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**Bills Committee on
Securities and Futures (Amendment) Bill 2005**

Background brief

Purpose

This paper sets out the background of the Securities and Futures (Amendment) Bill 2005 which seeks to provide for the separation of the role of the Chairman of the Securities and Futures Commission (SFC) from that of the executive arm of SFC. It also summarizes the major concerns expressed by Members on the proposal at meetings of the Legislative Council (LegCo) and the Panel on Financial Affairs (FA Panel).

Background

Existing arrangements under the Securities and Futures Ordinance (Cap. 571)

2. SFC was established under the then Securities and Futures Commission Ordinance (SFCO) in 1989 as the regulator of the securities and futures market. In 2002, ten ordinances including SFCO, which governed the securities and futures market, were consolidated and modernized into the Securities and Futures Ordinance (SFO) (Cap. 571) which came into operation on 1 April 2003. The regulatory objectives, functions and powers, and general duties of SFC are set out in Part II of SFO, while the constitution and proceedings of SFC are set out in Schedule 2 to the Ordinance. The salient provisions on the internal governance structure of SFC are as follows:

- (a) SFC shall consist of a chairman and such number of executive directors and non-executive directors as determined by the Chief Executive (CE), all of whom shall be appointed by CE as follows:
- The number of members of SFC shall not be less than eight; and
 - The majority of the members of SFC shall be non-executive directors of SFC.

- (b) The Chairman of SFC shall, by virtue of holding that office, be regarded as an executive director of SFC.
- (c) CE may appoint an executive director of SFC as the Deputy Chairman of SFC.
- (d) The terms and conditions of the office of a member of SFC (whether as the chairman, deputy chairman or otherwise) shall be determined by CE.

3. Currently, the Chairman of SFC heads both the governing body as well as the executive arm of the Commission.

Proposed changes

4. In an effort to continually enhance the regulatory structure for the securities and futures market in Hong Kong and to ensure the effective functioning of SFC to meet challenges of the future, the Administration has proposed to improve the governance structure of SFC by separating the role of the SFC Chairman from that of the executive arm. Under the proposed structure, the Commission will be led by a non-executive chairman while the executive arm will be headed by a chief executive officer (CEO). The respective role and responsibilities of the non-executive chairman and CEO are as follows:

- (a) The SFC Chairman will not be involved in the day-to-day regulatory work. He/she should not influence the decisions of the executive arm on individual cases being reviewed or investigated. The Chairman should focus on the following-
 - establishing and developing an effective governing body;
 - setting agenda and establishing priorities;
 - facilitating effective contribution of non-executive directors; and
 - representing SFC publicly in liaison with local and international financial institutions and other stakeholders.
- (b) The CEO will take up the executive responsibility on the day-to-day running of SFC. He/She should implement the objectives, policies and strategies agreed by the SFC governing body. The CEO's key responsibilities include-
 - reporting to the governing body regularly with appropriate, timely and quality information;
 - informing and consulting the Chairman on all matters of significance to SFC;

- developing and delivering the strategic objectives agreed with the governing body; and
- overseeing the day-to-day operation and regulatory work of the Commission and ensuring that the Commission is equipped with the necessary staffing and financial and risk management system for its mission.

5. According to the Administration, the proposed separation of functions of the Chairman and CEO of SFC is in line with the best governance practice both locally and internationally. For example, a similar governance structure is also adopted for regulators and public bodies such as the Mandatory Provident Fund Schemes Authority and the Airport Authority. To put in place the proposed changes, the Administration has introduced the Securities and Futures (Amendment) Bill 2005 into LegCo on 6 April 2005. In gist, the Bill provides for the removal of the executive director status of the Chairman of SFC, the power of CE to appoint a CEO for SFC, an excess of non-executive directors over executive directors on the SFC, and related and incidental matters.

