立法會
Legislative Council

LC Paper No. CB(1)1677/04-05
(These minutes have been seen by the Administration)

Ref : CB1/PL/FA/1

Panel on Financial Affairs

Minutes of meeting
held on Monday, 4 April 2005 at 10:45 am
in the Chamber of the Legislative Council Building

Members present	**:**	Hon Bernard CHAN, JP (Chairman) Hon Ronny TONG Ka-wah, SC (Deputy Chairman) Hon James TIEN Pei-chun, GBS, JP Hon Albert HO Chun-yan Hon LEE Cheuk-yan Hon James TO Kun-sun Hon SIN Chung-kai, JP Hon Emily LAU Wai-hing, JP Hon Abraham SHEK Lai-him, JP Hon Andrew LEUNG Kwan-yuen, SBS, JP Hon WONG Ting-kwong, BBS Hon CHIM Pui-chung Hon Albert Jinghan CHENG Hon TAM Heung-man
Members absent	**:**	Dr Hon David LI Kwok-po, GBS, JP Hon CHAN Kam-lam, JP Hon Jeffrey LAM Kin-fung, SBS, JP

Public officers attending	:	Agenda Item IV Mr Frederick MA, JP Secretary for Financial Services and the Treasury Mr Martin GLASS, JP Deputy Secretary for Financial Services and the Treasury (Treasury) Miss Erica NG Principal Assistant Secretary for Financial Services and the Treasury (Treasury) Mrs Dorothy MA Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) Mr TAM Kuen Chong, JP Deputy Commissioner of Inland Revenue Mr SO Chau Chuen, JP Assistant Commissioner of Inland Revenue Mr YIM Kwok Cheong Senior Assessor Inland Revenue Department Agenda Item V Mr Frederick MA, JP Secretary for Financial Services and the Treasury Mr Kevin HO, JP Permanent Secretary for Financial Services and the Treasury (Financial Services) Mrs Dorothy MA Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)

Attendance by invitation	:	Agenda Item V Securities and Futures Commission Mr Peter AU-YANG Executive Director (Corporate Finance) Mr Anthony WOOD Senior Counsel
Clerk in attendance	:	Miss Salumi CHAN Chief Council Secretary (1)5
Staff in attendance	:	Ms Pauline NG Assistant Secretary General 1 Ms Connie SZETO Senior Council Secretary (1)4 Miss Christy YAU Legislative Assistant (Acting) Agenda Items IV and V Mr KAU Kin-wah Assistant Legal Adviser 6

I. Confirmation of minutes of meeting

(LC Paper No. CB(1)1159/04-05 — Minutes of meeting on 17 February 2005)

The minutes of the meeting held on 17 February 2005 were confirmed.

II. Information paper issued since the last meeting

2. Members noted that no information paper had been issued since the last regular meeting held on 7 March 2005.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)1160/04-05(01) — List of outstanding items for discussion

LC Paper No. CB(1)1160/04-05(02) — List of follow-up actions

LC Paper Nos. CB(1)1184/04-05(01) and (02) — Letter from the Clerk to Panel and the reply from the Financial Secretary's Office on use of the accumulated surplus of the Exchange Fund)

Items for discussion at the next meeting

3. Members agreed that the following items be discussed at the next regular meeting of the Panel to be held on Friday, 6 May 2005, from 9:30 am to 12:45 pm:

(a) Briefing on the work of the Hong Kong Monetary Authority;

(b) Consultation conclusions on legislative proposals to establish the Financial Reporting Council; and

(c) Review of the disclosure of interests regime under Part XV of the Securities and Futures Ordinance.

4. On paragraph 3(a) above, members noted that the Chief Executive of the Hong Kong Monetary Authority (HKMA) would brief the Panel on the work of HKMA. On paragraph 3(b), the Administration would brief the Panel on the results of the public consultation on the legislative proposals to establish the Financial Reporting Council and provide the information requested by members at the Panel meeting on 7 March 2005. On paragraph 3(c), the Securities and Futures Commission (SFC) would brief the Panel on the results of the public consultation on the review of the disclosure of interests regime under Part XV of the Securities and Futures Ordinance (SFO).

Other discussion item

5. The Chairman pointed out that when the Panel was briefed on the work of HKMA at its meeting on 17 February 2005, some members suggested that the Financial Secretary (FS) be invited to discuss with the Panel on how the accumulated surplus of the Exchange Fund (EF) should and would be used. In this connection, they suggested that part of the accumulated surplus be transferred to the general revenue for the benefit of the public. The Chairman referred members to the letter issued by the Clerk to Panel inviting FS to discuss with the Panel on the subject (LC paper No. CB(1)1184/04-05(01)) and the reply from FS's Office (LC Paper

No. CB(1)1184/04-05(02)). According to the reply from FS's Office, FS did not intend to invoke section 8 of the Exchange Fund Ordinance for transferring part of the accumulated surplus of EF to the general revenue. If members were still interested in the subject, FS would be happy to restate and explain the Government's position at the Panel meeting on 6 June 2005 under the item "Briefing by the Financial Secretary on Hong Kong's latest overall economic situation". The Chairman invited members' views on whether they agreed to this arrangement.

6. Members agreed that the subject be discussed at the Panel meeting on 6 June 2005 under the item "Briefing by the Financial Secretary on Hong Kong's latest overall economic situation". Ms Emily LAU however expressed dissatisfaction that FS had a pre-determined stance on the subject before discussion with the Panel. To facilitate discussion at the meeting on 6 June, she requested the LegCo Secretariat to prepare a background brief on previous discussions on the subject by LegCo.

