

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

Follow-up to the second meeting on 19 May 2005

This paper sets out the Administration's response to the issues raised at the second meeting of the Bills Committee held on 19 May 2005. As many of the issues have been addressed by the Administration before, where appropriate, this paper should be read in conjunction with our previous submissions to the Bills Committee in May 2005 (*Ref : LC Paper No. CB(1)1537/04-05(04) and CB(1)1537/04-05(05)*) and to the Panel on Financial Affairs in February 2005 (*Ref : LC Paper No. CB(1)880/04-05(08)*).

(a) Executive or Non-executive Chairman

Issue	Administration's response
1. Why non-executive Chairman ?	<p>The policy intent of the Administration is that the future Chairman will, in principle, be non-executive so that -</p> <ul style="list-style-type: none"> (i) he/she could be relieved from the day-to-day operational and regulatory work; (ii) he/she could be independent from the executive arm and hence enhance the internal checks and balances mechanism; and (iii) duplication of responsibilities between the chairman and the Chief Executive Officer (CEO) can be avoided. <p>The Chairman will not be involved in the day-to-day operational and regulatory work but will focus on leading the governing body¹ in setting the overall directions, policies, agendas, strategies and priorities of the Commission; enhancing the effectiveness of the governing body; monitoring the performance of the executive arm in implementing the objectives set by the governing body; and representing the Securities and Futures Commission (SFC) publicly, in liaison with local and international financial institutions and other stakeholders.</p>

¹ Under the Securities and Futures Ordinance (SFO), the Commission shall consist of Chairman, Executive Directors (EDs) and Non-executive Directors (NEDs) (section 1 of Part 1 of Schedule 2). To distinguish between the Commission and its employees or staff, the term "governing body" is used in this paper.

Issue	Administration's response
	<p>We note the comments of some of the deputations at the Bills Committee meeting on 19 May 2005 that the powers of the Commission were over-concentrated and that the industry wished to see more checks and balances through the implementation of the splitting proposal. By separating the role of the Chairman from the executive arm, the SFC governing body will be led by a non-executive Chairman. This will increase internal checks and balances and enhance the role of the governing body in supervising the performance of the executive arm of the Commission.</p>
<p>2. Isn't there a separation of roles between the Chairman and the Chief Operating Officer (COO) ?</p>	<p>The division of labour between Chairman and the COO is a division of duties in the same executive arm, not separation of roles between executive and non-executive.</p> <p>As mentioned above, apart from relieving the Chairman from the day-to-day regulatory and operational work, another objective of the splitting proposal is to strengthen the internal governance and enhance the internal checks and balances of the SFC by separating the role of the Chairman from the executive arm. The splitting proposal will create conditions for enhancing the independence of the governing body and hence its ability to discharge its supervisory functions over the executive arm.</p>
<p>3. Who is the ultimate accountable face and head of the Commission ?</p>	<p>The Chairman is accountable for the policies of the Commission while the CEO is responsible for operational matters.</p> <p>It is not meaningful or practical to stipulate whether it is the non-executive Chairman or the CEO who is the public face of the SFC. At present, in addition to the Chairman, individual Executive Directors (EDs) may also represent the Commission publicly to speak on their respective subject areas.</p>

Issue	Administration's response
<p>4. The history of separating the roles and responsibilities of chairman and CEO is relatively short.</p>	<p>Hong Kong has accumulated much experience in implementing similar split model in other financial regulators such as the Hong Kong Exchanges and Clearing Limited (HKEx) and the Mandatory Provident Fund Schemes Authority (MPFA) and in a number of public bodies like the Airport Authority, Kowloon-Canton Railway Corporation (KCRC) and the Mass Transit Railway Corporation Limited (MTRCL).</p> <p>The current proposal is also in line with the best governance practice internationally². Regulatory bodies in the U.K., Sweden and Singapore have also implemented the split model for better governance.</p> <p>As a principal market regulator of the financial services sector, the SFC should set exemplary standard for others to follow.</p>

(b) Implementation details

Issue	Administration's response
<p>5. Division of roles and responsibilities between non-executive Chairman and CEO</p>	<p>The broad principles governing the division of roles and responsibilities between the future non-executive Chairman and CEO have been set out in the Administration's papers to the Panel on Financial Affairs (<i>Ref: CB(1)177/04-05(01) and CB(1)880/04-05(08)</i>), the Bills Committee (<i>Ref: CB(1)1537/04-05(04)</i>) and the Legislative Council Brief issued on 9 March 2005.</p> <p>Subject to the passage of the Securities and Futures (Amendment) Bill 2005, the SFC governing body will draw up and agree on the details of the division of responsibilities.</p>

² Report of the Committee on Financial Aspects of Corporate Governance by Adrian Cadbury, December 1992; and Review of the Role and Effectiveness of Non-executive Director by Derek Higgs, January 2003.