Major views and concerns expressed by Members

Scrutiny of the Securities and Futures Bill

6. The question of separating the functions of the SFC Chairman from those of the executive arm was first raised by some Members in the course of scrutinizing the Securities and Futures Bill in 2002. When considering the aforesaid Bill during the Committee Stage at the Council meeting on 13 March 2002, Mr Henry WU stated his view that the proposed provisions relating to the Chairman and members of SFC as set out in Schedule 2 of the Bill should be reviewed. To put in place an effective governance structure for enhancing the transparency, accountability and responsibility of SFC, it was specifically suggested that the post of the chairman should be split into the posts of a non-executive chairman and a CEO.

7. Subsequently, Mr Henry WU raised a written question at the Council meeting on 7 July 2004 to enquire whether the Administration would change the existing structure of SFC as provided under SFO in which the chairman also performed executive functions.

Consideration by the Panel on Financial Affairs

8. The FA Panel discussed the Administration's splitting proposal at its meetings on 10 November 2004, 3 January 2005 and 17 February 2005. It has also invited submissions and exchanged views with SFC, professional bodies, associations of the securities and futures industry and academics. A majority of

the organizations/individuals who have submitted views to the Panel expressly state that they support the splitting proposal while two indicate their objection. Some of the submissions have also expressed certain views and concerns on the proposal. A summary of the views submitted to the FA Panel is at the **Appendix**.

9. Members of the FA Panel have divided views on the splitting proposal. While some members support the proposal in principle for enhancing the governance structure of SFC, some members either do not support or express reservation on the proposal. Despite divided views among members, the Panel passed a motion at the meeting on 17 February 2005 supporting the splitting proposal in principle. The major areas of concern raised by members are summarized in the following paragraphs.

Position of the SFC

10. The Panel is keenly aware of the need to examine the views of SFC as the Bill has a direct bearing on its governance structure. Members note from SFC's submission that all SFC Board members agree in principle to the proposed split but are concerned about how the actual functions can be split between the posts of the chairman and the CEO. The majority of Board members have also expressed doubt on whether the chairmanship could be a part-time post, given the complexity and range of policy and regulatory issues that SFC has to handle. They also consider that it may not be easy to find a suitable candidate for the chairman post. The Panel also notes SFC's view that the Bill should not be taken as a reflection of the existing governance of the Commission which has been working well.

Appropriateness of splitting the chairman post

11. Whilst noting the Administration's view that the split model is in line with the best governance practice both locally and internationally, some Panel members point out that the splitting arrangement adopted by the Financial Services Authority in the United Kingdom and the Swedish Financial Supervisory Authority have only been implemented since 2003. The effectiveness or otherwise of the arrangement has yet to be tested. They therefore urge for careful consideration on whether the same practice should be adopted for SFC. Some members further query why the Administration has not adopted a consistent approach for the governance structure of public bodies by applying a similar split of functions on other regulators such as the Hong Kong Monetary Authority and the Office of the Telecommunications Authority.

12. Noting that the incumbent Chairman of SFC currently chairs the Technical Committee of the International Organization for Securities Commissions (IOSCO), some members are concerned whether changing the SFC chairman post into a non-executive post will have any impact on SFC's international status and its participation in IOSCO. In this regard, the Panel notes from the

Secretary General of IOSCO that the appointment of the IOSCO Technical Committee chairman is “a personal appointment based on the recognized experience and authority of the appointee” in providing strong input to the work of the organization, rather than on the executive nature or otherwise of the post held by the person.

Appointment of the Chairman

13. On the selection and appointment of the Chairman of SFC, some members are concerned about the lack of transparency in the existing appointment system under which appointments to public bodies are made by CE and doubt whether the appointment would be based on political considerations. There is a view that the appointment of the SFC Chairman should be endorsed by the legislature, similar to the appointment procedures for the Chairman of the Securities and Exchange Commission in the United States. Some other members however express reservation on this arrangement as it will render the appointment exercise highly politicized.