IV. Briefing on the legislative proposal to provide profits tax exemption to offshore funds

(LC Paper No. CB(1)1160/04-05(03) — Paper provided by the Administration)

Briefing by the Administration

7. At the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the background of the Administration's proposal of implementing profits tax exemption for offshore funds (the profit tax exemption proposal). He highlighted the following points:

(a) Financial services industry was playing an increasingly important role in Hong Kong's economy, and asset management service was an important sector of the industry. Hong Kong had become a key asset management centre in Asia. In 2003, the total assets in fund management business in Hong Kong amounted to $2,950 billion, of which $1,860 billion or 63% originated from overseas investors.

(b) There was good prospect for the development of asset management business in Hong Kong given the presence of favourable factors, including high savings rate in Asia, good prospects for economic growth in the region, and the Mainland policies towards broadening the scope of investment. To capitalize on the opportunities ahead and to reinforce the status of Hong Kong as an international financial centre (IFC), the Government proposed in the 2003-04 Budget to exempt offshore funds from profits tax. The proposal would help attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Anchoring offshore funds in Hong Kong markets could also help maintain international expertise, promote

new products, and encourage investments in the local fund management industry. In terms of tax treatment for offshore funds, major financial centres including New York and London as well as Hong Kong's major competitor in Asia, Singapore, all exempt offshore funds from taxation.

(c) The profits tax exemption proposal, if implemented, would make Hong Kong's tax treatment for offshore funds more favourable than other IFCs such as the United States (US), the United Kingdom (UK) and Singapore. At present, Singapore imposed a 20% threshold on the resident interest in offshore funds in order to qualify for exemption whereas both US and UK did not impose threshold requirements.

(d) The Administration had conducted two rounds of consultation with the industry and interested parties in early 2004 and early 2005 respectively on the approach for effecting the profits tax exemption proposal. Respondents generally considered that the Administration's proposed approach was the correct approach. The proposed legislative amendments had taken into account the views received from the two consultation exercises. The Administration planned to introduce a bill to LegCo in the 2004-05 session to amend the Inland Revenue Ordinance (IRO) (Cap. 112) for implementing the proposal (the Bill).

8. The Deputy Commissioner of Inland Revenue (DC/IR) then briefed members on the proposal. He highlighted the following points:

(a) Under section 14 of IRO, a person carrying on a trade, profession or business in Hong Kong was chargeable to profits tax in respect of assessable profits arising in or derived from that trade, profession or business. This requirement had no regard to the residency of the person. Where a person was a non-resident and the business was carried on through an agent, section 20A of IRO provided that the non-resident could be charged to tax in the name of the agent and the tax could be recovered from the agent unless the agent was relieved from such liability under section 20AA of IRO. However, this section did not exempt any possible profits tax liability of the non-resident clients themselves.

(b) Certain specified investment funds were currently exempted from profits tax under section 26A(1A) of IRO. These included mutual funds, unit trusts and similar investment schemes authorized under SFO or where the Commissioner of Inland Revenue (C of IR) was satisfied that they were bona fide widely held investment schemes which complied with the requirements of a supervisory authority within an acceptable regime. However, quite a number of offshore funds did not fall within the ambit of section 26A(1A) and therefore could not enjoy exemption.

(c) To provide profits tax exemption for offshore funds, the Administration proposed to introduce two sets of provisions to IRO - the Exemption Provisions and the Deeming Provisions, as follows:

Exemption Provisions

(i) The purpose of the exemption provisions was to exempt a non-resident person from profits tax in respect of any income derived from securities trading transactions undertaken in Hong Kong through an agent who was a broker or an approved investment adviser falling within section 20AA of IRO. The proposed qualifying conditions for the exemption provisions were set out in paragraph 9 of the Administration's paper.

Deeming Provisions

(ii) To implement the exemption, there was a need to put in specific anti-avoidance provisions to prevent abuse or round-tripping by local funds and other entities disguised as offshore funds or other entities to take advantage of the exemption.

(iii) The proposed deeming provisions would deem a Hong Kong resident holding a beneficial interest in a tax-exempt non-resident to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong. The amount of the deemed assessable profits would be ascertained by taking into account the percentage of the resident's beneficial interest and the length of ownership within the basis period of the relevant year of assessment, irrespective of whether the profits had been distributed to the resident. The resident beneficial owner would have the duty to report the deemed assessable profits to the Inland Revenue Department (IRD).

(iv) The application of the Deeming Provisions would be restricted to the following situations -

- funds that were not bona fide widely held;
- a Hong Kong resident, alone or with his associates, whether resident or non-resident, directly or indirectly held 30% or more of the beneficial interest in a tax-exempt non-resident entity (the 30% threshold); and
- a Hong Kong resident directly or indirectly held any percentage of the beneficial interest in a tax-exempt non-resident entity which was his associate.

(v) The Administration proposed that the Exemption Provisions should apply with retrospective effect to the year of assessment

commencing on 1 April 1996, while the Deeming Provisions should take effect upon enactment of the Bill.

Discussion

Benefits and financial implications of the profits tax exemption proposal

9. Ms Emily LAU considered that a number of proposals put forward by the Administration recently, including the profits tax exemption proposal and the proposal of abolishing the estate duty, would only benefit the middle and the wealthy classes. She expressed dissatisfaction that the Administration had not proposed concrete measures to address the needs and concerns of the less privileged class and alleviate their poverty. Ms LAU urged the Administration to devise concrete measures to address the problems faced by the less privileged class and deploy part of the accumulated surplus of EF for the benefit of the general public.

10. SFST stressed that both the profits tax exemption proposal and the proposal of abolishing the estate duty aimed at enhancing Hong Kong's competitiveness as an asset management centre and reinforcing its status as an IFC. The two proposals would promote the financial services industry and would be beneficial to the development of Hong Kong's economy in the long run, and would not have any negative impact on the less privileged class. As regards concrete measures to meet the needs of the less privileged class, SFST said that the issue should be discussed in the context of the debate on the 2005-06 Budget. In this connection, Ms Emily LAU stressed the importance for the Administration to adopt a comprehensive approach in formulating public policies and assessing the impact of the policies on various sectors of the community before implementing the policies.

