entities).

40. Section 138(4) of the SFO further requires licensed corporations and licensed representatives to submit annual returns to SFC containing certain information. Clause 5 of the draft Rules specify the information that must be contained.

41. Section 136(1) of the SFO requires SFC to maintain a register of licensed persons and registered institutions (RIs). Clause 6 of and Schedule 4 to the draft Rules set out the particulars to be contained in the register.

Information for applications

42. On the information to be provided to SFC for processing applications, members note that the draft Rules specify the "basic information" (e.g. name and address of an applicant) and "relevant information" (e.g. criminal convictions and disciplinary records) to be provided by applicants while the detailed requirements will be explained in the relevant application forms. To facilitate compliance by the industry, SFC has set up a working group to draft the forms in consultation with industry practitioners. The SFC stresses that in line with current practice, SFC will only require information from applicants which is not known to it.

43. It is noted that the information to be submitted to SFC include details such as examinations passed by an applicant. Some members consider the information irrelevant to the applications. According to SFC, the same information is required under existing regime. Such information is important for SFC to assess the competence of applicants and their fitness and properness. Other information such as matters relating to the corporation's solvency is important for investor protection. Nonetheless, after considering members' views, SFC agrees to revise the draft Rules to specify clearly the specific information required for different types of application. The revised draft Rules make clear that applicants need to submit information on "spent" convictions as required under existing regime, and require information only in respect of the highest educational qualification obtained by the applicant. The Rules also remove the need to provide information in relation to compliance with the continuous professional training requirement by both licensed corporations and licensed representatives. The SFC further agrees to update guidelines and relevant publications explaining to different applicants on information requirements.

Notification on changes in information

44. Concerning changes in information that notification to SFC/HKMA is required, the Subcommittee shares large international financial institutions' concern over the administrative burden arising from certain reporting requirements such as, changes in registration or stock exchange membership status of the substantial shareholders of their overseas companies, and changes in substantial shareholders' capital and shareholding structure. Noting the concern, SFC has amended the draft Rules to delete the requirements but retain the need to report changes relevant to the substantial shareholder's fitness and properness and substantial changes in the capital structure in the interest of investor protection.

45. Noting that there are differences in information requirements from RIs and licensed corporations, the brokerage industry reiterates its concern over the need to maintain a level playing field between SFC licensed corporations and RIs in the conduct of regulated activities. After careful consideration, SFC has amended the draft Rules to ensure the requirements are similar where appropriate. For instance, the revised draft Rules require RIs to notify changes in status of membership of a stock or futures exchange, issues relating to fitness and properness, and material changes in regulated business activities. However, on the requirement to report matters relating to solvency of a corporation, HKMA advises that RIs are subject to its supervision and reporting of such matters is already required under the Banking Ordinance (Cap. 155) (BO).

Particulars to be included in SFC's register

46. Section 136(1) of the SFO requires SFC to maintain a register of licensed persons (both corporation and individuals) and RIs available for public inspection. Section 4 of the Banking (Amendment) Ordinance 2002 (BAO) requires HKMA to maintain a public register for individuals engaged by RIs in relation to their conduct of regulated activities. While section 136 of the SFO set out the basic information to be included in the registers, additional particulars may be added pursuant to SFC rules made under section 397 of the SFO.

47. The Subcommittee welcomes SFC's initiative to include information on the history of enforcement/disciplinary actions against the licensed persons in the public register. Examples of other particulars to be included are certain information on waiver or modification granted, suspension status of the licensed persons and list of licensed representatives accredited to a licensed corporation.

48. Regarding the disclosure of disciplinary record of intermediaries and licensed representatives in the register, members note that while the market

generally supports the proposal, there are concerns about the long disclosure period of five years and the propriety of disclosing all types of disciplinary actions. According to SFC, the purpose for providing information on disciplinary record is to enable investor to get access to relevant information relating to their intermediaries. The disciplinary record to be included is confined to disciplinary actions taken by SFC. The information to be disclosed will not go beyond what is normally available in SFC's press releases on disciplinary actions. Minor breaches which do not warrant public disciplinary action will not be disclosed. As regards the disclosure period, SFC reiterates that similar periods are adopted in overseas jurisdictions while US practice is to retain such information indefinitely. The SFC is therefore of the view that the five-year period is appropriate. Nonetheless, SFC has taken on board members' suggestion to make clear that any disciplinary actions which is subject of a pending appeal or a successful appeal will not be included in the register.

49. Concerning the question about how HKMA's register on RIs' securities staff will be compiled, members note that according to section 4 of BAO, HKMA is required to give regard to the captioned draft Rules in preparing its register. In this respect, HKMA confirms that its register will include similar information as SFC's register. HKMA has issued guidelines to AIs confirming particulars of its securities staff in this respect.

Securities and Futures (Associated Entities – Notice) Rules

50. Part VI of the SFO empowers SFC to make rules imposing ongoing financial and operational requirements on market intermediaries⁽⁴⁾. It also closes a regulatory gap under the existing legislation that enables an intermediary, for example a securities dealer, to register client's securities held in the dealer's safe custody in the name of a nominee company set up by the securities dealer. These nominees are presently unregulated. To improve investor protection, section 164 of the SFO prescribes the types of persons that are allowed to receive or hold in Hong Kong client assets. These persons now include an "associated entity"⁽⁵⁾ of an intermediary" which would cover most nominees that hold assets of intermediaries. An associated entity is required to comply with the various rules made under Part VI, except the Financial Resources Rules.

51. Section 165(1) of the SFO requires a corporation to notify SFC within seven business days after it becomes, or ceases to be, an associated entity of an intermediary and provide the information specified in rules made by SFC under

⁽⁴⁾ The term "intermediary" means a licensed corporation (i.e. a corporation licensed by SFC under Part V of the SFO for a regulated activity) or a registered institution (i.e. an authorized financial institution, e.g. bank, registered under Part V of the SFO).

⁽⁵⁾ The term "associated entity" means a company that is in a controlling entity relationship with an intermediary and receives or holds in Hong Kong client assets of the intermediary.

section 397 for this purpose. The captioned draft Rules specify the types of information required. Clause 3 of the draft Rules provide that associated entities that are already licensed or registered with SFC are required to provide only certain basic information whilst other associated entities are required to provide more detailed information. Clause 4 prescribes the information to be submitted to SFC when a corporation ceases to be an associated entity.

52. The Subcommittee notes that the industry generally supports the draft Rules. The Subcommittee also shares that for better investor protection, associated entities (except AIs) must confirm that the client assets they held for intermediary have been properly accounted for before they cease to be such associated entities. If such confirmation cannot be given, such particulars of client assets must be provided to SFC.

53. The SFC agrees with the Subcommittee that the requirements should be clear, and has made amendments to the draft released for consultation to further particularize the information required and improved the drafting to facilitate understanding by intermediaries.

54. While agreeing that information on financial soundness of associated entities is important to investor protection, members note the concern raised by HKSbA and the Institute of Securities Dealers Limited (ISDL) about exempting associated entities which are AIs from reporting matters relating to their insolvency to SFC. The HKMA explains that AIs are required under the BO to report such matters to HKMA. According to MOU between SFC and HKMA, there will be mutual sharing of information. Hence, there will be no information gap on intermediaries between the two regulators.

Securities and Futures (Financial Resources) Rules

55. Section 145(1) of the SFO empowers SFC, after consultation with FS, to make rules requiring licensed corporations to maintain such financial resources as are specified in the Rules. The captioned draft Rules prescribe the financial resources requirements and related matters applicable to licensed corporations. The Financial Resources Rules (FRR) are designed to address risks arising from various aspects of the business activities carried out by licensed corporations to ensure that they have sufficient liquid assets to meet ongoing liabilities. In the event that a firm runs into problem, compliance with FRR will facilitate an orderly liquidation and repayment of liabilities to customers. Hence, FRR aim to protect investor interests, promote the transparency and orderliness of the securities and futures industry, and reduce systemic risks. The FRR require licensed corporations to comply with paid-up capital and liquid capital requirements as appropriate in order to be and remain licensed by SFC. The minimum amounts in which licensed corporations must maintain as paid-up capital and liquid capital vary amongst different categories of regulated activities. The amounts are designed to

mirror the level of risks each type of regulated activity may pose to investors and to the market. The draft Rules consolidate the current FRR made under the Securities and Futures Commission Ordinance (Cap. 24) which are mainly for corporations registered with SFC under the Securities Ordinance (Cap. 333) and the Commodities Trading Ordinance (Cap. 250), and the Leveraged Foreign Exchange Trading (Financial Resources) Rules for foreign exchange traders and seek to streamline and rationalize requirements as appropriate.

56. The new FRR introduce one standard set of capital rules for application to all types of licensed corporations to accommodate the conduct of multiple regulated activities by any licensed corporation. For instance, where a corporation is licensed for more than one regulated activity, the highest of the required paid-up capital requirements which are applicable to the different regulated activities shall apply (Part 3 and Schedule 1 to the draft Rules). Besides the paid-up capital, a licensed corporation is also required to maintain a liquid capital, the amount of which varies with the business risk undertaken by the corporation. In essence, the liquid capital requirement follows a risk-based approach under which risky assets and risk exposures of the corporation are subjected to adjustments to arrive at the firm's liquid capital (the details for accounting the assets and liabilities of a licensed corporation are spelt out in Part 4 and Schedules 2, 3 and 5). Other major new initiatives introduced under the new FRR include lower discount rates (i.e. haircut percentages) to certain stocks, allowing licensed corporations to use their own fiscal reporting date rather than calendar month-ends; and requiring quarterly submission instead of monthly submission for part of the financial returns. As a safeguard against non-compliance, licensed corporations are required to report periodically their financial positions, non-compliance with requirements, as well as submit returns (clauses 54 to 57 stipulate the notification and submission of returns requirements) to help SFC identify potential risky firms. Failure to comply with FRR or to report non-compliance with the rules is a criminal offence subject to penalty stipulated in section 146 of the SFO.

57. The Subcommittee welcomes the above mentioned new proposals introduced in the draft Rules as they represent SFC's ongoing effort to de-regulate, recognizing the industry's desire for a more streamlined regulatory approach, and the market's need for a facilitative regime, without compromising investor protection.

