

**Bills Committee on
Securities & Futures (Amendments) Bill 2005**

Meeting on Thursday, 19 May 2005 at 10.45 a.m.

**Opening Statement by Mr. Andrew Sheng
Chairman of the Securities and Futures Commission**

Mr. Chairman,
Honourable members of the Bills Committee,

1. I am honoured to be invited to provide my views to the Honourable members of the Bills Committee on this important proposal of the Administration to change the SFC's governance structure.
2. Honourable members may recall that I attended the Financial Affairs Panel meeting on 3 January 2005 and presented my views on the Administration's proposal in that forum.
3. The position of the Commission has already been set out in our previous submissions to the Financial Affairs Panel. In relation to the specific questions raised by the Bills Committee in its first meeting on 22 April 2005, the Commission's views have been set out in Annex A to the Administration's follow-up response dated 12 May 2005. Since this is such an important proposal that will change the governance structure of the Commission and its operation, I welcome the opportunity to share my personal views and experience on the practical issues in implementing the proposed changes.

4. First, the objective of the proposal is to enhance the governance structure of the SFC in line with best governance practice both locally and internationally. As currently proposed, the role of the SFC Chairman should be separate from that of the executive arm to further enhance the internal checks and balances of the SFC. This, according to the Administration, creates the conditions for enhancing the independence of the governing body and hence its ability to discharge its supervisory functions over senior management.
5. There are three key questions that should be considered here:
 - a. The clarity of accountability of the head of the Commission;
 - b. The checks and balances over the policy direction and execution of the policies of the Commission; and
 - c. The checks and balances over the internal management and administration.
6. The current law is very clear on who is the ultimate fully accountable face and head of the Commission. The Chairman is a full-time executive director of the Commission, ultimately responsible for the affairs of the Commission. His authority can be delegated to other staff, but the responsibility cannot be delegated. As I have said before, there can be only one captain in one ship. The amendment proposal makes this less clear, since the Chairman is neither an executive director nor a non-executive director. The work and authority will be split between two persons, the Chairman and Chief Executive Officer (CEO).
7. The current trend in listed companies to split the chairman's job from that of the CEO is because, in theory, the chairman is supposed to represent the shareholders' interests relative to management interests. In the case of statutory and regulatory bodies, both persons must represent the public interest, hence the question of direct accountability becomes even more important.
8. The need for a full-time executive Chairman is because it would be difficult, if not impossible to avoid getting into a

conflict of interests position (real or perceived) if s/he, as a regulator, were to work part-time and hold other positions. The SFC Chairman's position heading up a regulatory body involved in investigation, prosecution and disciplinary actions on a wide range of persons puts him/her in a similar position to judges or police in terms of the need to avoid and be seen to avoid any conflict of interests. The Commission is sometimes characterised as a cop for the securities markets. For example, I know of no jurisdiction where the commissioner of police is a part-time, non-executive person.

9. The reason for having full-time executives in charge is best explained by the Australian Securities and Investments Commission (ASIC) in its Annual Report 2003-04 on its Governance in which the following is stated:

"Three full-time Commissioners directed ASIC's affairs. Full-time membership let Commissioners monitor and direct ASIC's complex and wide-ranging activities, and avoided conflicts of interest that might otherwise affect part-time Commissioners still active in business, law or accounting" (at p.50).

10. Following the collapse of the HIH insurance company in Australia, the governance structure of the Australian Prudential Regulatory Authority (APRA) changed from a non-executive Board, with a non-executive chairman with the CEO as the only executive board member, to an executive Board, which comprises the executive chairman and two executive commissioners carrying the responsibility, and accountable to the government for the operations of the APRA. This echoes what happened in Hong Kong back in 1989 when the old system of a non-executive chairman and executive Commissioners of Securities and Commodities was replaced with the creation of the SFC headed by an executive chairman with a board comprising executive and non-executive directors. At that time, the Hay Davison Report was critical of the part-time role of the Securities Commission and the Commodities Trading Commission, since *"as part-time bodies, the Commissions cannot properly discharge their statutory duties of overseeing the Exchanges and ensuring investors are protected on a day-to-day basis"* (paragraph 9.26).