11. Mr SIN Chung-kai considered that while the profits tax exemption proposal would benefit Hong Kong's economy, the proposal merited detailed study. To facilitate members' consideration of the proposal, Mr SIN, Ms Emily LAU and Mr Albert HO considered that the Administration should quantify the economic benefits of the proposal, including the estimated number of jobs to be created for the financial services sector and other sectors, and other benefits for the economy of Hong Kong. They also considered that the Administration should provide information on the financial implications of the proposal, including the estimated amount of tax revenue foregone.

12. SFST re-iterated that the profits tax exemption proposal would enhance Hong Kong's competitiveness vis-à-vis other financial centres to help attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Continuous development of the fund industry in Hong Kong would help maintain international expertise, promote Hong Kong's financial markets and reinforce Hong Kong's position as an IFC. As regards the financial implications of the proposal, SFST advised that given that only a small amount of profits tax had been collected from offshore funds in the past, it was believed that the proposal would not

have significant impact on government revenue. DC/IR supplemented that offshore funds were required to report any assessable profits arising from their business in Hong Kong for taxation purpose. However, IRD had received very few tax returns from offshore funds in the past. Thus, it did not have sufficient information for assessing the financial implications of the current proposal.

13. Noting the Administration's advice that only a small amount of profits tax had been collected from offshore funds in the past, Ms Emily LAU was concerned about the need for the Administration to put forward the current proposal to exempt offshore funds from profits tax. She was also concerned whether IRD had taken effective enforcement actions to recover the profits tax payable by offshore funds. Ms LAU, Mr SIN Chung-kai and Mr Albert HO considered it essential for the Administration to provide the requested information mentioned in paragraph 11 above so as to facilitate members' consideration of the proposal. The Chairman requested the Administration to provide the information. SFST pointed out that it was difficult to compile the information, and yet the Administration would try its best.

(*Post-meeting note:* The information provided by the Administration was circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

Impact of the profits tax exemption proposal on investors of onshore and offshore funds

14. Mr James TIEN enquired about the impact of the proposal on investors of onshore funds. Given that the proposal would make offshore funds more attractive to investors, Mr TIEN was concerned whether it would put onshore funds in a less favourable position.

15. In response, SFST said that Hong Kong had put in place a simple tax regime with low tax rates. At present, the vast majority of investment funds invested by local investors were exempted from profits tax under IRO. Such funds included mutual funds, unit trusts and similar investment schemes authorized under SFO, or where the C of IR was satisfied that they were bona fide widely held investment schemes which complied with the requirements of a supervisory authority within an acceptable regime. As such, investment incomes of Hong Kong residents generated from these funds, regardless of whether they were onshore or offshore funds, were not liable to profits tax. The onshore funds which were not exempted mainly included institutional funds and corporate or private client portfolios that were not offered to the public. There had been views from the funds industry that the Administration should extend the exemption proposal to cover non-exempted onshore funds. However, the Administration considered that this might have implication on tax revenue. SFST also pointed out that Hong Kong's tax treatment of incomes derived from onshore funds compared favourably with other jurisdictions, such as UK and Singapore, in which investment incomes of residents were generally liable to income tax. In other major IFCs, preferential tax treatment was usually made available only

to public funds that were widely held, but rarely to privately held funds. The existing practice in Hong Kong was therefore in line with international practices.

16. DC/IR added that in order to facilitate implementation of the proposal, the Bill would include provisions on definitions of key terms such as "resident" and "non-resident" in respect of individuals, partnerships, corporations and trustees etc.. These definitions would apply for the purpose of the proposed profits tax exemption and would have no effect on other provisions of IRO. References would be made to the definitions adopted for the relevant terms in the agreements signed between Hong Kong and other jurisdictions for the avoidance of double taxation. In this connection, Miss Mandy TAM expressed support for using internationally adopted definitions for the key terms in the Bill.

Operation of the Exemption Provisions

17. In response to members' enquiry about the scope of activities of offshore funds eligible for exemption under the proposal, DC/IR explained that only profits derived from the securities trading transactions undertaken in Hong Kong would be exempted. The scope of "securities trading transactions" would cover dealings in securities, futures contracts, foreign exchange trading, trading through automated trading services and asset management as defined as Type 1, 2, 3, 7, and 9 Regulated Activities in Schedule 5 to SFO. Responding to Mr Albert HO's enquiry, DC/IR confirmed that profits derived from real property investments in Hong Kong by offshore funds would not be eligible for exemption.

18. Miss Mandy TAM noted from paragraph 9(iii) of the paper provided by the Administration that there would be provisions in the Bill to dispense with the existing "associate" test and "independent" test in section 20AA of IRO. She enquired about the reason for deleting the two tests and expressed concern about possible difficulties in enforcing section 20A after the deletion.

19. In response, DC/IR explained that the existing section 20A provided that a non-resident carrying on business through an agent could be charged to tax in the name of the agent and that the tax could be recovered from the agent, unless the agent was relieved from such a requirement under section 20AA. To qualify for the relief, certain conditions must be satisfied. These included that the brokers/approved investment advisers must not be the associates of the non-resident clients (i.e. the "associate" test) and must be independent from the non-resident clients (i.e. the "independent" test). As offshore funds would be exempted from profits tax under the current proposal, the tax liability of the agent in respect of the non-resident entity would be removed. Hence the two tests would become redundant and would be deleted.