58. Members appreciate that SFC has taken on board suggestions put forward by market participants and introduced a number of amendments to the draft Rules in order to facilitate industry's compliance. On the industry's suggestion to include more financial products as liquid assets, SFC has included equity linked instruments and certificates of deposits issued by banks in the calculation of a firm's liquid assets and has undertaken to review the need to amend the Rules regularly when new products are launched into the market. Regarding SFC's new proposal to make electronic filing of FRR

returns mandatory, notwithstanding that the proposal will enable timely and more accurate assessment of the financial and risk position of firms, as well as reduce input errors, members share the concern of small and medium-sized brokers about resources problems in automation. They welcome SFC's decision to withdraw the proposal and note its undertaking to revisit this issue in two years' time.

59. The Subcommittee also recognizes the concerns from the brokerage industry that the two amendments to the existing FRR introduced in October 2002 to increase the illiquid collateral haircut percentage to 80% and the gearing adjustment to 65% have posed operational problems to some brokerage firms. While members support the aims of the amendments which are to address financial risks posed to clients arising from a firm's aggressive lending and funding practices in conducting securities margin financing business, they see the need to address the industry's concerns. According to SFC, the two amendments are interim measures. Fundamental issues concerning financial resources requirements and practice of firms to pool and pledge clients securities collateral to banks will be reviewed in the context of improving the overall regulatory framework for managing intermediaries' financial risks. The SFC is reviewing the practices of overseas jurisdictions in this respect and plans to set out the results and proposals in a White Paper to be released for public consultation in due course. Meanwhile, SFC has undertaken to implement the new FRR flexibly and in the event that a firm has genuine difficulty in complying with the new amendments, it will consider granting modification or relief as appropriate, provided that no investor protection issues are involved.

Securities and Futures (Client Securities) Rules

60. Section 148(1) of the SFO empowers SFC to make rules to prescribe the manner in which intermediaries and their associated entities must treat and deal with client securities and securities collateral they received or held on behalf of clients in order to protect clients assets and regulate the business conduct of intermediaries. The captioned draft Rules are mainly to ensure that:

- (a) client securities or securities collateral received are deposited in safe custody in segregated accounts, or registered in the name of the relevant clients or associated entities (or, in the case of securities collateral, registered or deposited in accounts in the names of the relevant intermediaries) (clause 5);
- (b) to specify the circumstances in which client securities or securities collateral may be dealt with (clause 6 specifies general requirements, while clauses 7, 8 and 9 specify particular requirements for particular types of regulated activities); and

- (c) to require report of non-compliance with certain provisions of the rules to SFC (clause 12).

61. On the application of the draft Rules, members welcome the extension of the scope to cover all intermediaries and their associated entities that may handle client securities or securities collateral to enhance protection for client assets. Nominee companies operated by securities dealers to deal with client securities or securities collateral are presently not subject to any regulation. By extending the scope of coverage to associated entities, these nominee companies are brought under the regulation of the SFO.

62. The Subcommittee notes that the draft Rules allow continuation of the existing practice for intermediaries to pledge securities collateral with banks for raising funds. There are provisions in the draft Rules to guard against possible abuse under which pledging is subject to the standing authority given by clients. As there is practical difficulty for intermediaries to obtain affirmative renewals of clients' authority, SFC agrees to amend the draft Rules to relax requirement in this respect. For instance, subject to no objection by clients, the intermediary may arrange for the renewal of authority up to 12 months, whereas for professional investors, the renewal period may exceed 12 months.

Securities and Futures (Client Money) Rules

63. In order to ensure that client money received by licensed corporations or their associated entities are properly segregated and safeguarded against misuse, section 149(1) of the SFO empowers SFC to make rules to prescribe the manner in which these parties must treat and deal with client money. The captioned Rules include major features of requiring licensed corporations and their associated entities to establish and maintain segregated accounts (to be designated as a trust account or client account) for client money received or held in Hong Kong, and generally to pay client money into such accounts within one business day of receipt (clause 4); specifying the circumstances in which client money may be paid out of segregated accounts (clause 5); and requiring these parties to report non-compliance with certain provisions of the Rules to SFC (clause 11).

64. Members welcome the new initiative to extend the draft Rules to cover associated entities in addition to licensed corporations as they are often used as nominee companies to hold client assets. The current law does not forbid such a practice. The SFO and the draft Rules will bring the associated entities into the regulatory net.

65. While agreeing that reducing the time limit for corporation to segregate client money into a trust account from the existing requirement of four days in

the case of securities dealers to one business day will better protect investor interests, members recognize the concerns of market participants over the practical difficulties in meeting the new deadline. The SFC maintains that the one-day time limit is both practicable and necessary in order to protect client money. Indeed, the time limit was instituted in the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) in 1994 and has been complied with by licensed leverage foreign exchange traders without difficulties. Members also note from SFC's research that the same time limit is imposed in UK, Australia and Singapore. However, to address market participants' concern that it may take longer time for the clearance of cheques received from clients, SFC has agreed to revise the draft Rules to clarify that the relevant time limit in relation to a cheque received will count from the time when the proceeds of the cheque have been received. Members welcome this amendment.

66. Since the segregation requirement for client money will only confine to money received or held in Hong Kong, there is concern about the rationale for not imposing the same requirement on client money received or held outside Hong Kong which is the current requirement under existing rules. Some members are particularly concerned that the relaxed requirement may be abused to circumvent protection for client assets. According to SFC, the revised policy is premised on the practical difficulty of complying with the money segregation requirements in overseas countries, especially where there is no trust law (e.g. Taiwan) or where AIs is not available for opening segregated account in accordance with the requirement of the draft Rules. Given the limitations, applying the draft Rules to client money held outside Hong Kong may give a false sense of security to investors that their money will enjoy the same level of protection as held in Hong Kong. On balance, SFC is of the view that it is inappropriate to apply the draft Rules in such circumstances. On the safeguard against client money being transferred out of Hong Kong, the Subcommittee notes that clauses 4(4) and 5(1) of the draft Rules require a licensed corporation or an associated entity to act in accordance with clients' written direction or written standing authority. Hence, transfer of client money overseas is subject to this requirement. There are also specific requirements governing the validity period and renewal procedures of client's standing authority. Nevertheless, SFC has undertaken to further strengthen investor education by promoting investors' alertness of protecting their own interest and to stipulate in the Code of Conduct for intermediaries the requirement for a licensed corporation to make proper risk disclosure to its clients if their money is to be transferred out of Hong Kong.

67. Members agree that the new initiative which permits handling of client money in accordance with clients' standing written authority (clause 4) will give clients greater flexibility in managing their assets. However, they are aware of market participants' concern that the requirement to obtain affirmative annual renewal from clients for the standing authority is burdensome and costly to the licensed corporations. There is also suggestion to relax the renewal

requirement in respect of client money of professional investors. To address these concerns, SFC has modified the draft Rules to the effect that subject to no objection from clients, renewal of written authority valid for 12 months may be arranged by the corporation. In respect of professional investors, the renewed written authority can exceed 12 months.

Securities and Futures (Keeping of Records) Rules

68. Section 151(1) of the SFO empowers SFC to make rules to provide for the keeping of specified records by intermediaries and their associated entities (in respect of client assets of the intermediaries that they have received and held).

69. The captioned draft Rules, which have rationalized record keeping requirements under existing ordinances, specify general record keeping requirements for all intermediaries and their associated entities (clauses 3 and 4) and additional particular requirements for intermediaries carrying on particular regulated activities (clauses 5, 6, 7 and 8). The draft Rules prescribe the form in which such records must be kept (clause 9) and the retention period of either seven years or two years depending on the nature of the records (clause 10).

70. The Subcommittee notes that the draft Rules are generally welcomed by the market. The draft Rules will enhance the transparency and orderliness of the securities and futures industry and protection for investors as sufficient details are available to explain business activities and operations of intermediaries and their associated entities, and to account for client assets. Moreover, SFC has made a number of improvements to address concerns of the industry. Market practitioners are concerned about the broad requirement for intermediaries and associated entities to maintain sufficient records to demonstrate compliance with their systems of control and all applicable provisions and rules under the SFO. To address the concern, SFC has revised the draft Rules to limit the intermediary's obligation to keep records sufficient to demonstrate compliance with certain provisions in the Securities and Futures (Client Money) Rules and in the Securities and Futures (Client Securities) Rules, as well as to demonstrate that it has put in place systems of control to ensure such compliance. As for licensed corporations, the records kept shall be able to show compliance with the Securities and Futures (Financial Resources) Rules.

71. Members share some market participants' concern that the new requirement for intermediaries to keep records of advice given to clients on corporate finance and dealings in securities or futures contracts is too onerous. After consideration, SFC has removed the requirements. Instead, the requirements will be included in the relevant codes of conduct for intermediaries. The Subcommittee welcomes this move.

72. Responding to the market comment that the retention period for different records is unclear and may conflict with requirement in other subsidiary legislation under the SFO, SFC has amended the draft Rules to clarify that where a more specific retention period is prescribed under the SFO or its subsidiary legislation, such period shall override any general period provided for in the draft Rules. Furthermore, the draft Rules have been amended to exclude tape records from the two-year retention requirement so that intermediaries are only required to comply with the three-month retention requirement as stipulated in SFC code of conduct.

73. On the industry's comment that it will be unduly harsh to impose criminal liability for all breaches of the draft Rules since requirements are mainly administrative in nature, some members have requested SFC to consider imposing penalties on material breaches only. In this respect, SFC reiterates that breaches will be considered on a case-by-case basis having regard to the nature and intention. However, to address the industry's concern, SFC agrees to delete the imprisonment penalty as well as lower the level of applicable fine so that a breach without reasonable excuse will be subject to a fine at level 4 only (i.e. currently up to \$25,000).

Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules

74. Section 152(1) of the SFO empowers SFC to make rules to provide for contract notes, statements of account and receipts to be prepared by intermediaries and provided to their clients. The captioned draft Rules, which prescribe these matters, are based on provisions in existing ordinances and rules, as well as relevant codes of conduct issued by SFC for market intermediaries. The purpose of the captioned draft Rules is to ensure that clients get timely and meaningful information about transactions conducted on their behalf, so that they can properly understand their circumstances and protect their own interests. By streamlining the existing requirement and providing appropriate exemption, the draft Rules also seek to reduce compliance cost on intermediaries.