Issue	Administration's response
<p>6. Why no explicit provisions setting out the division of roles and responsibilities of Chairman and CEO in the Bill ?</p>	<p>We do not consider it appropriate to stipulate rigidly in the legislation the different roles and responsibilities of Chairman and other members of the Commission, as duties and responsibilities would evolve over time with the developments of the financial markets. Besides, stipulating the division of work and duties in the legislation would impose unnecessary inflexibility on the future division of work in the Commission.</p> <p>The current provisions in the SFO do not stipulate the division of duties and responsibilities of Chairman, EDs and Non-Executive Directors (NEDs). In the local experiences we made reference to, such as the MPFA, Airport Authority, MTRCL , KCRC etc., the division of responsibilities of their Chairmen, members or directors are also not prescribed in the relevant legislation. In the overseas experience we made reference to, the U.K. Financial Services Authority also does not stipulate the division of responsibilities between the Chairman and CEO in its Financial Services and Market Act.</p> <p>Every organization, public or private, has division of work, and they are implemented by administrative means. In the case of the SFC, save for the non-delegable functions of the Commission, there are also division of work among Chairman, EDs, NEDs and staff, and such division of work is also implemented through administrative means.</p>
<p>7. If there are no explicit provisions in the legislation, how to ensure clear division of roles and responsibilities ?</p>	<p>Upon the passage of the Bill, the SFC will draw up, deliberate and agree on the details of the division of roles and responsibilities. Such details will be attached to the appointment letter of the Chairman and the employment contract of the CEO. They will also be made known to the public in the form of a press release and uploaded onto the website of the SFC.</p>

Issue	Administration's response
<p>8. What will be the future arrangements governing the division of work ?</p>	<p>The existing arrangements governing the division of work of Chairman, EDs and NEDs will by and large continue, except that the executive management and regulatory functions of the current Chairman will be transferred to the CEO.</p> <p>We expect the arrangements to be along the following lines:</p> <p>(a) The role of the future Chairman will, in-principle, be non-executive so that he could be relieved from the day-to-day operational and regulatory work. The Chairman will focus on setting the overall directions, policies, agendas, strategies and priorities of the Commission; enhancing the effectiveness of the governing body; monitoring the performance of the executive arm in implementing the objectives set by the governing body; and representing the SFC publicly, in liaison with local and international financial institutions and other stakeholders. All of these functions are currently carried out by the incumbent Chairman and will continue with the future Chairman. The future Chairman will also continue to exercise the statutory functions expressly provided by the SFO.</p> <p>(b) Each ED will continue to assume management responsibility for his or her Division (as set out in paragraph 5 in SFC's reply extracted at <u>Annex</u>).</p> <p>(c) The CEO will assume overall executive management responsibility including –</p> <ul style="list-style-type: none"> (i) implementing the objectives, policies and strategies agreed by the SFC governing body; (ii) reporting to the governing body regularly with appropriate, timely and quality information; (iii) informing and consulting the Chairman and the governing body on all matters of significance to the Commission;