20. Miss Mandy TAM enquired about the operation of the de minimis rule referred to in paragraph 9(iv) of the paper provided by the Administration. DC/IR explained that in order to qualify for the proposed exemption, one of the conditions

was that a non-resident entity should not carry on any other business in Hong Kong. Given that it was not unusual for offshore funds to undertake activities incidental to the exempted business, the Administration proposed that non-residents deriving income incidental to the exempted business in Hong Kong would not be regarded as carrying on other business in Hong Kong. Exemption for such incidental income would be subject to a de minimis rule, i.e. exemption for profits tax would be provided for the incidental income if such income did not exceed 5% of the total income earned by the non-resident entity in Hong Kong.

Effective date of the Exemption Provisions

21. On the Administration's proposal to apply the Exemption Provisions with retrospective effect to the year of assessment commencing on 1 April 1996, Mr SIN Chung-kai considered the proposal controversial. He requested the Administration to explain the reasons for and financial implications of the proposal. In particular, he was concerned about the impact of the proposal on tax revenue and whether the Government would be required to refund the profits tax collected from offshore funds since 1 April 1996.

22. DC/IR advised that due to the limited information available about offshore funds, IRD had been unable to initiate proactive actions to recover profits tax from offshore funds until 2000. Since 2000, IRD had collected more information and started to recover profits tax payable by offshore funds in respect of the assessable profits arising from their business in Hong Kong. While some of the offshore funds had paid profits tax, some had raised objections to the assessment and their cases were still being processed. In order to be fair to all offshore funds, the Administration proposed to apply the Exemption Provisions with retrospective effect from the financial year 1996-97 to put it beyond doubt that such profits were exempted from profits tax. DC/IR further pointed out that in the absence of relevant statistical figures, it was difficult for the Administration to assess the impact of the proposal on tax revenue. SFST also pointed out that given that profits tax from offshore funds only accounted for a very small share of the tax revenue, the proposal would not have significant impact on government revenue.

23. Mr SIN Chung-kai was not convinced by the Administration's response. He pointed out that it was a common practice for the Administration, in putting forward a legislative proposal to LegCo, to provide the financial implications of the proposal. He considered such information essential to facilitate Members' consideration of the current proposal, in particular on whether the Exemption Provisions should be applied with retrospective effect. Mr SIN requested the Administration to provide information on the estimated amount of tax revenue foregone in two scenarios, i.e. in the scenario where the Exemption Provisions were applied with retrospective effect to the year of assessment commencing on 1 April 1996, and the scenario where the Exemption Provisions were applied without retrospective effect.

(*Post-meeting note:* The information provided by the Administration was circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

24. Mr Albert HO was also not convinced by the Administration's response. He considered that as a matter of principle, legislative provisions should take effect from the enactment of the relevant bill and should not have retrospective effect. For the current case, the crux of the problem was that IRD had not taken effective enforcement actions in the past to recover profits tax from the offshore funds concerned. If the proposed Exemption Provisions were endorsed by LegCo, the provisions should be applied upon enactment of the Bill and there were no strong justifications for applying the provisions with retrospective effect.

25. Mr James TIEN said that he was not aware of any precedent case in which a legislative provision was applied with retrospective effect to such a long period of time. The LegCo Members of the Liberal Party were of the view that the Administration should avoid setting such a precedent which might have implications on other legislative proposals. For the current proposal, given the Administration's advice that the amount of profits tax involved was small, it should not be a matter of concern to the fund industry as to whether the Exemption Provisions would be applied with or without retrospective effect. Mr TIEN considered that the Exemption Provisions, if endorsed by LegCo, should take effect upon enactment of the Bill.

26. SFST pointed out that as IRD was empowered to recover tax payable in the previous six years, the fund industry was concerned that if the Exemption Provisions would be applied without retrospective effect, IRD might recover from offshore funds the profits tax payable before enactment of the Bill. Such uncertainty gave rise to the concern on whether an entry about profits tax liability should be made in the accounts of the offshore funds. To provide certainty that offshore funds would be exempt from any profits tax liability under section 14 of IRO for the financial years since 1996-97, it was proposed that the Exemption Provisions be applied with retrospective effect to the financial year 1996-97. Nevertheless, SFST said that he appreciated members' concern and would take account of their views in finalizing the details of the proposal.

Admin

Application of the Deeming Provisions

27. Mr Ronny TONG indicated that he supported the profits tax exemption proposal in principle. He was however concerned that the Deeming Provisions would have negative impact on Hong Kong residents. He pointed out that currently Hong Kong residents were not liable to pay profits tax in respect of investment incomes derived from onshore or offshore funds if they did not engage in investment activities as a trade, profession or business. However, by virtue of the Deeming Provisions, Hong Kong residents directly or indirectly held 30% or more of the beneficial interest in a tax-exempt non-resident entity would be deemed to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong and thus liable to pay profits tax. Mr TONG also

doubted the effectiveness of the proposed 30% threshold in preventing abuse by local funds and other entities to take advantage of the Exemption Provisions to evade from profits tax liability.

28. The Chairman and Mr Albert HO also expressed concern about the effectiveness of the Deeming Provisions in preventing abuse by local funds and other entities.

29. Mr LEE Cheuk-yan indicated that he objected to the profits tax exemption proposal in principle. He expressed concern about the difficulties in enforcing the proposed Deeming Provisions where the non-resident entity refused to provide information relating to its assessable profits to the Hong Kong residents concerned. He requested the Administration to provide justifications for proposing the 30% threshold.

30. Mr James TIEN said that LegCo Members of the Liberal Party considered it appropriate to set a higher threshold for applying the Deeming Provisions, such as 50%. He enquired about the reasons for the Administration to propose a 30% threshold.

31. On the concern about the impact of the Deeming Provisions on Hong Kong residents, SFST re-iterated that currently a large number of investment funds were exempted from profits tax under IRO, and Hong Kong residents might make their own choices in the selection of investment funds. DC/IR further advised that the Deeming Provisions would be restricted to funds which were not bona fide widely held. As such, it was unlikely that Hong Kong investors in general would be affected by the Deeming Provisions.