75. Major new initiatives introduced in the draft Rules are as follows:

- (a) to require all intermediaries to issue contract notes or statement of account whenever they enter into a contract, margined transaction, or provide financial accommodation, in the course of any regulated activity, and to issue receipt when receiving client assets (including associated entities of intermediaries);
- (b) to avoid duplicate documents being sent to the same client where two intermediaries acting for the same client are involved in the same transaction;

- (c) to allow for consolidation of contract notes and statement of account to clients; and
- (d) to permit reporting of average pricing in contract notes.

76. The SFC agrees with the Subcommittee that compliance burden should be minimized if this would not compromise investors' interest, and has positively responded to the views and suggestions of the market and introduced changes to the draft Rules, including the following:

- (a) to exempt an asset manager (who do not normally hold client assets) or its associated entity from the Rules except in relation to the preparation and provision to clients of monthly statements of account and receipts which is in line with existing market practices;
- (b) to widen the scope of exemption for transaction with professional investors so that intermediaries are not required to comply with certain Rules in their dealings with professional investors with the latter's consent;
- (c) to allow intermediaries' offshore related corporations which are subject to regulation of an approved jurisdiction⁽⁶⁾ to issue equivalent documents for clients in Hong Kong as it is a common practice for international corporations to subcontract their responsibility for providing documentation to local clients to their related corporations overseas;
- (d) to delete certain details in the contract notes, daily statement of account and receipts to avoid duplicative and superfluous information;
- (e) to provide more flexibility to the provision of average pricing in contract notes to clients by amending the relevant rule to stipulate that intermediary "may provide" such information so that small scale firms do not need to change their existing systems in order to meet the new requirement;
- (f) to relax the requirement for the delivery of monthly statement of account to clients especially when information on asset management involve overseas parties by allowing intermediaries to determine their own month end dates, and to change the deadline from seven days to ten business days for asset managers and to seven business days for other intermediaries; and

⁽⁶⁾ The UK and US are recognized as the approved jurisdictions in the draft Rules.

- (g) to give the intermediaries discretion to use either English or Chinese in their documents issued to clients to cater for their business needs.

Members welcome the above changes as they will facilitate the operation of the intermediaries without compromising investor protection.

77. However, the Subcommittee notes that breaches to the Rules will be a criminal offence subject to a fine at level 4 (currently up to \$25,000). Members are aware that some market participants have questioned the appropriateness of imposing criminal penalties for breaches of the Rules that are minor or administrative in nature. The SFC's explanation is that the penalties prescribed are appropriate. The SFC's decision on a breach will be made with regard to all the circumstances including inadvertance and nature of the breach. It is only when the breach is without reasonable excuse or with intent to defraud that criminal liability will be imposed. Regarding the industry's views that only breaches of material requirements should be reported to SFC, the Subcommittee notes SFC's views that it is in the interest of client protection to have SFC notified of all non-compliance with the prescribed requirements of the Rules as soon as possible to enable it to assess the implications. The SFC takes the view that after being informed by the intermediary, SFC and the intermediary can work out the appropriate remedial action to be taken.

Securities and Futures (Accounts and Audit) Rules

78. Section 156 of the SFO stipulates that SFC may make rules under section 397 to require licensed corporations and associated entities of intermediaries to prepare financial statements and other documents, and auditors to give statements of opinion in respect of the accounts of the licensed corporations or associated entities in their auditor reports. Section 157 provides that an auditor shall report to SFC or HKMA, as appropriate, as soon as reasonably practicable when he becomes aware of a non-compliance of "prescribed requirements"⁽⁷⁾ by a licensed corporation or an associated entity of an intermediary. The captioned draft Rules prescribe the requirements for the purposes of sections 156 and 157 of the SFO.

79. The Subcommittee appreciates the new initiatives to apply the draft Rules to all licensed corporations and their associated entities and the requirement on these parties to provide annual analysis of client assets and a business and risk management questionnaire in their annual accounts. The draft Rules are useful for strengthening regulation on licensed corporations and

⁽⁷⁾ These requirements are stipulated in the Securities and Futures (Client Securities) Rules, the Securities and Futures (Client Money) Rules, the Securities and Futures (Keeping of Records) Rules and the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules.

enhancing investor protection. However, members are aware of the concern expressed by the Hong Kong Society of Accountants about possible cost implications of requiring auditors to express opinions on whether the corporations' financial statements are in order and whether their internal control systems are adequate (clause 4(1)). While SFC notes that more work will be required from auditor under the Rules, it considers that the additional costs will be minimal and justified on grounds of better protection for investors. The SFC is of the view that much of the work is already required under current rules and auditors' professional standards. Nonetheless, in order to facilitate intermediaries and accounting professionals in establishing an acceptable internal control system, SFC will work with concerned parties with a view to developing guidelines in this respect.

Securities and Futures (Short Selling Exemption and Stock Lending (Miscellaneous)) Rules

80. Section 170 of the SFO prohibits "naked" short selling of securities⁽⁸⁾, while section 170(3) provides exemptions which are to be prescribed by SFC in rules under section 397. These exemptions are spelt out in clause 3 of the captioned draft Rules which is largely adapted from the existing Securities (Miscellaneous) Rules made under the Securities Ordinance (Cap. 333). The exemptions include HKMA-appointed market-makers and all classes of market-makers and liquidity providers registered with the Stock Exchange of Hong Kong (SEHK) or the Hong Kong Futures Exchange. The exemptions for market makers registered with SEHK will also be available to issuers of structured products like derivative warrants and equity linked notes and instruments. The Subcommittee agrees that market-makers perform important functions in enhancing the liquidity of the market and facilitate market development. Hence, members support exclusion of market-makers from the naked short selling prohibition to allow flexibility in their operation and give them additional means to hedge against their risks in fulfilling their market making obligations.

81. Section 171 of the SFO requires a seller of a short selling order to confirm that it is a short selling order and that the sale is covered at the time the order is placed or received. A broker who has received a short selling order is required to obtain a documentary confirmation from the seller before transmitting the order. Clause 4 of the draft Rules provides new exemptions to sellers of short selling orders from complying with the exact requirements prescribed in section 171 of the SFO provided that sellers receive an oral assurance for the order with certain particulars put down on a time-stamped record, a tape-recording of the assurance, or a documentary confirmation of the assurance by the end of the trading day. The record keeping requirements for

⁽⁸⁾ "Naked" short selling refers to the selling of securities at or through the Exchange where the seller does not believe or does not have reasonable grounds to believe that he has a presently exercisable and unconditional right to vest the securities in the purchaser of them.

stock lenders to keep records for 12 months and to provide to SFC for inspection upon request are adapted from the existing Securities (Stock Lending) Rules (Cap. 333 Sub. Leg. M).

82. The Subcommittee concurs that relaxation in reporting requirements will help reduce compliance burden on the market and facilitate timely execution of transactions while preserving a proper audit trail for transactions. Members note that the market generally welcomes the draft Rules.

83. In order to bring the benefits of the proposals enshrined in the draft Rules to the market as soon as possible, SFC has made the Securities (Miscellaneous) (Amendment) Rules 2002 pursuant to section 146 of the Securities Ordinance (Cap. 333) ahead of the commencement of the SFO to effect the proposals. The Rules have come into effect from 15 November 2002.

Securities and Futures (Unsolicited Calls - Exclusion) Rules

84. Section 174(1) of the SFO generally prohibits unsolicited calls made by intermediaries and their representatives in order to protect the interests of investors against cold calls and improper selling techniques exerting unacceptable pressure on investors to buy financial products. The definition of “call” in section 174(7) has an encompassing scope to cover not just personal visits and telephone calls, but also other means of electronic or mechanical communication to cater for development of communication technology. An “unsolicited call” is defined in section 174(7) as “any call made otherwise than at the express invitation of person called upon...”. The SFC is given the power in section 174(3) and (4) to make rules to be made under section 397 to exclude types of agreements or calls from the ambit of prohibition.

85. Members note that exclusions from unsolicited calls prescribed in the captioned draft Rules include, among others, any call that is a “permissible communication” (i.e. any communication that is not made in the course of a visit in person, a telephone conversation or any other interactive dialogue during which statements and responses to them are exchanged immediately). Exclusions also include any agreement to sell or purchase securities of a corporation to a person who is already the holder of securities of that corporation, and any call made by a registered institution in relation to a leveraged foreign exchange contract which complies with guidelines made by HKMA.

86. Members note that the market generally welcomes the draft rules, but there is concern over the narrow scope of “permissible communication” which may affect effective marketing and promotion of products and services by intermediaries. According to SFC, the concept of “permissible

communication” is modeled on the United Kingdom Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. Members, however consider that intermediaries may have difficulty in determining whether a particular kind of communication is permissible. Having regard to the suggestion of members, SFC agrees to amend the draft Rules to make clearer the meaning of “permissible communication”. For instance, the communication is made by way of a system which does not require the recipient to respond to it immediately, e.g. internet message system. The SFC also undertakes to review the need to tighten or relax the definition of “permissible communication” in the light of experience in implementing the Rules.

Securities and Futures (Registration of Commission Disciplinary Orders) Rules

87. Part IX of the SFO provides for SFC's disciplinary functions. Provisions therein set out the sanctions that SFC may impose, and the categories of persons on whom sanctions may be imposed. Sections 194(2) and 196(2) of the SFO empower SFC to order a regulated person to pay pecuniary penalty in certain circumstances (e.g. guilty of misconduct) provided that it has had regard to the fining guidelines published in the Gazette under section 199. Sections 194(5) and 196(5) allow SFC to register such an order in the Court of First Instance. On registration, the order is regarded for all purposes as an order of the Court for First Instance for payment of money. The captioned draft Rules are to be made under section 397(1) of the SFO, and prescribe the manner in which SFC is to register such an order with the Court of First Instance.

Securities and Futures (Registration of Appeals Tribunal Orders) Rules

88. Part XI of the SFO provides for the establishment of SFAT which has the jurisdiction to review a wide range of decisions by SFC, HKMA and a recognized investor compensation company and make orders concerning proceedings before it.