Issue	Administration's response
	<p>(iv) developing and delivering the strategic objectives agreed with the governing body; and</p> <p>(v) supervising the work of other EDs, 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 systems for its missions.</p> <p>The above functions are currently carried out by the incumbent Chairman. With these functions transferred to the CEO, the Chairman can focus on the overall directions, policy and strategic development of the Commission.</p> <p>(d) As for NEDs, they will continue to play their independent role of supervising the SFC's executive functions as set out in paragraph 10 in SFC's reply extracted at <u>Annex</u>.</p> <p>Although the policy intent is for the future Chairman to be non-executive in-principle, the Chairman (and NEDs alike), as part of the Commission, would continue to perform and discharge the statutory functions of the Commission, including the non-delegable functions listed in Part 2, Schedule 2 of SFO, as well as the statutory functions specially assigned to him under SFO.</p> <p>As at present, all important policies will continue to be discussed and approved by the SFC governing body, which meets monthly and holds additional meetings as necessary. The governing body will continue to discharge the non-delegable functions under the SFO. It will continue to be briefed on the financial position of the Commission and be provided with monthly financial statements. Divisional staff will continue to attend Board meetings on a need basis to explain policy proposals, report on important operational matters and regulatory issues.</p>

Issue	Administration's response
<p>9. Will there be difficulties for a non-executive Chairman to discharge his/her responsibilities without hands-on understanding of the day-to-day operation of the SFC ?</p>	<p>We note the worries of some Members that the future Chairman may not be able to discharge his/her responsibilities without hands-on understanding of the day-to-day operation of the SFC or regulatory details of individual cases.</p> <p>The Administration wishes to reiterate that the policy intention is for the future Chairman to be non-executive in-principle, so that he/she could be relieved from day-to-day operational and regulatory details. Notwithstanding that, as part of the Commission, the future Chairman and NEDs alike, are required to discharge their statutory functions under the SFO, including the non-delegable functions.</p> <p>Where there are matters or decisions of which the responsibilities are vested with the full Commission (i.e. the governing body), it will be the responsibility of the executive arm to be led by the CEO to handle the administrative side of the task and to brief the governing body so that members may exercise their powers / functions / discretion properly and efficiently, as at present.</p> <p>As set out in the broad principles of the responsibilities of the CEO, the CEO is also expected to inform and consult the Chairman as well as the governing body on matters of significance to the SFC.</p> <p>As evident in the cases of HKEx and MPFA, a non-executive chairman can successfully lead and develop the regulatory body without being involved in the day-to-day regulatory work. The division of responsibilities between non-executive chairman and CEO is also workable in many other local statutory bodies like the Airport Authority, KCRC and MTRCL.</p> <p>Successful implementation of the splitting proposal can be achieved with careful and detailed planning. The</p>

Issue	Administration's response
	<p>Administration will continue to liaise closely with the SFC on the implementation details to ensure a smooth execution of the proposal.</p>
<p>10. Will the future non-executive Chairman have access to information on individual cases under investigation ?</p>	<p>The future Chairman is a non-executive Chairman in-principle and would not be involved in the day-to-day operational and regulatory details.</p> <p>As noted in paragraphs 6-9 in SFC's reply at Annex, the current executive Chairman is also not involved in the regulatory details of individual cases under investigation. We also understand from the SFC that the governing body currently does not receive regular report on the executive management's enforcement work. The governing body is only briefed on cases considered to be of public and/or media interest, and cases considered to be of significance to the Commission.</p> <p>Under the splitting proposal, the non-executive Chairman is not expected to be involved in or request for regulatory details of individual cases. However, should an individual case is considered to be of significance to the Commission or in the interest of the public, the CEO is expected to inform the governing body of the case. If an individual case under investigation has become public or has attracted wide media and public interest, the CEO is also expected to inform the governing body of the case. Alternatively, the governing body may wish to be briefed on the case and may request the executive management to provide information.</p>

Issue	Administration's response
<p>11. Why no explicit provisions to safeguard against conflict of interests ?</p>	<p>The Administration agrees that it is important for Chairman, and indeed all members and staff of the SFC, to maintain independence and avoid conflict of interests.</p> <p>Firstly, there are <u>statutory</u> safeguards in place to govern the preservation of secrecy (section 378, SFO) and avoidance of conflict of interests (section 379, SFO) of all members and staff of the SFC. The legal requirements in the Prevention of Bribery Ordinance are also applicable to all members (including Chairman, EDs and NEDs) and staff of the SFC.</p> <p>Secondly, the SFC's internal Code of Conduct which sets out the requirements on confidentiality, conflict of interests, personal investments and prevention of bribery, is binding on all members and staff of the SFC and shall continue to apply to the non-executive Chairman under the splitting proposal.</p> <p>Thirdly, in response to high public expectation on the independence of the SFC Chairman, we have proposed additional requirements for the future Chairman to comply :</p> <ul style="list-style-type: none"> (i) He/she should not be a director in any listed company in Hong Kong; (ii) He/she should not have any material interest in any principal business activity or involved in any material business dealing with a listed company or any person or institution engaged in activities regulated by the SFC. <p>The above requirements will be included in the terms of appointment of the future Chairman. The prospective Chairman will be required to agree to comply with these requirements before his / her appointment takes effect.</p>