32. DC/IR advised that the 30% threshold was proposed on the basis that a resident holding a 30% beneficial interest in a non-resident entity should not have difficulty in obtaining information from that entity on the latter's assessable profits from exempted business in Hong Kong for the purposes of reporting deemed assessable profits to IRD. SFST pointed out that in considering the threshold to be adopted, the Administration had taken into account the need to prevent abuses of the Exemption Provisions in order to safeguard against revenue losses, and to avoid imposing compliance burden on resident persons. The Administration considered that a 30% threshold was appropriate to strike a proper balance. Nevertheless, it was suggested by a number of respondents in the second round of consultation that the threshold should be increased to 50%. The Administration welcomed Members' views on whether the threshold should be increased.

33. Mr Ronny TONG suggested that the Administration should employ experts to assess the impact of applying different threshold levels for the Deeming Provisions on tax revenue. DC/IR pointed out that owing to the difficulties in obtaining details of the transactions engaged by offshore funds, IRD did not have information on their

investment incomes derived from different sources. It was therefore difficult to assess the impact of applying different threshold levels on tax revenue.

34. SFST said that if Members were in support of the proposal to provide profits tax exemption to offshore funds, the Administration would introduce the Bill to LegCo. If a bills committee was subsequently formed to scrutinize the Bill, he would suggest to the bills committee that experts from the fund industry be invited to explain the relevant details to the bills committee.

Admin

Views of the fund industry

35. Miss TAM Heung-man indicated that she supported the profits tax exemption proposal in principle. Responding to Miss TAM's enquiry, SFST advised that the Administration had consulted the fund industry and taken into account their views before arriving at the current proposal. The fund industry generally considered the current proposal acceptable and urged for its early implementation. However, there were some areas in which the fund industry and the Administration held different views, such as the level of threshold to be adopted for the Deeming Provisions.

Conclusion

36. There being no further questions from members, the Chairman concluded the discussion. He said that a great majority of the members present supported in principle the Administration's proposal to provide profits tax exemption to offshore funds. However, given that members had raised various concerns about the proposed Exemption and Deeming Provisions, the Chairman requested the Administration to provide the following information to address their concerns:

(a) The operation of offshore funds in Hong Kong;

(b) The operation of the existing provisions of IRO relating to profits tax liability and exemption for offshore funds and onshore funds, including the effect of the provisions on resident and non-resident investors (including individuals, partnerships, trusts and corporations) of the funds;

(c) The operation of the proposed Exemption Provisions in respect of offshore funds, including the effect of the provisions on resident and non-resident investors (including individuals, partnerships, trusts and corporations) of the funds;

(d) The operation of the proposed Deeming Provisions in order to -
    (i) prevent abuse of the exemption or round-tripping; and
    (ii) address the concern about the beneficial owners of a fund concealing their interests in the fund to circumvent the proposed 30% threshold.

(*Post-meeting note:* The information provided by the Administration was circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

V. Briefing on the Securities and Futures (Amendment) (No. 2) Bill 2005 - Proposals to give statutory backing to major listing requirements

(LC Paper No. CB(1)1160/04-05(04) — Paper provided by the Administration

LC Paper No. CB(1)1200/04-05(01) — Submission dated 31 March 2005 from the Securities and Futures Commission

LC Paper No. CB(1)1160/04-05(05) — Background brief prepared by the Legislative Council Secretariat

LC Paper No. CB(1)670/04-05 — Consultation papers on:

(a) Proposed amendments to the Securities and Futures Ordinance to give statutory backing to major listing requirements; and

(b) Proposed amendments to the Securities and Futures (Stock Market Listing) Rules)

37. The Chairman pointed out that according to the agreed arrangement between LegCo and the Administration, the Administration was required to provide a paper for a discussion item at least five clear days before the relevant Panel meeting. For the Chinese version of the paper for this discussion item, the Administration had missed the agreed deadline (i.e. 24 March 2005) by one day. He reminded the Administration to adhere to the agreed deadline for submission of papers in future.

Briefing by the Administration

38. At the invitation of the Chairman, SFST briefed the Panel on the Administration's proposal to amend the SFO to give statutory backing to major listing requirements. He highlighted the following points:

(a) To maintain Hong Kong's position as an international financial centre, it was important to enhance market quality and investors' protection. The Government had all along attached great importance to the regulatory regime of the financial markets, and giving statutory backing to major listing requirements was one of its major tasks in this area.

(b) The existing legislation did not prescribe positive obligations on disclosure and no statutory sanctions were imposed on non-disclosure, late disclosure or selective disclosure. Giving statutory backing to major listing requirements would create a positive statutory obligation for compliance with these requirements and enable the imposition of a wide range of statutory sanctions which would be commensurate with the seriousness of the breach.

(c) The Government proposed giving statutory backing to the following major listing requirements –
   (i) financial reporting and other periodic disclosure;
   (ii) disclosure of price-sensitive information; and
   (iii) shareholders' approval for certain notifiable transactions.

   The Administration had consulted the public on the above proposals which received wide support. The Administration briefed the Panel on the consultation outcome in 2004.

(d) In early 2005, the Administration consulted the public on proposed legislative amendments. The majority of submissions received supported the proposed amendments which aimed to -
   (i) provide SFC with power to make rules for prescribing listing requirements and ongoing obligations of listed corporations under section 36 of the SFO;
   (ii) extend the market misconduct regime in the SFO to cover breaches of the statutory listing rules made by SFC;
   (iii) empower the Market Misconduct Tribunal (MMT) to impose, in addition to existing sanctions such as disqualification orders and disgorgement orders, new civil sanctions, namely public reprimands and civil fines, on the primary targets, i.e. issuers, directors and officers, for breaches of the statutory listing rules made by SFC; and
   (iv) empower SFC to impose civil sanctions, namely public reprimands, disqualification orders and disgorgement orders, on

the primary targets for breaches of the statutory listing rules made by SFC.