89. Under section 226 of the SFO, the Court of First Instance may, on notice in writing given by SFAT in the manner prescribed by rules made by CJ under section 233, register an order of SFAT in the Court of First Instance. On registration, SFAT order becomes for all purposes an order of the Court of First Instance. The captioned draft Rules are to prescribe the manner in which SFAT is to give notice to the Court of First Instance in respect of SFAT orders.

Securities and Futures (Registration of Market Misconduct Tribunal Orders) Rules

90. Part XIII of the SFO provides for the establishment of the Market Misconduct Tribunal (MMT), which has the jurisdiction to conduct

proceedings on suspected cases of market misconduct, and to make a wide range of orders imposing civil sanctions on offenders and concerning proceedings before it.

91. Under section 264(1) of the SFO, the Court of First Instance may, on notice in writing given by MMT in the manner prescribed by rules made by CJ under section 269, register an order of MMT in the Court of First Instance. On registration, the order becomes for all purposes an order of the Court of First Instance. The captioned draft Rules are to prescribe the manner in which MMT is to give notice to the Court of First Instance in respect of MMT orders.

92. The Subcommittee notes that SFC has consulted the market on the draft Securities and Futures (Registration of Commission Disciplinary Orders) Rules and received no adverse comment. The Judiciary Administrator has been consulted on a draft of the Securities and Futures (Registration of Appeals Tribunal Orders) Rules and the Securities and Futures (Registration of Market Misconduct Tribunal Orders) Rules and is content.

93. Members note the comment of the LegCo Legal Service Division that the proposed procedures for registration of orders to the Court of the First Instance as contained in the above three sets of draft rules do not provide for other details and only administrative practices are relied on. While members concur that there may be merits to stipulate practices in the draft Rules to facilitate compliance by relevant parties, they are concerned that codifying registration practices may compromise flexibility. As these Rules are modeled on the arrangements in existing subsidiary legislation made under the Securities (Insider Dealing) Ordinance (Cap. 395) and no practical difficulties have been encountered in implementation, members agree to maintain the status quo.

Securities and Futures (Investor Compensation - Levy) Rules

94. In Part XII, a compensation fund known as the Investor Compensation Fund (ICF) shall be established to provide compensation to investor for losses sustained in the event of defaults of market intermediaries. Sections 244(1)(a) and (d) of the SFO provide that CE in Council may make rules setting out the means of funding of ICF and providing for the better carrying out of the objects and purposes of Part XII.

95. The captioned draft Rules provides for a levy rate of 0.002% on securities transactions (subject to several exceptions) and a levy amount of \$0.5 on each futures contract (\$0.1 for each Mini-Hang Seng Index futures and options contract and stock futures contract) payable by both the buyer and the seller. The proposed levy rates are the same as the existing rates for the Unified Exchange Compensation Fund (UECF) and the Futures Exchange Compensation Fund (FECF) specified in relevant subsidiary legislation. The

draft Rules also provide for the manner of payment of the levy and other incidental matters, such as the levies are to be collected by the exchange companies for remittance to SFC.

96. The SFC estimates that the prudent level for ICF is \$1 billion which is appropriate to meet the expanded scope to cover all licensed/registered intermediaries in relation to products traded on recognized stock or futures markets. Members, however, notice a suggestion from the industry to stipulate the target size of \$1 billion for ICF in the draft Rules and to provide a proper mechanism for adjusting the levy rates when the fund's reserves exceed or fall below the target level by a wide margin. The SFC opines that it is inappropriate to incorporate the target reserves of ICF and spell out the mechanism for adjusting the levy rates in the Rules as these are subject to regular review in the light of the operational experience of ICF and the prevailing circumstances. The SFC also considers that the balance of funds from UECF and FECF together with the proposed levies will help ensure ICF be properly funded on inception to meet its obligations. The Subcommittee accepts SFC's explanation.

97. Members note that in line with existing practice, the draft Rules provide that certain securities and futures contract products are exempted from levy payment. There are market comments that the exemption should be extended to all new products launched in the recognized markets so as to assist the development of new products. The SFC considers that the proposed exemption will undermine the integrity of ICF and deviate from the current practice where no such exemption is provided. Hence, SFC has not accepted the proposal.

Securities and Futures (Investor Compensation - Compensation Limits) Rules

98. Section 244(1)(b) of the SFO provides that CE in Council may make rules on the limit of compensation per person making a claim for compensation. The captioned draft Rules provides that the maximum amount of compensation that may be paid to each claimant is \$150,000 for each case of default for the losses sustained as a result of a default in relation to securities listed or traded, or futures contracts traded on a recognized exchange market.

99. Members note that SFC conducted a consultation exercise on the new investor compensation scheme in March 2001 and the public generally agreed with setting the per investor compensation limit at \$150,000. As to the industry's concern about how the compensation limit for a client who maintains both securities and futures trading accounts with a licensed intermediary is to be set, SFC clarifies that clause 3 of the draft Rules provides that a claimant is entitled to be awarded a maximum of \$150,000 for loss as a result of a default in relation to securities and also \$150,000 for the loss as a result of a default in futures trading activities. Hence, for a client who suffers loss as a result of a

default in relation to both trading activities, a maximum sum of \$300,000 can be awarded.

Securities and Futures (Investor Compensation - Claims) Rules

100. Under section 244(2) of the SFO, SFC may make rules relating to various matters including the circumstances in which a person is entitled to claim compensation, the manner in which a claim for compensation is to be determined, the persons who are not entitled to make a claim, the determination and payment of the claim, and the procedures for dealing with a claim, etc. The captioned draft Rules provide for these matters.

101. Clause 4 of the draft Rules provides that a qualifying client of a specified person (which includes mainly licensed/registered intermediaries dealing in securities and futures contracts) who sustains loss as a result of a default committed by the specified person or his associated person is allowed to make a claim. “Qualifying client”, “associated person” and “specified person” are defined in clause 2 of the draft Rules. An “associated person” is defined to include any person employed or engaged by a specified person, or any person who may under section 164 of the SFO hold client assets of a specified person. The SFC further clarifies that a clearing agent of a specified person falls within the meaning of an associated person and hence a qualifying client is able to claim for compensation for defaults in relation to a clearing agent.

102. As regards HKSbA’s suggestion that only those claimants who have paid the compensation levy will be entitled to make claims, the Subcommittee notes SFC’s explanation that in order to enhance protection for investors, ICF should cover transactions relating to products traded on recognized exchange markets irrespective of whether levy has been paid. Moreover, it will not be feasible administratively for SFC to differentiate between trades which have paid the levy or otherwise.

103. Members note a query from ISDL on whether a claimant who holds joint accounts with others is eligible for compensation. The SFC confirms that individual holders of a joint account will be eligible to claim compensation and the compensation limit of \$150,000 will be applicable provides that he falls under the definition of “qualifying client”. This arrangement is in line with practices of compensation funds established in overseas jurisdictions. As to whether this will give rise to abuse, SFC assures that all facts and information submitted by claimants in establishing their interests to joint accounts will be carefully considered in processing the claims.

104. Clauses 3 and 4 of the draft Rules provide that a claim must be lodged not later than three months if a notice inviting claims has been published, or in the absence of such a notice, within six months after the claimant is first aware

of the default. Some members consider that the three-month deadline for submission of claims lacks flexibility. According to the explanation of SFC, the concerned deadline is the existing arrangement. The SFC may accept late claims under clause 4(4) where justified. To ensure wide publicity for claims invitation notices, the draft Rules require such notices be published in newspapers (clause 3(1)). Press releases and publicity on website, which are effective means to alert the public, will also be arranged to inform the public on the claim notice. As regards the suggestion made by the Consumer Council that standard claims form should be available at SFC's website and allowed for submission online to facilitate claimants, SFC agrees to provide such claims forms in its website. It nevertheless points out that online submission of claims is not feasible as the relevant documents to substantiate claims are not available in electronic form.

105. Clause 7 of the draft Rules provides that the calculation of compensation is to be based on the “market value” of the claimant's assets “as at the date of the default”. Some members consider that the “date of default” should be specified and that whether a claimant should be compensated for interest accrued should be clarified. The SFC points out that as the “date of default” varies with the circumstance of each case, it cannot be provided in the draft Rules. However, the date will be specified in the determination notice (clause 8). On the issue about interest accrued, SFC clarifies that the policy intention is to value a claimant's assets at face value. The Subcommittee agrees that as compensation is determined having regard to value of the assets at the date of default, interest accrued before such a date should have been included. It is reasonable that loss of interest which may have been earned for assets lost due to the default after the date of default should be excluded.

106. On the notice of determination of a claim, clause 8 of the draft Rules provides that such notice should be issued to the claimant as soon as practicable and requires SFC to give the reasons therein if the claim has been disallowed. Some members suggest that the claimant should be provided with an opportunity to state his case to SFC before his claim is disallowed. The SFC explains that the decision on compensation claim is appealable to SFAT. Nonetheless, SFC has taken on board members' suggestion and amended clause 8 to provide the claimant with the opportunity of being heard before SFC can reject his claim in whole or in part. The Subcommittee welcomes the amendment.

107. Regarding the payment of compensation, clause 9(4) of the draft Rules provides that SFC may pay the compensation by instalments and clause 11 further provides that where the money available in ICF is insufficient to meet claims, SFC may apportion the fund as it sees fit for compensating claimants. Members share the views of HKSbA that in order to provide greater certainty to claimants, the draft Rules should specify a time limit for payment of compensation. The SFC explains that it is the practice to pay the

compensation to claimants as soon as practicable after the determination. If it is decided that payment will be made in instalments, SFC will inform the claimant in the notice of determination. As regards the concern about insufficient funds in ICF to meet claims, SFC stresses that such situation is unlikely to happen as the compensation levies will provide a stable source of income for ICF and SFC is allowed to borrow money for the fund (section 237 of the SFO). The SFC reiterates that the policy intention is to provide determined compensation to claimant. Clause 11(2) specifically provides that the unpaid amount of compensation is to be paid when there is sufficient money available in the Fund. The payment of compensation is simply deferred and the claimants' entitlements are not affected.