Issue	Administration's response
<p>12. Should a non-executive Chairman avoid any contact with the stakeholders of the industry ?</p>	<p>As the head of the Commission, it is not reasonable or practical for the Chairman to refuse any contact with the personnel of the stakeholders of the industry, e.g. listed companies, banks, stockbrokers and other intermediaries, etc. as the Chairman cannot operate in a vacuum. He/she must keep abreast of the market development and liaise with the industry to gauge their views on the work of the SFC for the purpose of setting the agendas, policies and priorities of the Commission.</p> <p>We consider the statutory, administrative and contractual measures mentioned above in respect of ensuring the independence of Chairman and avoidance of conflict of interests adequate.</p>
<p>13. Impact of the splitting proposal on the non-delegable functions of the SFC</p>	<p>Under section 10 of the SFO, the Commission may delegate any of its functions to any member, staff or committee established by the SFC; but no delegation shall be made in respect of any of the non-delegable functions specified in Part 2 of Schedule 2 of SFO. This means the non-delegable functions are to be exercised by the Commission only, i.e. the governing body.</p> <p>Although the policy intent is for the future Chairman to be non-executive in-principle, the Chairman (and NEDs alike), as part of the Commission, is required to discharge the non-delegable functions together with other members of the governing body. Irrespective of whether the Chairman is executive or non-executive in nature, nothing should affect his/her responsibility under the SFO to discharge the non-delegable functions together with other members of the governing body. In short, the splitting proposal would not have impact on the non-delegable functions of the Commission.</p> <p>On how the non-delegable functions would be performed, the governing body may ask the executive arm of the</p>

Issue	Administration's response
	<p>Commission or its staff to handle the administrative side of the work of a non-delegable function (e.g. do the necessary ground work, gather the necessary information relevant to the performance of that function, seek legal advice, etc.) before the subject matter of that non-delegable function is to be discussed, agreed and decided by the governing body and discharged in the name of the Commission.</p>

(c) Full-time or Part-time

Issue	Administration's response
<p>14. Should the Chairman work full-time ?</p>	<p>It is not meaningful or necessary to specify the future non-executive Chairman post to be full-time or not as the post is not an employment with the Commission but a service to the community.</p> <p>The candidate's acceptance of the Chairman appointment signifies his/her acceptance of the heavy responsibilities of the post and high expectations of the public on the post-holder. It also signifies the candidate's commitment to serve the Commission, who will spend as much time and efforts as necessary to fulfill his/her roles and responsibilities. He/she is also expected to work anytime, anywhere if necessary.</p>

(d) Remuneration

Issue	Administration's response
<p>15. How to determine the level of remuneration for future non-executive Chairman</p>	<p>The overriding principle in determining the level of remuneration of the future Chairman of SFC is that the appointment is a service to the community, not an employment with the SFC. Having considered the remuneration of non-executive chairmen of other major statutory bodies in Hong Kong and the remuneration of NEDs of the SFC, we propose to recommend setting the remuneration at around \$702,000 per annum, which is three times of that for NEDs of the SFC.</p>

Issue	Administration's response
16. Is the proposed level of remuneration for future non-executive Chairman appropriate ?	We wish to reiterate that the appointment is a community service, not an employment. The Administration does not consider it appropriate to compare the remuneration for a community service with the remuneration for an employment. It should also be noted that the remuneration for the non-executive chairmen of other major public / statutory bodies in Hong Kong ranges from nil to not more than \$1 million. Our proposed remuneration is considered an appropriate level.
17. Whether it is feasible to identify a suitable candidate with the proposed level of remuneration ?	We wish to reiterate that the appointment is a community service, not an employment. The future Chairman's acceptance of the appointment will be out of a spirit and commitment to serve Hong Kong. We do not think that remuneration is a key consideration of the suitable candidate in deciding whether to accept the appointment.