11. There are two technical points on the need for clarity in the law. The Administration in its letter to the Legal Services Division of the Legislative Council Secretariat dated 1 April 2005 stated that the SFC Chairman will not be regarded as an executive or non-executive director of the SFC. The SFC Chairman will simply be the “chairman”. As Section 2 of Part 1 of Schedule 2 to the SFO would no longer exist, s/he will not be included for the purpose of calculating the requisite majority or quorum under the Schedule 2 provisions that expressly refer to executive directors or non-executive directors. It seems odd that the SFC Chairman will be invisible for quorum purposes but still have a casting vote.
12. The same letter states that the SFC Chairman will be the head of the Commission and will sign the financial statements of the Commission, but the CEO, who will be responsible for the day-to-day affairs of the Commission will not sign the financial statements. Since the accounts must be signed by an NED anyway under the SFO and given the role to be played by the CEO it might make more sense to enable the CEO to sign off on the accounts instead, particularly if the SFC Chairman is non-executive and not full time.
13. The nature of the regulatory work of the Commission, which is highly legalistic and procedural, requires anyone accountable for the work to devote his or her full time attention to that work, particularly since what appears to be an individual case can set precedent for other cases or have wide policy implications. This in practice requires full time attention.
14. In other words, in practical terms, under the new system it will be difficult to say that the CEO is responsible for day-to-day decisions of the SFC and the SFC Chairman is fully accountable as the Head of the Commission. If the CEO reports to the Chairman, then in practice, he is not the Chief Executive. All in all, the practical implications of the proposal cannot be ignored and must be carefully thought through.

15. The second issue is which part of the governance of the current structure will the split role improve or enhance? Since both the Chairman and the CEO, and indeed the whole Board, serve the public interest, the key policy objective is to ensure that the Commission meets its statutory objectives and carries out its statutory functions. The current checks and balances on the Commission are already extremely transparent and world class, with non-executive directors chairing the Budget, Audit and Remuneration Committees, and with non-executive directors out-numbering the executive directors. The regulatory processes and decisions of the Commission are subject to checks such as the Ombudsman, the Process Review Panel, the SFAT or judicial review. The Commission is already fully accountable to the public on the extent to which it fulfils its statutory objectives and functions. How will the split role enhance that accountability?
16. The third part of the governance structure is internal management and administration. If the Chairman is also the CEO, then should there be further checks and balances on the internal management and administration? Currently, the Management Committee of the Commission is already chaired by the Chief Operating Officer. As mentioned earlier, the internal Budget, Audit and Remuneration Committees are all chaired by NEDs. Both the Audit and Remuneration Committees comprise only NEDs. An NED chairs the Budget Committee and the majority of its members are NEDs.
17. In the case of the Ontario Securities Commission where the Chairman and CEO have not been separated, the position of Lead Director was created, filled by a NED. Acting in consultation with the Chair and the Chairs of the Board Committees, the Lead Director is responsible for overseeing the operations of the OSC's Board of Directors to ensure that it carries out its responsibilities effectively. This includes providing greater assurance that the responsibilities of the Board and its Committees are well understood by Commission members and management, that its resources are adequate, that it receives relevant information on a timely basis and that its effectiveness is assessed on a regular basis. This is one possible model that can be examined.

18. On the international implications of the proposed amendment, I would just like to point out that all current Chairmen of the fifteen members of the IOSCO Technical Committee are executive chairmen and are full time. Since I am currently chair of the Technical Committee, it would be helpful for the Legislative Council Secretariat to directly consult the Chairman of the Executive Committee of IOSCO and the Deputy Chairman of the Technical Committee of IOSCO for independent assessments of the questions posed on international implications and experience.

Concluding remarks

19. As previously mentioned, the Commission fully recognises that the decision regarding the split between SFC Chairman and a CEO is a policy decision that is the prerogative of the Government. However, given the importance of this policy decision, we feel that the Administration and Legislative Council should carefully weigh all the relevant factors and long-term implications. I personally believe that it would be important that the law is clear on who exactly is the fully accountable face of the Commission. As an international financial centre proud of its rule of law, we should have clarity of law in this matter. I wish to repeat that whatever change is made, it needs to be handled in a way which does not undermine the reputation or the authority of the SFC domestically or internationally, which could affect Hong Kong's standing as an international financial centre.
20. Thank you for giving me the opportunity to present my views.