14. Panel members have also discussed the pros and cons of conducting a global search in order to identify the most suitable candidate for the chairman post. There is a suggestion that the candidate should be selected by an independent nomination/appointment committee comprising members from the industry, academia and the public. The Panel nevertheless notes the Administration’s stance that it does not consider it necessary to make changes to the existing appointment system which has been operating efficiently and effectively in the appointment of public offices.

Independence of the Chairman

15. The Panel notes that to safeguard independence of the SFC Chairman, the current provisions in SFO concerning the avoidance of conflict of interests will apply. In addition, the Chairman should not have any material interest or active involvement in listed companies. Some members are concerned whether such detachment from the market is realistic and whether this will result in the Chairman’s over-reliance on the CEO.

16. On the level of remuneration for the chairman post, some members consider that to ensure the appointment of a candidate who is professional, independent and free from any real or perceived conflict of interests, a reasonable level of remuneration should be offered for the post. Given the important role and functions of SFC, it may be necessary for the Chairman of SFC to work full-time and be fully remunerated. Otherwise, there is a high likelihood for the Administration to appoint a candidate from the limited pool of tycoons or businessmen who do not need the financial support of a fully remunerated full-time job. In this connection, the Panel notes that in setting the level of remuneration for the chairman post, the Administration will take into account factors such as the nature of the chairman post as a service for the community,

relativity with the remuneration of non-executive chairmen of other statutory or public bodies, as well as relativity with the remuneration of non-executive directors of SFC. Moreover, the Administration has preferred not to categorize the non-executive chairman post as part-time or full-time, given that the Chairman is expected to spend as much time as is appropriate to fulfill his/her role and responsibilities.

Division of responsibilities between the Chairman and the CEO

17. Concern has been raised on the practical implementation of the proposal in terms of the division of responsibilities between the SFC Chairman and the CEO, notably the possible overlapping of responsibilities between the two and the impact of such overlapping on the operational efficiency of SFC. Some members have referred to the scenario in which the incumbents of the two posts have conflicting views, and asked whether the difference in opinion will affect the operation of SFC. The Panel notes the Administration's explanation that there is no question of conflicting interests or views between the Chairman and the CEO as they share the common objectives in discharging their duties, i.e. maintaining the status of Hong Kong as an international financial centre and enhancing the protection for investors.

Timing for implementing the splitting proposal for Hong Kong

18. As the SFO has only commenced operation in 2003, some members do not see any strong justification for making the proposed significant changes to the governance structure of SFC. In view of the important regulatory role of SFC and the fact that no major problems have been identified in the existing governance structure, they opine that the splitting proposal should not be implemented in a hasty manner. As the incumbent Chairman of SFC will leave office upon the expiry of his current contract in September 2005, members have enquired about the arrangement for the chairman post if the legislative amendments for implementing the split are not passed in time before his departure in September 2005.

19. The Panel has been advised that pending the enactment of the Bill, the existing governance structure of SFC will be maintained and the Administration will proceed to recruit a suitable person to fill the post to be vacated by the incumbent Chairman. In case there is a time gap between the departure of the incumbent Chairman and the implementation of the Bill, if enacted, it will be made clear to the selected candidate that upon the passage of the Bill which will give effect to the splitting proposal, he/she will take up the CEO post to head the executive arm of the Commission and a new SFC Chairman will be appointed.