Securities and Future (Transfer of Functions - Investor Compensation Company) Order

108. Section 79 of the SFO provides that SFC may recognize an independent investor compensation company (ICC) to handle compensation matters and administer ICF. The SFC may request CE in Council under section 80(1) to make an order transferring certain functions of SFC in relation to ICF under Part XII and rules made under that Part to ICC.

109. Members note that the captioned draft Order provides for the transfer of specific functions to ICC (specified in the Schedule to the Order) including management of ICF, keeping of proper accounts, investment of money, payments out of ICF and certain functions of SFC as set out in the draft Securities and Futures (Investor Compensation - Claims) Rules, such as publishing the notice for inviting claims, accepting late claims, and making determination in respect of the compensation. Nevertheless, the overall responsibility for ICF continues to rest with SFC. However, the Subcommittee notes the comment from ISDL that SFC should be responsible for the administration of ICF. The SFC explains that an independent ICC will enable the company to dedicate its focus to investor compensation matters. This approach is adopted for managing compensation arrangements in most overseas jurisdictions, such as US, UK, Canada and Australia. The SFC assures that the governing body of ICC will be broadly based and representatives of the relevant stakeholders, including SFC, Hong Kong Exchanges and Clearing Ltd, brokers, banking community and investors. The SFC also takes note of the market comment on the need to keep the structure of ICC as lean as possible. As regards safeguards to check the functions transferred to ICC, members note that clause 3(2) of the draft Order provides for the concurrent discharge of functions by SFC and ICC. Moreover, clause 3(4) provides that SFC may issue written directions to ICC on certain transferred functions.

Securities and Futures (Price Stabilizing) Rules

110. Parts XIII and XIV of the SFO provide for parallel civil and criminal regimes to deal with market misconduct respectively. Sections 282 (Part XIII) and 306 (Part XIV) empower SFC, after consulting FS, to make rules to create “safe harbours” for the market misconduct civil and criminal provisions which provide that a person who may otherwise have contravened the market misconduct provisions shall not be so regarded or shall have a defence if he establishes that the conduct in question is in accordance with rules made under the sections. The purpose of the sections is not to outlaw legitimate market activities so as to cater for the development of the market.

111. The captioned draft Rules provide that price stabilization activities⁽⁹⁾ conducted in connection with initial public offerings in compliance with the Rules are to be excluded from the application of civil and criminal market misconduct provisions. The draft Rules prescribe the minimum size of public offerings of shares and debentures of HK\$100 million where stabilizing action is permitted (clause 3), a period of 30-day in which stabilizing action can be conducted (clauses 2 & 6), the appointment of a stabilizing manager (or its agent) (clause 12(4)), and the related disclosure and record keeping requirements (clauses 8, 9, 13, 14 & Schedules 1 & 3).

112. Members note that the draft Rules are generally accepted by the market and are consistent with international standards to facilitate global offerings of securities conducted in Hong Kong and in other markets. They recognize that SFC currently permits stabilizing actions to be carried out in a restricted manner. Regulating such activities will assist in maintaining the order, efficiency and transparency of the markets without compromising investor protection.

113. As regards the imposition of a threshold amount for public offers under the draft Rules, the Subcommittee notes that the threshold amount applicable to price stabilizing activities has been reduced from the original proposed HK\$200 million to HK\$100 million. According to SFC, after examining most fund raising exercises in Hong Kong in recent years, it considers that the threshold amount of HK\$100 million will cater for small offerings of securities whose prices tend to be more volatile after offers, necessitating stabilizing actions to address short-term fluctuations. The Subcommittee also considers it reasonable to begin with a lower threshold. Nevertheless, SFC would monitor the stabilizing activities and the performance of offers of different sizes in the light of implementing the Rules and review the threshold level in

⁽⁹⁾ Price stabilization generally refers to transaction undertaken to stabilize the price of securities either to prevent them from declining or rising. Such activity is potentially manipulative as it seeks to maintain or support the price of a security at a certain level and therefore distorts the price and may be considered market misconduct under Parts XIII and XIV of the SFO.

future as necessary.

114. As regards the conduct of stabilizing actions overseas, members note that the draft Rules also allow stabilizing actions conducted overseas with a view to stabilizing the price of securities in the overseas market which may affect the price of securities traded in the Hong Kong market (clause 15). The SFC advises that such action has to be effected in accordance with the stabilizing rules in recognized jurisdictions specified in Schedule 4 to the draft Rules, which provide similar regulatory safeguards against market manipulation. The SFC is engaging US and UK authorities with a view to including them in the Schedule once mutual recognition of respective price stabilizing rules is in place.

Securities and Futures (Disclosure of Interests - Exclusions) Regulation

115. Part XV of the SFO requires the disclosure of interests in securities by any person who is interested in 5% or more of the relevant share capital of a listed corporation and by the directors and chief executives of listed corporations. Sections 323 and 346 of the SFO provide that certain interests in shares are to be excluded from the disclosure requirements under Part XV. Under section 376 of the SFO, CE in Council may make regulations covering a range of matters including prescribing interests for the purpose of sections 323 and 346 to provide exclusions from the requirements of Part XV.

116. The captioned draft Regulation is adapted from the existing Securities (Disclosure of Interests) (Exclusions) Regulations (Cap. 356 Sub. Leg. A). It removes two existing exemptions granted to interests held by trust companies and their subsidiaries that are locally incorporated, and interests held by an investment manager in certain circumstances. The Subcommittee notes that the removal will promote market transparency and meet international disclosure standards. It also notes that there has been an expansion of exemptions applicable to trustees, custodians and investment managers provided in Part XV of the SFO.

117. However, members notice that some market practitioners have called for wider exemptions from disclosure to include the interest of intermediaries entering in an exchange-traded options and futures contracts solely for a client, “client facilitation” transactions, and certain transactions in relation to initial public offerings (IPO). Having considered market comments, SFC has provided an additional exemption covering intermediaries entering in options and futures contract solely for a client. Nevertheless, SFC considers that for the “client facilitation” transactions and IPOs related transactions, it is inappropriate to provide the proposed exemption as the intermediary/manager will acquire an economic interest in the shares. In this connection, members note SFC’s undertaking to review the new disclosure regime under Part XV of the SFO at an appropriate time in the light of its actual implementation, in

consultation with the Legislative Council Panel on Financial Affairs. The above suggestions will be revisited in the light of the experience gained.

Securities and Futures (Disclosure of Interests - Securities Borrowing and Lending) Rules

118. Provisions in Part XV of the SFO impose a disclosure obligation on the change in nature of interest, including changes that occur in stock borrowing and lending (SBL) transactions. However, in SBL business, a large number of loans and returns of shares can be transacted from the same lending pool. This will give rise to a large number of disclosures for movements in the same lending pool, which may be of limited value to investors. Hence, a simplified disclosure regime that will limit the disclosure obligations of certain classes of participants in SBL market will facilitate market development without undermining the integrity of the disclosure regime.

119. Section 377 of the SFO empowers SFC to make rules to provide exemptions of SBL activities from interests disclosure requirements stipulated in Part XV of the SFO. The captioned draft Rules establish a simplified disclosure regime for approved lending agents (ALAs) (mainly custodians), and regulated persons (including SFC licensed intermediaries) with respect to their SBL transactions. ALAs and regulated persons taking advantage of the simplified disclosure regime are required to keep records of transactions for three years.

120. The Subcommittee notes that the market supports the draft Rules in general but has called for provision for more exemptions. In respect of persons eligible for the exemption, members share the market's view that the original proposed class of "institutional investors", which mainly covers managers of collective investment schemes, banks and insurance companies is too restrictive and will exclude a lot of investors who engage in SBL business from the simplified disclosure regime. Members welcome SFC's revised proposal to expand the scope to cover substantial shareholders who lend through an ALA. Moreover, in response to industry suggestion, SFC has also amended the draft Rules to further simplify the disclosure regime for ALAs and extend it to holding companies of ALAs. It has also accepted the suggestion to add a requirement on SFC to give reasons for refusal or withdrawal of approval of ALAs, and to subject such decisions to review of SFAT. Members also welcome the initiative of SFC to develop guidelines to set out the criteria SFC will take into account in considering applications for approval of ALAs.

121. On members' question about the rationale for imposing the three-year record-keeping requirement on ALAs and regulated persons, SFC explains that the requirement is consistent with provisions of the SFO and will facilitate investigation of share interest where applicable.

Securities and Futures (Levy) Order

122. Section 394(1)(a) and (b) of the SFO empowers CE in Council to specify, by order published in the Gazette, the rate of levies payable to SFC by specified persons for sale and purchase of securities or futures contracts traded on a recognized market. The levies income is retained by SFC for its own expenses. The levies specified in the captioned draft Order are adapted from the existing Securities and Futures Commission (Levy) (Securities) Order and the Securities and Futures Commission (Levy) (Futures Contracts) Order made under the Securities and Futures Commission Ordinance (Cap. 24 Sub. Leg. A & B). The levies are as follows:

- (a) a levy rate of 0.005% on securities payable by both the buyer and the seller; and
- (b) \$1 for every purchase or sale of a futures contract, (save that \$0.2 is levied for Mini Hang Seng Index Futures and Options contracts and stock futures contracts and no levy for currency futures contracts and new futures contracts).

The Subcommittee supports the draft Order.

Securities and Futures (Levy) Rules

123. Section 394(5) of the SFO empowers CE in Council to make rules for the payment of levies under section 394(1) and the imposition of charges or penalties for late payment of such levies, and the keeping, examination and audit of the accounts relating to the collection and payment to SFC of such levies. The captioned draft Rules which are adapted from the existing Securities and Futures Commission (Levy) Rules (Cap. 24 Sub. Leg. G) provides that the levies payable is to be collected by the relevant exchange companies in accordance with their rules. The exchange companies are required to remit the levies collected to SFC in specific manner, submit remittance notice, keep proper records relating to the levies, as well as furnish annual auditor's report to SFC.

124. On the question of whether sanction will be imposed on the exchange companies for failure to remit the collected levies to SFC, members note that clause 7(1) of the draft Rules imposes a 2% late remittance charge on the exchange companies. Clause 7(2) further provides that SFC may recover the late remittance charges payable to it as a civil debt due to SFC.