(e) On the proposal of empowering the MMT to impose civil fines, some submissions called for the power for the MMT to impose much higher fines or even unlimited fines. Having considered the views received and practices in other jurisdictions, the Administration proposed not to specify in the SFO the upper limit on the level of civil fines that might be imposed by the MMT.

(f) There were different views on the proposal for empowering SFC to impose civil fines. Those supported the proposal considered that the proposal would enable SFC to take swift action to deal with breaches, and to adopt regulatory actions commensurate with the severity of the misconduct. Those against the proposal considered that -

(i) Since SFC would be responsible for enforcing the statutory listing requirements, the proposal would effectively transform SFC into the police, the prosecutor and the judge;

(ii) Unlike the MMT which was a quasi-judicial body subject to the due process of hearing, SFC's disciplinary hearing which was conducted by way of "paper hearing" gave rise to concern about fairness of the disciplinary process to issuers and directors; and

(iii) The proposal for empowering SFC, in addition to the MMT, to impose fines would result in two similar civil regimes and hence confusion and uncertainty as to which authority should be responsible for handling a particular breach.

(g) The Administration had not taken a stance on whether SFC should be given the power to impose civil fines. Members' views were welcomed in this respect.

(h) Giving statutory backing to listing requirements was a significant step forward in upgrading the regulation of the listed sector with a view to enhancing market quality and protection for investors. The Administration recognized the need to strike a balance so as not to cause unnecessary compliance burden to market participants, which would not be conducive to market development. The current proposal sought to achieve an appropriate balance. Members' comments were welcomed.

(i) The Administration planned to introduce the relevant bill to LegCo in June 2005.

39. Upon invitation by the Chairman, the Permanent Secretary for Financial Services and the Treasury (Financial Services) took members through other proposals relating to enhancement of regulation of listing. He highlighted the following points:

(a) Following the publication of the Consultation Conclusions on Proposals to Enhance the Regulation of Listing in March 2004, the Administration invited SFC to expose the draft statutory listing rules for public consultation before introducing to LegCo the amendments to the SFO. The purpose was to facilitate consideration of the amendments to the SFO by the legislature and the public. In this context, SFC published on 7 January 2005 the Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules (SFSMLR) to be made by SFC under the amended SFO. The consultation closed on 31 March 2005.

(b) The Administration noted from the responses to the Consultation Paper on Amendments to the SFO market's concern about potential mismatch between SFC's statutory listing rules and the non-statutory listing rules of the Stocks Exchange of Hong Kong (SEHK) in terms of content, interpretation and administration. It had to be noted that there were already statutory safeguards to prevent inconsistency between SFC's statutory listing rules and SEHK's Listing Rules. The current SFO provided that SEHK's Listing Rules should have effect only to the extent that they were not repugnant to any rule made by SFC governing listing. To address market's concern about the potential problems concerning the interface between SFC and SEHK, the Administration had recommended in the Consultation Conclusions on Proposals to Enhance the Regulation of Listing to articulate in a public statement their division of responsibilities, both as at present and upon the introduction of statutory listing rules. On 31 March 2005, SFC and SEHK published a joint statement on existing arrangements for listing regulation to enhance public understanding about their respective roles and duties in this area.

(c) As regards administrative checks and balances on SFC's disciplinary power relating to listing, submissions received in the Consultation Paper on Amendments to the SFO in general supported the proposal for setting up a committee comprising SFC and independent members to deal with SFC's disciplinary decisions relating to listing. This would help to allay concern that SFC would become the investigator, the prosecutor, and the judge in respect of enforcement actions against issuers and their management. A number of submissions agreed that the Regulatory Decisions Committee (RDC) set up by the Financial Services Authority (FSA) in the United Kingdom (UK) could provide a useful reference. The Administration had invited SFC to consider this proposal or any

other measures that could effectively enhance the checks and balances on SFC's new regulatory responsibilities relating to listing.

Discussion

Proposal for empowering SFC to impose civil fines

40. Mr Ronny TONG indicated support for the proposal for empowering SFC to impose civil fines so as to provide SFC with the power necessary for the effective performance of its new regulatory responsibilities relating to listing. Otherwise, SFC would become a toothless tiger. Miss Mandy TAM shared Mr TONG's views and expressed support for the proposal in principle.

41. Ms Emily LAU said that she supported the proposal in principle with a view to enhancing SFC's regulatory power in listing. However, noting that 12 submissions supported the proposal but 21 submissions did not support it, Ms LAU considered that SFC should elaborate on the merits of the proposal.

42. On the merits of the proposal, Mr Peter AU-YANG, Executive Director (Corporate Finance), SFC pointed out that the power to impose civil fines would enable SFC to take swift action to uphold its regulatory objectives of maintaining a fair and transparent market and enhancing protection for investors. In view of the nature of breaches under the listing regime, the available sanctions other than civil fines would be ineffective against an issuer. For instance, disqualification as a director did not apply to an issuer. Disgorgement did not come into play either as it would be some or all of the shareholders, not the company, who had made the profit or avoided a loss as a result of the breach. The failure of the existing regime also showed that public reprimands did not work. Mr AU-YANG further pointed out that reliance on the MMT fines alone would deny a key enforcement tool to SFC. SFC would be deprived of medium sanctions in between reprimands and disqualifications. There were likely to be many cases in between, calling for a sanction more severe than a public reprimand but which were not serious enough to merit disqualification. Without the power to impose civil fines as the most appropriate sanction in these cases, SFC would be compelled to refer a large number of cases to the MMT, creating workload which the MMT was not equipped to deal with or to handle efficiently as required for the proper regulation of the listed sector. Moreover, the cost and time involved in taking most cases to the MMT would be prohibitive for both SFC and offenders (who would also have to bear SFC's costs if they lost). The practical experience of the Insider Dealing Tribunal (replaced by the MMT established under the SFO) illustrated that it worked best in dealing with the more important and complex cases involving the serious sanctions. Mr AU-YANG added that there was strong support from the industry to provide SFC with the power to impose civil fines as showed in the consolidated submission by nine major investment banks. He stressed that there was significant support backed up by sound reasons for proceeding with the proposal.