**Proposal of splitting the post of the Chairman of Securities and Futures Commission
into a non-executive chairman post and a chief executive officer post**

**Summary of views submitted to the Panel on Financial Affairs
(Position as at 3 January 2005)**

Part A Major views of the organizations attending the meeting

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
Securities and Futures Commission (SFC) (LC Paper No. CB(1)547/04-05(04))	<p><u>All Board members</u></p> <ul style="list-style-type: none"> ● Agree to the split in principle ● The real practical issue is how the actual functions could be split between the two posts <p><u>Most Board members</u></p> <ul style="list-style-type: none"> ● Express concern that it may not be easy to find a suitable candidate 	<p><u>Majority of Board members</u></p> <ul style="list-style-type: none"> ● Doubt that the chairman could be part-time, given the complexity and range of policy and regulatory issues that the Commission has to handle 	—	<p><u>Some Board members</u></p> <ul style="list-style-type: none"> ● Question why a change needs to be brought about now and in such a short timeframe
Professor Simon SM HO Dean and Professor School of Business Hong Kong Baptist University (LC Paper No. CB(1)631/04-05(01))	<ul style="list-style-type: none"> ● Supports strongly the proposal to strengthen the internal governance practice and to enhance the effective functioning of SFC 	—	<ul style="list-style-type: none"> ● The non-executive chairman should be an honorary public office but not a paid job. Cost-saving 	<ul style="list-style-type: none"> ● The proposal should be implemented when the contract of the current chairman expired to minimize

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
	<ul style="list-style-type: none"> ● Agrees with the role of the non-executive chairman and the CEO as suggested in the Administration's paper 		should not be the reason for having a non-executive chairman	unnecessary intervention
Hong Kong Securities Professionals Association (LC Paper No. CB(1)547/04-05(05))	<ul style="list-style-type: none"> ● Fully agrees with the proposal ● Should be very cautious in choosing the candidates for the two posts 	—	—	—
Hong Kong Securities & Futures Industry Staff Union (LC Paper No. CB(1)547/04-05(06))	<ul style="list-style-type: none"> ● No comment on the restructuring proposal of the senior management ● The chairman and CEO must have sufficient knowledge about the operation of the securities and futures industry 	—	<ul style="list-style-type: none"> ● It may not be easy to find a suitable candidate for the chairman post given the low level of remuneration and other requirements 	—
The Institute of Securities Dealers Limited	<ul style="list-style-type: none"> ● Supports the splitting proposal in principle ● Knowledge of local market and ability to 	—	—	—

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
	maintain close liaison with the industry are crucial criteria in the selection of candidates for the chairman and CEO posts			
The Hong Kong Society of Financial Analysts Limited (LC Paper No. CB(1)547/04-05(07))	<ul style="list-style-type: none"> ● There are some merits of the splitting proposal ● The chairman post must be filled on the basis of professional and ethical merit, and must not be a political appointment 	—	<ul style="list-style-type: none"> ● Both the chairman and CEO should be remunerated at full market rates 	The decision of separating the duties of the chairman and CEO is a complex one and needs to be made after considerable consultation. The hiring of the chairman and CEO must not be done in haste
Hong Kong Stockbrokers Association Limited (LC Paper No. CB(1)547/04-05(08))	<ul style="list-style-type: none"> ● The separation of roles will have a number of advantages ● Whether the chairman is an executive or non-executive needs to be addressed 	<ul style="list-style-type: none"> ● Whether the chairman is full-time or part-time needs to be addressed 	<ul style="list-style-type: none"> ● Expresses concern about the remuneration package of the chairman post and how the package is determined 	—
ACI – The Financial Markets Association of	<ul style="list-style-type: none"> ● Supports the splitting proposal to enhance the 	—	—	—

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
Hong Kong (<i>LC Paper No. CB(1)631/04-05(02)</i>)	transparency and credibility of SFC provided that the proposal is implemented in a proper manner that the smooth work flow of SFC will be maintained			
Hong Kong Institute of Certified Public Accountants (<i>LC Paper No. CB(1)547/04-05(15)</i>)	<ul style="list-style-type: none"> ● Supports the principle of splitting the chairman post into chairman and CEO posts ● To avoid any confusion of roles and overlapping of responsibilities, the chairman should ideally be an independent non-executive member of the governing board 	<ul style="list-style-type: none"> ● Not necessary to define the chairman as a “full-time” or “part-time” chairman 	<ul style="list-style-type: none"> ● The chairman should be adequately remunerated having regard to his role and responsibilities as well as the fact that he should be non-executive and is not an employee of SFC 	