125. It is noted that as clause 4(b) of the draft Rules requires an exchange company to remit the levies collected to SFC once a month. The question of whether the interest earned from substantial levies accumulated in the exchange company's account will be payable to SFC has been raised. The SFC explains

that as the time gap between the collection and remittance of levies is small, the amount of interest accrued on the levies will be insignificant and hence will not be included in the remittance to SFC. The proposed arrangements on collection and remittance of levies to SFC are the same as existing arrangements which have been operating well.

Securities and Futures (Fees) Rules

126. Section 395(1) of the SFO empowers CE in Council to make rules to prescribe fees, and require and provide for payment of fees to SFC. The captioned draft Rules, which are adapted from the existing Securities and Futures Commission (Fees) Rules (Cap. 24 Sub. Leg. C) set out the fees and the requirement for payment of fees to SFC under relevant provisions of the SFO and the Companies Ordinance (Cap. 32), and subsidiary legislation prescribed under the SFO. The draft Rules also empower SFC to waive or refund fees under certain circumstances. Fees items such as application fees and annual fees in respect of licensing and registration of intermediaries and their representatives, applications for waivers or modifications of various requirements under the SFO, etc. are specified in Schedules 1 and 3 to the draft Rules. Fees items relating to functions performed by SFC under the Takeovers Panel and the Takeovers Appeal Committee are prescribed in Part 3 of and Schedule 2 to the draft Rules.

127. Members welcome SFC's proposal to reduce all existing licensing fees for licensed corporations and licensed representatives by 3%. Moreover, to encourage existing licensees and exempt persons to migrate to the new licensing regime early, SFC also proposes to make available an additional 5% discount (based on the existing fee scale) to those who apply to migrate to the new regime during the first year of the transitional period. The discount will be available from the date of the submission of the application for migration till the end of the two-year transitional period. The SFC will exercise its waiver power provided for in the draft Rules to ensure that existing regulatees of SFC will not incur extra licensing fees over and above which they are paying under the existing licensing regime. The SFC will publish guidelines explaining its policy in this regard.

128. In respect of other fees, members note that the rates are based on the existing fees. No new policy is introduced regarding payment of these fees but certain amendments are made in order to streamline the fee structure for collective investment schemes. A number of new fees are introduced to accommodate new elements of the licensing regime (e.g. application for authorization of automated trading services). The levels of new fees are set having regard to similar activities under the existing regulatory regime.

Licensing fees for market intermediaries under the new licensing regime

129. Part V of the SFO introduces a new licensing regime for market intermediaries where an intermediary will only need one licence to engage in different types of regulated activities (the nine types of regulated activities are defined in Schedule 5 to the SFO). An intermediary will be required to appoint at least two “responsible officer” (RO) for each regulated activity it is licensed to conduct.

130. A standard fee will be charged for each of the regulated activities (i.e. \$4,740 and \$1,790 per activity for a corporation and a representative licence respectively) while a higher fee will be charged for leveraged foreign exchange trading (i.e. \$129,730 and \$2,420 for a corporate and a representative licence respectively). The higher fees for the leveraged foreign exchange trading activity is consistent with the arrangement in the current regime. The fee for approval to be a RO for an intermediary will be \$2,950 per regulated activity.

131. As regards HKSB's concern about cost burden on intermediaries under the new licensing regime, SFC explains that the single licensing system will do away the need for a corporation to apply for different licences or to set up subsidiaries to engage in different regulated activities, thus allowing for a more efficient allocation of capital and deployment of resources. Hence the new licensing regime will help cut down the compliance costs for intermediaries. The economic benefits of the new regime will become apparent if licensees streamline their businesses in an effort to reduce the number of licensed entities. As to whether further reduction in licensing fees can be achieved through the implementation of the new licensing regime, SFC points out that the new licensing regime will not result in substantial savings as the savings achieved in administering the new regime will be offset by increase in resources for supervising the nine regulated activities. Under the new regime, the licensing fees to be payable by most licensees will be comparable or even lower than those paid under the existing licensing system. Additional cost burden on intermediaries therefore does not exist.

132. Regarding the industry's concern about extra licensing fees to be incurred for applying licence for each regulated activity, the Subcommittee notes SFC's clarification that an intermediary or a representative will not need to apply for separate endorsement for a particular activity in the licence if the regulated activity is incidental to the business of its/his licensed activity. The SFC agrees with members' suggestion and will issue guidelines explaining the need for application of licence for different regulated activities so as to help the industry comply with the new licensing regime.

133. On HKSB's concern about cost on intermediaries for seeking SFC approval in licensing different ROs for different regulated activities, SFC clarifies that the same person may be designated as ROs for different regulated

activities of the same intermediary provided he is fit and proper to be so approved and that there is no conflict of interest for him to carry out the regulated activities concerned at the same time. To facilitate industry's understanding, SFC undertakes to explain further on this subject in the relevant guidelines issued to the industry.

134. Members note the concern of Hong Kong Association of Banks that the 3% reduction in licensing fee will not be applicable to RIs. The application fee for registration as an RI is \$23,500 per regulated activity. The RIs are also subject to an increase in the annual fees (from \$14,000 to \$35,000 per regulated activity). The SFC explains that the increase is to reflect the enhanced functions and responsibilities assumed by HKMA under the new regime in respect of ongoing supervision of RIs. The fees collected by SFC from RIs will be shared with HKMA. The details will be set out in MOU between SFC and HKMA. The latter also confirms that it has no intention to charge banks for supervising their securities business on top of the fees proposed in the draft Rules.

Securities and Futures (Miscellaneous) Rules

135. The captioned draft Rules contain a range of provisions which do not readily fit into other subsidiary legislation to be made under the SFO. They cover the following three areas :

- (a) Sections 397(1)(g) and (h) of the SFO empower SFC to make rules on filing of documents and information to SFC. Clause 3 of the draft rules specifies the general requirements in this area.
- (b) Sections 397(1)(b) of the SFO empowers SFC to make rules regarding the display and return of licences and certificates of registration for specific purposes. Clauses 4 and 5 of the draft Rules specify these matters.
- (c) Section 179 of the SFO empowers a person authorized by of SFC to inquire into suspected crimes or misconduct of a corporation that is or was listed. The authorized person can require an auditor of a listed corporation to produce audit working papers and explain the documents in the course of the inquiry. The term “auditor” is defined in section 1 of Part 1 of Schedule 1 to the SFO to include a person registered under the Professional Accountants Ordinance (PAO) (Cap. 50) who holds a practicing certificate, or a person specified in rules made by SFC under section 397 of the SFO. Clause 6 of the captioned draft Rules seeks to widen the scope of “auditor” to cover among others, people employed or engaged by the an “auditor” for the purposes of section 179.

Widening the definition of “auditor”

136. On clause 6 of the draft Rules, members note the views of the Hong Kong Society of Accountants (HKSA) that it is inappropriate to expand the definition of “auditor” to cover all people employed or engaged by the auditing firm. Minor staff or engaged consultants are not in a position to produce or explain documents because the documents are the property of the “practice unit” (defined in section 2 of PAO). The HKSA also considers that it is not the intention of section 179 of the SFO to go beyond an audit firm to its employees and consultants. Members appreciate that a wider definition of the term will better bridge the gap in seeking useful information and explanation. However, they share the concerns of HKSA. The Subcommittee welcomes SFC's agreement to redefine the scope of the definition of auditor as suggested by HKSA by reference to the definition of a “practice unit” defined in the PAO.

Complaints register for licensed intermediaries

137. The Subcommittee notes that SFC's original proposal included a requirement for intermediaries to establish a complaints register open for public inspection with a view to enhancing investor protection. Having regard to the industry's concern about data privacy and client confidentiality implications, SFC has removed the proposal.

Securities and Futures (Offences and Penalties) Regulation

138. Section 398(6) of the SFO provides that where the SFO has not specified that it is an offence to contravene rules made by SFC under the SFO, CE in Council may make regulations to provide that a person who contravenes any specified provision of the rules commits an offence and is liable to a specified penalty not exceeding the maximum levels specified in section 398(6).

139. The draft Regulation makes it an offence for persons who fail to comply with clauses 4 or 5 of the draft Securities and Futures (Miscellaneous) Rules which relate to the display and return of licences/certificates of registration and imposes sanctions of fines at level 5 (\$50,000) and level 6 (\$100,000) for contravention of clauses 4 and 5 respectively.

140. On the proposed penalty levels, members note the comment from the Hong Kong Securities Institute that the proposed fine of \$100,000 on an intermediary for failure to return the licence or certificate of registration is too high and should be reduced to \$50,000 with a daily fine of \$2,000 for ongoing offences. The SFC explains that the penalties are proposed having regard to the nature of the offences and the penalties provided for similar offences in the SFO. The proposed penalty for failure to return the licence or certificate of registration is consistent with that applicable to a licensed representative under

section 123(3) of the SFO. Hence, SFC considers the proposed level of penalty appropriate and will not introduce amendment in the draft Rules. Members accepted SFC's explanations.

Securities and Futures Ordinance (Amendment of Schedule 8) Order 2002

141. The SFAT, established under Part XI of the SFO, is an independent full-time body chaired by a judge established to provide an appeal channel for aggrieved parties to decisions made by SFC, HKMA and ICC.

142. Under section 217 of the SFO, a person aggrieved by a "specified decision" may apply to SFAT for a review of the decision. "Specified decisions" are set out in different divisions in Part 2 of Schedule 8 to the SFO. Division 1 sets out the specified decisions which SFC may make under the primary legislation (e.g. refusal to grant a licence under section 116 of the SFO). Division 3 sets out the specified decisions which SFC, or ICC performing a SFC function transferred to it, may make in respect of the new investor compensation arrangements. Division 5 of Part 3 of Schedule 8 sets out the specified decisions which will take immediate effect (e.g. decision to impose condition in case of non-compliance with FRR). Under section 234, CE in Council may by Order amend Parts 2 and 3 of Schedule 8 to the SFO.