(e) Appointment of Chairman

Issue	Administration's response
18. How will the future Chairman be appointed ?	<p>Appointment of the future non-executive Chairman will be made in accordance with the present appointment system for advisory and statutory bodies based on merit. The system has been operating efficiently and effectively in the appointment of public offices.</p> <p>The Administration attaches great importance to good governance, effective functioning and credibility of the SFC as these are essential to maintaining Hong Kong's reputation as an international financial centre. The Government would be very careful in the selection of the most suitable candidate based on merit and having regard to the essential qualities of the candidate. The Administration is keenly aware that the appointment of the SFC Chairman will be subject to public scrutiny. We welcome views from the industry and the community on the appointment.</p>

Issue	Administration's response
19. Whether the Legislative Council should have a role in the appointment of SFC Chairman ?	<p>The powers of appointments and removals of members of the SFC are vested with the Chief Executive as stipulated in sections 1 and 13 of Part 1 of Schedule 2 of the SFO.</p> <p>The present appointment system has been operating efficiently and effectively in the appointment of public offices. We do not consider that there is a need to make changes to the existing system. We also note that some members of this Council and deputations do not support the idea that the Legislative Council should have a role in the appointment of the SFC Chairman.</p>
20. Any preference that the Chairman should preferably be a local resident or of Chinese nationality ?	<p>The suitable candidate for the post of the non-executive Chairman should have good understanding about Hong Kong as well as knowledge about our business environment and the securities market. Other essential qualities of the candidate include integrity, commitment to serve the community, knowledge of the local and international financial markets, vision and leadership, ability to communicate with the public and relevant stakeholders and to establish a rapport with relevant bodies in other jurisdictions.</p>

(f) Other issues

Issue	Administration's response
21. Impact of a non-executive SFC Chairman on the standing of Hong Kong in IOSCO	<p>The Secretary General of IOSCO has indicated clearly in his reply to the Administration on 12 January 2005 that the appointment of the IOSCO Technical Committee Chairman is a personal appointment based on the recognized experience and authority of the appointee. A copy of the letter has been provided to the Panel on Financial Affairs in January 2005 and the Bills Committee vide CB(1)1537/04-05(04).</p>

Financial Services Branch
Financial Services and the Treasury Bureau
26 May 2005

**Extract of information provided by the Securities and Futures Commission to
the Bills Committee on Securities and Futures (Amendment) Bill 2005**

(Extract of Annex A to LC Paper No. CB(1)1537/04-05(04))

Question 1(b):

*The existing arrangements governing the division of roles and responsibilities
between the executive and non-executive directors of the SFC*

1. The Board of the SFC at present comprises eleven members: four full time Executive Directors (EDs) (including the Chairman and will be increased to five later this month) and seven Non-Executive Directors (NEDs). As required by the SFO, the majority of the Board members (Members) must be NEDs. All Members are appointed by the HKSAR Chief Executive.
2. All important policies are discussed and approved by the Board, which meets regularly every month and holds additional meetings as necessary. Divisional staff attend Board meetings to explain policy proposals, report on important operational matters and regulatory issues. Members are briefed on the financial position of the SFC and provided with monthly financial statements.
3. To play an effective oversight role, the Board has delegated most of the regulatory powers and functions to the individual EDs or Committees, with power to sub-delegate to staff within their respective operational divisions. Non-delegable and other key powers are retained at Board level.
4. Each of the Audit Committee, Remuneration Committee and Budget Committee is chaired by a NED. Apart from the Budget Committee (which has three ED members), all members of the Audit Committee and Remuneration Committee are NEDs. So far as the Audit Committee and Remuneration Committee are concerned, whilst certain senior SFC staff are invited to attend these Committee meetings, they have no voting rights in respect of decisions to be made by the Committees.

Division of roles and responsibilities between the EDs and NEDs

(I) EDs

5. Each ED assumes full management responsibility for his or her Division. This responsibility includes:
 - a) exercising statutory powers as delegated under the SFO or where appropriate making recommendations to the Board regarding the exercise of statutory powers;
 - b) establishing procedures which ensure that SFC powers are exercised properly and judiciously, bearing in mind the legal responsibilities of SFC;

- c) leading policy development and formulation in relation to respective functions of the Divisions with regard to international standards and experience of overseas regulatory bodies;
- d) participating in general policy formulation and collective decision-making as members of the Board;
- e) liaising with relevant Government Departments, local agencies, appropriate market organisations and participants as well as overseas financial and regulatory bodies; and
- f) managing the Divisions including leading, motivating and training staff and developing succession plans.