43. Responding to Ms Emily LAU's enquiry about the MMT's existing and anticipated workload with the proposed expansion of the market misconduct regime to cover breaches of the statutory listing rules, Mr Peter AU-YANG advised that under the existing listing regime, breaches of SEHK's Listing Rules were handled by the Listing Committee. During the period between 1 July 2004 to 31 January 2005, the Committee had dealt with 18 cases. As at 31 January 2005, there were 26 cases pending consideration by the Committee. As for the MMT, given the complex nature of market misconduct cases, SFC had not yet referred any suspected breach for action by the MMT since the commencement of the SFO in April 2003. While two cases were being studied by SFC's legal services department for referral to the MMT, investigation for another four cases had been completed pending study by the legal services department on whether referral to the MMT should be made.

44. Ms Emily LAU noted from the SFC's submission to the Panel that the European Union had recently directed that all member countries should pass legislation to provide for administrative sanctions to be imposed on public companies and their directors. It seemed that the legislation was not yet in place. Ms LAU was concerned whether it was appropriate for SFC to take the lead in adopting a civil fine regime for breaches of listing requirements.

45. In response, Mr Peter AU-YANG advised that most major jurisdictions which Hong Kong benchmarked with had put in place a disclosure regime that relied heavily on the ability to impose civil sanctions. A number of jurisdictions, including the UK, Canada, France, Spain, and Japan, had adopted a regime enabling the regulators, rather than the courts, to impose civil fines against public companies and their directors. Hence, it was the worldwide trend for securities regulators to use fining powers given the complexity of the issues that arose in relation to the securities industry. It was an appropriate model for Hong Kong to follow.

46. Mr SIN Chung-kai said that the proposal would be in line with similar powers conferred to securities regulators in overseas markets, such as the Securities and Exchange Commission (SEC) in the United States (US), and other regulators in Hong Kong, such as Office of the Telecommunications Authority. However, given the short history of SFC and the fact that its credibility had yet to be established, Members of the Democratic Party considered it more appropriate for SFC to concentrate on its work at the present stage and for the Administration to review at a later stage the need to empower SFC to impose civil fines. Mr SIN also noted that currently SFC could impose disciplinary fines on parties for non-compliance with the requirements under the SFO. He enquired about the difference between such disciplinary fines and the proposed civil fines.

47. In respect of the situation of SEC in US, SFST advised that, as far as he understood, the regulator could agree with listed corporations for the latter to pay a specific amount of money to settle instead of SEC taking disciplinary actions. For other types of breaches, SEC would refer them to courts where a range of sanctions, including civil fines, were available.

48. Mr Peter AU-YANG added that, as far as he understood, SEC was not conferred the power to impose civil fines on listed corporations and their officers. As for the situation in Hong Kong, while SFC was empowered under Part IX of the SFO to impose financial penalty on its licensees for breaches of requirements, such fines did not apply to issuers and directors. SFC considered it essential for it to be empowered to impose civil fines to enable effective enforcement of the statutory listing rules. Imposition of civil fines was a medium sanction in between public reprimands for lesser infractions and disqualification of directors or officers for more serious breaches. For more severe breaches, SFC would refer them to the MMT.

49. While supporting the proposal for empowering the MMT to impose civil fines on breaches of the statutory listing rules, Mr Abraham SHEK expressed reservation on the proposal to provide SFC with the power to impose civil fines, as it might turn SFC into the police, the prosecutor and the judge.

50. While SFST claimed that the Administration adopted an open mind on whether the proposal for empowering SFC to impose civil fines should be pursued, members noted from recent press reports that the Administration inclined not to support the proposal. Given the apparent difference in views between SFC and the Administration over the proposal, Mr Ronny TONG, Mr SIN Chun-kai and Ms Emily LAU considered that the Administration should clarify its stance. Mr Albert CHENG opined that the Administration should have resolved the differences with SFC before presenting the proposal to LegCo.

51. In response, SFST stressed that the Administration had not taken any stance on the matter. It respected SFC's views from the perspective of a regulator, and also welcomed views from Members. In considering the proposal, the Administration would be mindful of the need to strike an appropriate balance between enhancing regulation of the market and preserving the efficiency of the listing process and hence competitiveness of the market. SFST assured Members that the Administration would carefully consider the views and concerns expressed by various parties before making the final decision on the proposal.

Admin

Targets of sanctions

52. Mr CHIM Pui-chung supported the idea of imposing civil fines on listed corporations for beaches of the statutory listing rules. He was however concerned whether listed corporations or the responsible staff would be the targets of sanctions. He pointed out that if civil fines were to be imposed on listed corporations, it would be the small shareholders bearing the ultimate penalty. On determining the level of civil fines, Mr CHIM emphasized the need to work out a mechanism in order to facilitate enforcement and enhance transparency. He further suggested that factors, such as the damage and severity of a breach, should be taken into account in determining the level of civil fines.

53. In response, Mr Peter AU-YANG said that the primary targets would include issuers, their directors and officers. The specific target accountable for the breach, irrespective whether it was the issuer (the corporation itself) or its directors or officers, would be subject to sanctions as appropriate. Mr AU-YANG added that at present, the MMT was empowered to impose disgorgement on a corporation, or its director, or both which/who was proven responsible for the market misconduct. The responsible party was required to surrender the profits gained or loss avoided as a result of engaging the misconduct.