143. Members agree that to be in line with the approach taken in the primary legislation, certain "decisions" made by SFC under subsidiary legislation should be subject to the review of SFAT upon application by the party affected. This also applies to certain "decisions" made by ICC performing a function transferred to it by SFC under rules made under section 80 of the SFO. Members support the captioned draft Order and note that the proposed Order has taken into account suggestions of the market. The "decisions" to be included are as follows:

- (a) SFC's decisions to be added to Division 1 of Part 2 of Schedule 8 to the SFO -
 - (i) Objection to a listing of securities and imposition of condition to a non-objection to listing made under the draft Securities and Futures (Stock Market Listing) Rules;
 - (ii) Refusal on approval of lending agent and imposition of condition when giving approval; and withdrawal of approval made under the draft Securities and Futures (Disclosure of Interest - Securities Borrowing and Lending) Rules; and

- (iii) Refusal to allow persons to hold or control futures or options contracts in excess of the limits prescribed under the draft Securities and Futures (Contracts Limits and Reportable Positions) Rules.
- (b) ICC's decisions to be added to Division 3 of Part 2 of Schedule 8 to the SFO -
 - (i) Refusal to determine a claim, determination in relation to default, date of default, or whether the claimant is entitled to compensation, and aggregation of separate claims made under the draft Securities and Futures (Investor Compensation - Claims) Rules.
- (c) SFC's decisions to object listing of securities and impose condition on non-objection of listing made under the Securities and Futures (Stock Market Listing) Rules to be added to Division 5 of Part 3 of Schedule 8 to the SFO so that these decisions will take immediate effect.

Securities and Futures Ordinance (Amendment of Schedule 10) Order 2002

144. In order to ensure proper discharge of statutory functions by SFC, the definitions of "public body" and "public servant" under the Prevention of Bribery Ordinance (POBO) (Cap. 201) extend respectively to SFC and its relevant personnel. As certain functions performed by SFC in relation to ICC will be transferred to ICC under the Securities and Futures (Transfer of Functions - Investor Compensation Company) Order, it is necessary to subject ICC to similar safeguards as SFC.

145. Members note that the captioned draft Order is to amend Schedule 10 to the SFO to include a company recognized as an investor compensation company and its relevant personnel within the meaning of "public body" and "public servant" under the POBO. Schedule 10 to the SFO deals with, among others, consequential amendments to other legislation. CE in Council is empowered under section 409 of the SFO to amend Schedule 10.

146. The Subcommittee notes that the proposal in the draft Order is one of technical nature.

Securities and Futures (Insurance) Rules

147. The captioned draft Rules are made under section 116(5) of the SFO to specify the insurance coverage requirements for licensed corporations which are likely to receive or hold client assets in their business. As further

consultation with the industry is required, this set of draft Rules is to be gazetted and tabled in the Council at a later date.

148. To foster market stability and investor protection, currently exchange participants of SEHK are required under exchange rules to participate in a compulsory Brokers' Fidelity Insurance (BFI) Scheme which insures them against losses arising from infidelity events, fraud and theft caused by employees, and errors and omissions. The SFC considers it essential for all licensed corporations which are likely to receive or hold client assets in their business to take out and maintain such insurance as an additional layer of protection against the more prominent fidelity risks in their business. Section 116(3) of the SFO provides that SFC shall refuse to grant licence to carry on a regulated activity unless the applicant satisfies SFC that it is insured in accordance with rules made under section 116(5).

149. According to the captioned draft Rules submitted to the Subcommittee for examination, the insurance scheme will replace the BFI which will expire on 1 April 2003. Corporations that are licensed to carry on dealing in securities, dealing in futures contracts or providing securities margin financing are required to take out and maintain insurance, subject to certain exceptions for licensed corporations that are not exchange participants.

150. The industry was generally in support of the draft Rules during the public consultation ended in July 2002. A few Subcommittee members are concerned that some stock exchange participants may need to pay more premium under the new scheme as its scope will be extended to cover futures brokers, non-participants of the two exchanges and securities margin financiers. Moreover, some members of the Subcommittee considers that stipulating the insurance coverage and making the scheme mandatory may weaken the bargaining position in negotiating a more favourable insurance scheme for the industry, hence making the premium level more uncertain.

151. The Subcommittee notes that SFC has further consulted the three industry associations in view of the concerns raised by members. Parties concerned have agreed to a number of broad principles on the insurance arrangements. In gist, SFC will authorize a single master policy of brokers fidelity insurance which all prescribed licensed corporations are obliged to participate. All licensed corporations concerned will not be required to take out any insurance cover if SFC does not authorize any master insurance policy. SFC will from time to time review the risk coverage and the insured amount.

152. As regards some members' suggestion that more details about the insurance cover should be written into the draft Rules, the industry is of the view that a lot of the details of the master policy are subject to commercial negotiation and should not be included in the Rules.

153. The SFC has undertaken to revise the draft Rules in consultation with the industry. The Administration and SFC aim to finalize the Rules in early 2003 and bring them into operation in tandem with the SFO.

Level playing field between licensed corporations and registered institutions

154. During the course of deliberation, the Subcommittee has discussed at great length the applicability of rules to RIs in the conduct of their regulated activities. The RIs are not subject to the Securities and Futures (Client Money) Rules, the Securities and Futures (Financial Resources) Rules and, the Securities and Futures (Accounts and Audit) Rules. Some members share the concern of the brokerage industry about how a level playing field could be maintained between licensed corporations and RIs, in particular having regard to the rapid growth of regulated activities in the overall business of RIs.

155. In this regard, HKMA reiterates that the purpose of the dual-regulator approach enshrined under the SFO where HKMA remains as the frontline regulator of AIs supervising the various business undertaken by them on a consolidated basis is to reduce regulatory overlap and cost. Although some of the subsidiary legislation under the SFO will not apply to RIs and their associated entities, RIs are subject to equally stringent regulation under relevant ordinances, such as the BO governing the banking sector. The capital adequacy and liquidity requirements imposed under the BO will address the same risks as those covered by FRR including credit risk, market risk, liquidity risk and solvency risk.

156. As regards the concern over subjecting licensed corporations and associated entities to report non-compliance with certain requirements to SFC and imposing criminal sanction on failure to report, a members questions whether there is similar requirement on RIs for reporting non-compliance with statutory requirements to HKMA. The HKMA advises that there are similar requirements under the BO. For instance, sections 99 and 103 of the BO requires an AI to notify HKMA on contravention of the minimum capital adequacy ratio or the minimum liquidity ratio. Failure to report is a criminal offence and directors, chief executive and managers of the relevant AIs are subject to penalty of a fine at tier 8 (currently \$1,000,000) and imprisonment of five years. Another example is section 67 of the BO which requires any AI that is likely to become unable to meet its obligations to report to HKMA. Failure to report is a criminal offence and directors, chief executive and managers of the relevant AIs are subject to penalty of a fine at tier 7 (currently \$400,000) and imprisonment of two years.

Other subsidiary legislation necessary for the commencement of the SFO

Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) (Amendment) Notice 2002

157. The Subcommittee notes SFC's proposal to make the captioned Amendment Notice to exempt companies which are collective investment schemes authorized by SFC from compliance with certain provisions of the Companies Ordinance (Cap. 32) relating to the content and language requirements for prospectuses issued by companies. The intention of the exemption is to reduce unnecessary compliance burden by minimizing any regulatory overlap.

158. In authorizing collective investment schemes under section 104(1) of the SFO, SFC will have regard to the similar regulatory requirements in certain provisions in the Companies Ordinance. Moreover, given the unique nature of collective investment schemes, some of the requirements of the Companies Ordinance are inappropriate for application to them. Hence, SFC considers it appropriate to provide the exemption. The Amendment Notice is a technical amendment with no policy change, as similar exemption has been granted currently.

Revised Draft Rules and Technical Amendments

159. To facilitate Members' understanding of the changes made to the draft Rules in the light of the discussion with the Subcommittee, the Administration has produced revised drafts for various Rules. Due to the voluminous documents involved (over 500 pages), the revised drafts are not attached to this report but are available at the LegCo website (http://www.legco.gov.hk/yr01-02/english/hc/sub_com/hs01/reports/hs01_ld.htm). In the meantime, the Subcommittee has entrusted the LegCo Legal Service Division to follow-up with the Administration on other technical and drafting amendments.

Recommendation of the Subcommittee

160. The Subcommittee supports the above 37 sets of draft subsidiary legislation with the proposed amendments to be made by the relevant authorities. According to the Administration's plan, these subsidiary legislation are targeted for implementation on the commencement of the SFO in early 2003. The Administration advises that the draft subsidiary legislation will be submitted to the relevant rule-making authorities for approval and thereafter gazetted for negative vetting by the Council in three batches from late November to mid-December 2002. The Subcommittee supports this approach and considers it practical having regard to the large number of

subsidiary legislation concerned. It also provides more time for the industry to make preparation for the commencement of the SFO. To facilitate Council Members in considering the various subsidiary legislation, the Administration has undertaken to provide LegCo Briefs upon gazettal of the subsidiary legislation. The LegCo Legal Service Division will also produce legal service reports on the gazetted subsidiary legislation.

Advice sought

161. Members are invited to note the deliberations of the Subcommittee in the Report and its views in paragraph 160 above.