Part B Major views of the organizations/academics not attending the meeting

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
The Law Society of Hong Kong (Securities Law Committee) (<i>LC Paper No. CB(1)547/04-05(10)</i>)	<ul style="list-style-type: none"> ● Supports the split ● Supports the proposal that the chairman be non-executive 	<ul style="list-style-type: none"> ● If the chairman is to be the public face of SFC, the chairman should be full-time ● To make the chairman post a part-time position will send a wrong message to the market. It would not be easy to find a suitable candidate who has absolutely no conflicts of interest to fill the part-time chairman post 	—	<ul style="list-style-type: none"> ● The timing is rushed and more time should be taken to consider the details of the proposal
Dr Stanley C K HOI Associate Professor Department of Finance & Insurance Lingnan University (<i>LC Paper No. CB(1)547/04-05(11)</i>)	<ul style="list-style-type: none"> ● Expresses concern about the appropriateness of a non-executive chairman 	<ul style="list-style-type: none"> ● It would seem appropriate to provide a full-time status to the chairman post 	—	—

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
Hong Kong Exchanges and Clearing Limited (<i>LC Paper No. CB(1)547/04-05(12)</i>)	<ul style="list-style-type: none"> ● Not appropriate for HKEx to comment on the question of SFC's chairmanship 	—	—	—
Professor Stephen Y L CHEUNG Chair Professor Department of Economics & Finance City University of HK (<i>LC Paper No. CB(1)547/04-05(13)</i>)	<ul style="list-style-type: none"> ● Splitting would bring about benefits to SFC 	—	—	—
The Hong Kong Association of Online Brokers (<i>LC Paper No. CB(1)547/04-05(14)</i>)	<ul style="list-style-type: none"> ● Supports the splitting of functions, but bureaucracy should not be brought into the regulatory system by the creation of a new post 	—	—	—
Mr David M WEBB (<i>LC Paper No. CB(1)547/04-05(16)</i>)	<ul style="list-style-type: none"> ● What is proposed would be negative to the governance and effectiveness of SFC ● There is already a separation of roles within SFC: an executive 	<ul style="list-style-type: none"> ● The chairman of a regulator can only fulfill his role if he is a full-time chairman 	<ul style="list-style-type: none"> ● Any role which is full-time, whether it is called executive or not, deserves a full-time remuneration 	—

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
	chairman and a Chief Operations Officer			
Hong Kong Investment Funds Association (<i>LC Paper No. CB(1)547/04-05(17)</i>)	<ul style="list-style-type: none"> ● Supports the splitting proposal ● A non-executive chairman would have more time to keep abreast of the latest developments in the European Union and would be in a better position to map out the appropriate policies 	—	—	—
Professor LOW Chee-keong Associate Professor in Corporate Law The Chinese University of Hong Kong (<i>LC Paper No. CB(1)547/04-05(18)</i>)	<ul style="list-style-type: none"> ● Not in favour of the proposal 	—	<ul style="list-style-type: none"> ● The chairman of the Financial Services Authority in the United Kingdom draws a substantial salary and the separation of the post has increased the costs by the 	<ul style="list-style-type: none"> ● The speed at which the Administration is seeking to implement the proposal may expose it to the type of oversight that was evident in the recent deferment of the listing of the Link

	Splitting the SFC chairman post into non-executive chairman and CEO posts	Full-time or part-time chairman	Remuneration	Timeframe for the proposed changes
			equivalent of at least one full-time director	REIT on the Stock Exchange of Hong Kong
The Hong Kong Institute of Directors (<i>LC Paper No. CB(1)547/04-05(19)</i>)	<ul style="list-style-type: none"> It would be the best practice in the corporate governance of SFC to separate the post of the chairman into two: an independent, non-executive chairman post and a CEO post 	—	—	—