Division of responsibilities between SFC and SEHK over listing

54. While expressing support for the enhancement of the quality of the local market and reinforcement of Hong Kong's status as an international financial centre, Mr Albert CHENG was concerned that the proposal of giving statutory backing to major listing requirements would not provide SFC with effective regulatory power in listing and would not enhance the protection for investors. Pointing out that there were overlap and confusion in the roles and functions of SFC and HKEx in the current listing regime, Mr CHENG urged the Administration to clarify the roles and functions of the two parties before providing SFC with new regulatory powers in listing.

55. SFST stressed that the lack of regulatory teeth in SEHK's Listing Rules had remained an issue of concern to the market and the general public. The purposes of giving statutory backing to major listing rules relating to financial reporting and disclosure of information by listed corporations were to create a positive statutory obligation for compliance with the requirements with a view to enhancing the regulation of listing. On the concern about overlap in roles of SFC and SEHK in the listing regime, SFST advised that SFC and SEHK had entered into Memorandum of Understanding delineating their respective roles and functions in listing. The two parties also published a joint statement on 31 March 2005 to outline the existing arrangements to enhance public understanding. SFST pointed out that there would be a clear division of responsibilities between SFC and SEHK in administering the listing functions and dual filing system under the proposal of giving statutory backing to listing rules. SFC would be responsible for enforcing the new statutory listing requirements while SEHK would continue to enforce the non-statutory listing rules. SEHK would continue to receive initial public offer applications at the frontline and be responsible for administering the listing process. All documents filed with SEHK would also be filed with SFC. Mr Peter AU-YANG supplemented that SFC appreciated market's concern about potential problems concerning enforcement of the statutory and non-statutory listing rules by SFC and SEHK respectively. He assured Members that SFC and SEHK would maintain close communication to avoid possible regulatory gaps or overlaps.

56. Miss Mandy TAM expressed concern about the possible confusion arising from tackling non-compliance with statutory listing requirements by imposing civil

sanctions by SFC and by the MMT, and the existing civil and criminal regimes under the SFO.

57. In response, Mr Peter AU-YANG said that there were clear mechanisms and procedures for instituting the civil and criminal regimes for tackling market misconduct. Moreover, there were provisions in the SFO to avoid "double jeopardy" on a person so that he would not be subject to both the MMT and criminal regimes for the same misconduct committed. The same provisions would be applied to breaches of statutory listing rules.

Checks and balances on SFC's disciplinary power relating to listing

58. Mr Abraham SHEK expressed concern about the lack of sufficient checks on powers of SFC. Noting that other jurisdictions had put in place independent committees comprising lay persons to review regulatory decisions relating to listing made by their respective regulatory bodies, Mr SHEK enquired about SFC's plan to enhance checks and balances on its powers after taking up new regulatory responsibilities in listing.

59. Mr Peter AU-YANG stressed that there were sufficient safeguards on SFC's regulatory powers. Details of the existing checks and balances measures were set out in Appendix B to the Consultation Paper on Amendments to the SFO. He emphasized that, in making the disciplinary decisions relating to listings, SFC would observe due procedures for exercising civil sanctions to ensure fairness and transparency in the process. SFC would be required to inform the party, which was the subject of disciplinary decision, of its decision in writing together with written statement of the reasons for the decision. The party would be given an opportunity of being heard before SFC imposed a disciplinary sanction. All types of SFC's disciplinary decisions against issuers, directors and officers would be subject to appeal to the Securities and Futures Appeals Tribunal (SFAT), which was established under the SFO as an independent body responsible for hearing appeals against a wide range of SFC's decisions. SFAT was chaired by a full-time judge and with Government-appointed market participants as its members. SFAT was empowered to conduct full merit review of a case. It might affirm, vary or substitute SFC's decisions. Mr AU-YANG added that SFC was prepared to explore additional measures to strengthen the existing checks and balances regime. It also noted a proposal of establishing a committee modelled on the RDC. He pointed out that the RDC had been in operation for three years in UK. SFC was aware that the FSA had commenced an in-depth review of the structure and functioning of the committee in March 2005, which was expected to be completed in this summer. Mr AU-YANG assured Members that SFC would take into account the results of the review before making the decision on the issue.

60. To address the concern about the checks and balances on the powers of SFC in the regulation of listing, Mr Abraham SHEK requested the Administration to provide the following information on practices in overseas jurisdictions (including UK and

Canada):

(a) The compositions of relevant overseas regulatory bodies and whether they were comparable to that of SFC;

(b) The powers of relevant overseas regulatory bodies, in particular whether they had the power to impose civil fines on issuers, directors and officers and if they had, the upper limit; and

(c) The mechanism for reviews/appeals on the regulatory decisions relating to listing made by relevant overseas regulatory bodies.

(*Post-meeting note:* Information provided by the Administration was circulated to Members vide LC Paper No. CB(1)1463/04-05(01) on 5 May 2005.)

Conclusion

61. There being no further questions from members, the Chairman concluded the discussion. He invited members' views on whether they supported in principle the Administration's proposal to amend the SFO to give statutory backing to major listing requirements. In this connection, Ms Emily LAU requested the Administration to confirm whether it supported the proposal for empowering SFC to impose civil fines for breaches of the statutory listing rules.

Admin

62. SFST re-iterated that the Administration would consider the views and concerns expressed by various parties carefully before making a decision on the matter. The final proposal would be incorporated in the Bill.

63. The Chairman concluded that the Panel supported in principle the Administration's proposal to amend the SFO to give statutory backing to major listing requirements.

VI. Any other business

64. There being no other business, the meeting ended at 1:05 pm.

Council Business Division 1
Legislative Council Secretariat
3 June 2005