Council Business Division 1
Legislative Council Secretariat
5 December 2002

**Subcommittee on Draft Subsidiary Legislation
to be made under the Securities and Futures Ordinance**

Membership list

Chairman Hon SIN Chung-kai

Deputy Chairman Hon Margaret NG

Members Hon Albert HO Chun-yan
Hon Eric LI Ka-cheung, JP
Dr Hon David LI Kwok-po, GBS, JP
Hon NG Leung-sing, JP
Hon James TO Kun-sun
Hon Bernard CHAN (up to 02.07.2002)
Hon Mrs Sophie LEUNG LAU Yau-fun, SBS, JP
Hon Jasper TSANG Yok-sing, GBS, JP
Hon Ambrose LAU Hon-chuen, GBS, JP
Hon Henry WU King-cheong, BBS, JP
Hon Audrey EU Yuet-mee, SC, JP

(Total : 12 Members)

Clerk Ms Connie SZETO

Legal Adviser Mr KAU Kin-wah

Date 3 July 2002

**Summary of the Draft Subsidiary Legislation
for commencing the Securities and Futures Ordinance**

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Part I Preliminary					
Securities and Futures (Recognized Counterparty) Rules	Part I, Schedule 1	397	Securities and Futures Commission (SFC)	To prescribe certain institutions which will qualify as recognized counterparties defined in Part 1 of Schedule 1 to the SFO.	7 - 10
Part III Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services					
Securities and Futures (Transfer of Functions - Stock Exchange Company) Order	25	25	Chief Executive (CE) in Council	To transfer certain functions of SFC in relation to prospectuses under the Companies Ordinance (Cap. 32) to the Stock Exchange of Hong Kong.	17 - 18
Securities and Futures (Contracts Limits and Reportable Positions) Rules	35	35(1)	SFC	To prescribe the limit on the number of specified futures or options contracts which may be held by certain persons.	19 - 21
Securities and Futures (Stock	36	36(1)	SFC (after consultation with	To prescribe requirements relating to listing of securities	11 - 16

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Market Listing) Rules			Financial Secretary (FS) and the Stock Exchange of Hong Kong)	and to provide for dual-filing with SFC of copies of listing applications and information disclosed to the public by listed corporations.	
Securities and Futures (Transfer of Functions - Investor Compensation Company) Order	80	80(1)	CE in Council	To transfer certain functions of SFC in relation to the investor compensation fund to the investor compensation company.	108 - 109
Part IV Offers of Investments					
Securities and Futures (Professional Investor) Rules	103, 174 & 175	397	SFC	To extend the definition of “professional investor” in Part 1 of Schedule 1 to the SFO.	22 - 29
Securities and Futures (Exempted Instruments - Information) Rules	103 & 110	397(1)	SFC	To prescribe the information to be submitted to SFC in respect of the issue of certificate of deposit or other commercial papers.	30 - 31
Securities and Futures (Collective Investment Schemes) Notice	104	393	FS	To prescribe arrangements that are to be regarded as collective investment schemes.	32 - 34

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Part V Licensing and Registration					
Securities and Futures (Insurance) Rules (refer to remarks (2))	116	116(5)	SFC	To specify the insurance coverage to be taken out and maintained by specified licensed corporations.	147 - 153
Securities and Futures (Leveraged Foreign Exchange Trading - Exemption) Rules	Part V, Schedule 5 (Part 2)	397	SFC	To exclude the acts carried on by certain classes of persons from the definition of “leveraged foreign exchange trading” in Part 2 of Schedule 5 to the SFO.	35 - 36
Securities and Futures (Leveraged Foreign Exchange Trading) (Arbitration) Rules	118	118(2)	SFC	To prescribe the procedure for the settlement by arbitration of dispute between a client and a licensed corporation in relation to leveraged foreign exchange trading.	37 - 38
Securities and Futures (Licensing and Registration) (Information) Rules	128, 135, 136 & 138	397	SFC	To prescribe information to be provided to SFC by persons making applications to SFC, and the particulars to be entered in the public register of licensed persons and registered institutions.	39- 49

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Part VI Capital Requirements, Client Assets, Records and Audit Relating to Intermediaries					
Securities and Futures (Financial Resources) Rules	145	145 & 397	SFC (after consultation with FS)	To prescribe the financial resources requirements of licensed corporations.	55 - 59, & 154- 156
Securities and Futures (Client Securities) Rules	148	148(1)	SFC	To prescribe the manner in which intermediaries and associated entities shall treat and deal with client securities and securities collateral.	60 - 62
Securities and Futures (Client Money) Rules	149	149(1)	SFC	To prescribe the manner in which licensed corporations and associated entities shall treat and deal with client money.	63 - 67, & 154 - 156
Securities and Futures (Keeping of Records) Rules	151	151(1)	SFC	To specify the records that intermediaries and associated entities are required to keep.	68 - 73
Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules	152	152(1)	SFC	To prescribe rules for provision of contract notes, statements of account and receipts by intermediaries and associated entities to clients.	74 - 77

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Securities and Futures (Accounts and Audit) Rules	156 & 157	397	SFC	To prescribe rules for provision of financial statements and other documents by licensed corporations and associated entities, and require auditors to report licensed corporations' non-compliance with certain requirements.	78 - 79, & 154 - 156
Securities and Futures (Associated Entities – Notice) Rules	157 & 165	397(1)	SFC	To prescribe the information that shall be provided to SFC by a corporation when it becomes, or ceases to be an associated entity of an intermediary.	50 -54
Part VII Business Conduct of Intermediaries					
Securities and Futures (Short Selling Exemption and Stock Lending (Miscellaneous)) Rules	170 & 171	397 & 398	SFC (after consultation with FS in respect of certain provisions)	To provide exemptions from the “naked” short selling prohibition in section 170 of the SFO and reporting requirements to confirm short selling orders in section 171, and to prescribe reporting requirements for stock lending.	80 - 83

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Securities and Futures (Unsolicited Calls - Exclusion) Rules	174	397	SFC	To exclude certain agreements and calls from the prohibition against unsolicited calls in section 174 of the SFO.	84 - 86
Part IX Discipline					
Securities and Futures (Registration of Commission Disciplinary Orders) Rules	194 & 196	397	Chief Justice	To prescribe the manner in which SFC applies to register an order made under section 194 or 196 of the SFO to the Court of First Instance.	87, & 92 - 93
Part XI Securities and Futures Appeals Tribunal					
Securities and Futures Ordinance (Amendment of Schedule 8) Order 2002	217 & 232(2), Schedule 8 (Parts 2 & 3)	234	CE in Council	To amend Parts 2 and 3 of Schedule 8 to the SFO to make certain decisions of SFC or the investor compensation company reviewable by the Securities and Futures Appeals Tribunal, and certain decisions of SFC to take immediate effect.	141 - 143
Securities and Futures (Registration of Appeals Tribunal Orders) Rules	226	233	Chief Justice	To prescribe the manner in which the Securities and Futures Appeals Tribunal gives notice to the Court of First Instance for	88 - 89, & 92 - 93

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
				registration of its orders.	
Part XII Investor Compensation					
Securities and Futures (Investor Compensation - Levy) Rules	244(1)	244(1)	CE in Council	To prescribe the rates of levy payable by sellers and purchasers of securities and futures contracts for funding of the investor compensation fund.	94 - 97
Securities and Futures (Investor Compensation - Compensation Limits) Rules	244(1)	244(1)	CE in Council	To prescribe the maximum amount of compensation that may be paid to a person making a claim for compensation to the investor compensation fund.	98 - 99
Securities and Futures (Investor Compensation - Claims) Rules	244(2)	244(2)	SFC (after consultation with FS in respect of certain provisions)	To prescribe matters relating to entitlement to make claims, the manner for making claims, and determination and payment of claims, etc.	100- 107
Part XIII Market Misconduct Tribunal					
Part XIV Offences Relating to Dealings in Securities and Futures Contracts					
Securities and Futures (Registration of Market	264	269	Chief Justice	To prescribe the manner in which the Market Misconduct Tribunal gives notice to the Court of First	90 - 93

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Misconduct Tribunal Orders) Rules				Instance for registration of its orders.	
Securities and Futures (Price Stabilizing) Rules	282(2) & 306(2) Parts XIII & XIV	282(2) & 306(2)	SFC (after consultation with FS)	To exclude price stabilization activities conducted in accordance with the Rules from the application of the market misconduct provisions in Parts XIII and XIV of the SFO.	110 - 114
Part XV Disclosure of Interests					
Securities and Futures (Disclosure of Interests - Exclusions) Regulation	376	376	CE in Council	To prescribe certain interests and short positions to be disregarded for the purposes of notification under Part XV of the SFO.	115 - 117
Securities and Futures (Disclosure of Interests - Securities Borrowing and Lending) Rules	Part XV	377	SFC (after consultation with FS)	To exempt certain stock borrowing and lending transactions from disclosure requirements under Part XV of the SFO.	118 - 121
Part XVI Miscellaneous					
Securities and Futures (Levy) Order	394(1)	394	CE in Council	To specify the rates of levy payable by sellers and purchasers	122

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
				of securities and futures contracts. The levies will be retained by SFC as its expenses.	
Securities and Futures (Levy) Rules	394(5)	394	CE in Council	To prescribe matters relating to payment and collection of levies.	123 - 125
Securities and Futures (Fees) Rules	395 & 399	395	CE in Council (after consultation with SFC)	To prescribe fees for various matters relating to the SFO.	126 - 134
Securities and Futures (Offences and Penalties) Regulation	398(6)	398(6)	CE in Council	To provide that a person who contravenes certain sections of the Securities and Futures (Miscellaneous) Rules commits an offence and is liable to specified penalties.	138 - 140
Securities and Futures (Miscellaneous) Rules	Part XVI 179	397(1)	SFC	To provide for a range of miscellaneous matters including service of notice, exhibition of licences or certificates of registration for intermediaries, and the definition of “auditor” in Part 1 of Schedule 1 to the SFO.	135 - 137

Name of Subsidiary Legislation	Relevant Provisions in the Securities and Futures Ordinance (SFO)		Authority to make Subsidiary Legislation	Main Purposes	Paragraph numbers in the Report
	Relevant Parts/Sections/ Schedule	Enabling Provisions			
Part XVII Repeals and Related Provisions					
Securities and Futures Ordinance (Amendment of Schedule 10) Order 2002	Schedule 10, Part II	409	CE in Council	To amend Schedule 10 to the SFO to include the investor compensation company recognized by SFC and its relevant personnel respectively as “public body” and “public servant” under the Prevention of Bribery Ordinance (Cap. 201).	144 - 146

Remarks :

- (1) The Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) (Amendment) Notice 2002 is to be made under the Companies Ordinance to reflect the related SFO provisions (paragraphs 157 to 158 of the Report).
- (2) The Securities and Futures (Insurance) Rules last discussed by the Subcommittee on 24 October 2002 are being reviewed in consultation with the market. The Administration’s target is to finalize the Rules in early 2003 and to commence the Rules together with the SFO and other subsidiary legislation.
- (3) Notices will be made separately to commence the SFO and to repeal existing ordinances. They are subject to negative vetting by LegCo.

Council Business Division 1
Legislative Council Secretariat
5 December 2002