(II) Chairman

- 6. The SFO expressly provides that the following functions are to be performed by the SFC Chairman:
 - a) to be the channel for consultation by the Chief Executive (CE) when the CE is contemplating issuing directions to the SFC under section 11, SFO;
 - b) to sign financial statements of the SFC under section 15 and of the Investors Compensation Fund under section 240, SFO;
 - c) to designate an ED as acting chairman under section 6 of Part 1 of Schedule 2, SFO;
 - d) to preside at Board meetings and exercise a casting vote under sections 15 and 19 of Part 1 of Schedule 2, SFO;
 - e) to authorise affixing of the seal under section 25 of Part 1 of Schedule 2, SFO; and
 - f) to convene and chair meetings of the Advisory Committee under sections 27-29 of Part 1 of Schedule 2, SFO.
- 7. Apart from these express statutory functions, the current SFC Chairman also has the following roles and responsibilities.
- 8. The current Chairman is the public face of the SFC, accountable for the SFC's policy and regulatory decisions. He is responsible for:
 - a) providing leadership to the Board and the management;
 - b) ensuring that Members of the SFC are fully briefed on matters to be discussed at Board meetings and that key issues are discussed by the Board in a timely manner, that the Board has adequate support and is provided with all the necessary information on which to base decisions;
 - c) giving all Members an opportunity to express their views at Board meetings, encouraging all Members to contribute fully to the Board's affairs. In addition to Board meetings, the Chairman also telephones or meets with NEDs regularly to consult them on various corporate governance and important issues;
 - d) overseeing the implementation of the Board's strategies and decisions;
 - e) ensuring that procedures are in place so that all due process, checks and balances are followed in the performance of the SFC's functions;
 - f) evaluating performance of EDs' and senior management and discussing these with the NEDs;
 - g) ensuring proper control of and effective use of financial resources;

- h) advising and reporting to the Financial Secretary and Secretary for Financial Services and the Treasury on matters relating to the securities and futures industry; and
 - i) ensuring that the SFC communicates effectively with the Administration, Legislative Council, the investors, the public and the industry.
9. The current SFC Chairman is also actively involved in cross-border and international work. He is presently the Chairman of the Technical Committee of IOSCO, the international organization of securities commissions, which is a standard-setting body. The Chairman is responsible for:
- a) meeting with international financial institutions and foreign visitors to brief them on Hong Kong and relevant international financial issues ;
 - b) engaging in dialogue with the international financial sector to maintain Hong Kong's participation at the top level in international consultations on financial issues;
 - c) contributing to the development of international standards/policies in the financial industry in particular the securities and futures industry;
 - d) ensuring that Hong Kong's standards are on a par with international standards;
 - e) developing cooperative arrangements with other jurisdictions;
 - g) attending important international conferences for the benefit of the HKSAR and SFC; and
 - h) engaging the Mainland regulatory organizations, exchanges and policy makers on cross-border issues of mutual interest.

(III) NEDs

10. NEDs are independent of the management and play the role of supervising the SFC's executive functions. Their responsibilities include:
- a) participating in Board meetings to bring their independent judgment to issues of strategy, policy, performance, accountability, resources etc.
 - b) promoting critical review and control of the management process;
 - c) taking the lead where potential conflicts of interest arise (e.g. audit report on anonymous complaint letters)
 - d) leading and serving on the SFC's Audit Committee, Budget Committee and Remuneration Committee (the Audit Committee and Remuneration Committee only comprise NEDs);
 - e) giving the Board and any Committees on which they serve the benefit of their skills, expertise and varied backgrounds and qualifications through regular attendance and active participation;
 - f) bringing a wide range of business and financial experience to the Board which contributes to the effective direction of the Commission; and
 - g) positively contributing to the development of the SFC's strategy and policies, scrutinising the SFC's performance in achieving agreed corporate goals and objectives, and monitoring the reporting of performance.