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Submission to Panel on Financial Affairs

20th December 2004

To the Chairman
[Panel on Financial Affairs](#)
[Hong Kong Legislative Council](#)

Dear Sir,

Thank you for the letter of 24-Nov-04 inviting my submission on the question of whether the Securities and Futures Commission (**SFC**) should have a non-executive Chairman, thereby splitting the roles of Chairman and Chief Executive. I hereby submit my views. I do not currently intend to attend the Panel's meeting on 3-Jan-05 but would be pleased to do so if members require elaboration.

I have read the 4-Nov-04 [briefing paper](#) from the Government's Financial Services Branch and the 8-Nov-04 [briefing paper](#) from the Legislative Council Secretariat.

I must admit to being surprised by the Administration's sudden purported interest in good governance. Nevertheless, what is proposed would be negative to the governance and effectiveness of the SFC, for the reasons I state below, and given the circumstances it is difficult to resist the conclusion that the administration has other, unstated goals in making this proposal.

Local and international practice

The Government states that it has "*drawn reference to the best governance practice both locally and internationally*" and cites the Standing Committee on Company Law Reform (**SCCLR**) in Hong Kong and the Dec-92 Cadbury report and Jan-03 Higgs Report in the UK.

However, these reports established best practice for widely-held listed companies. The SFC is not a listed company, it is a statutory regulator. Different considerations apply. Even in the case of listed companies, the corporate control structure is a key consideration in whether any benefit can be obtained from having a non-executive Chairman.

Where there is a controlling or dominant shareholder, as is the case for 90% (by number) of HK-listed companies, then I doubt that there is any material improvement in governance or financial performance caused by splitting the roles of Chairman and Chief Executive. The controlling shareholder gets to vote on the election of both positions as well as voting on the election of so-called independent directors, so they are indeed all dependent on the controlling shareholder. If any comparison is to be made between the SFC and listed companies, then it should be noted that the 100% "controlling" shareholder of the SFC is the Government, which appoints all the directors. I shall return to this point later.

When looking at domestic practice, one should note that the [Hong Kong Monetary Authority](#) (HKMA), which regulates the banking sector, has no Chairman, indeed, it doesn't even a board. A Chief Executive and two deputies oversee the banks. Meanwhile, in the insurance sector, the [Office of the Commissioner of Insurance](#) regulates insurers (who often sell investment-lined products) without a board or Chairman, and likewise for the [Office of the Telecommunications Authority](#). There has not been any suggestion from Government of having a non-executive Chairman for these entities, or that their governance is somehow lacking. Government has not explained why it thinks the regulation of securities and futures merits a different approach to that of banking or insurance.

In terms of international practice for securities regulation, this points in the other direction. In the UK, although roles are split, the Chairman of the FSA is stated in its annual report to be an executive director and is practically full time. He was once briefly my boss. The Chairman of the US SEC is also a full-time executive. Both have extensive work experience at senior positions in the financial services industry. In Australia and Germany the situation is similar.

There is a simple reason for this. As stated in the Government Briefing, the role of Chairman includes setting agenda, establishing priorities, and representing the SFC publicly. In my view, a Chairman of a regulator can only fulfil that role if he or she is a full-time Chairman who is up to speed with all the technical and regulatory issues in a highly complex industry. It would be dangerous for Hong Kong to be represented in entities such as the [International Organization of Securities Commissions](#) (IOSCO) by a Chairman who was not in command of his facts and the principles behind them. He or she would have to liaise with counterparts who are. This is not a role in which a Chairman who spends only a fraction of his time on the job can bluff his way through with scripted speeches.

The Government has a habit of appointing tycoons and businessmen, often from among its narrow electorate, to Chair government-appointed entities such as the [Airport Authority](#), [Hospital Authority](#), [MTRC](#), [KCRC](#) and the [Trade Development Council](#). The role is often part-time, with the Chairman also running a major business and holding numerous other posts at the same time. They are, in effect, political appointees holding titular positions. This practice is highly questionable, but in the case of a regulatory organisation it is downright dangerous.

Remuneration

Any role which is full-time in a role, whether you call it executive or not, deserves a full-time remuneration that will attract suitable professional and experienced candidates in a competitive selection process, not a token payment. The Government Briefing states that the financial implications of splitting the role would be "*minima*" and by implication that the Chairman would receive only a token fee as a non-executive director. This is wrong in principle and would inevitably mean that only those seeking the status or influence of the role and who are independently wealthy, without the need of an earned income, would be interested in serving. Token payments increase the probability of influence-peddling by those who serve, and decrease the probability of recruiting the most competent and professional candidate.

Independence from Government

The Government Briefing places emphasis on strengthening the independence of the SFC, but "independent" is of course an adjective and one must ask, "independent of whom?". While it is rightly stated in the Government Briefing that the Chairman should continue to have no involvement in the management or directorship of listed companies or regulated entities, the more pressing question is whether the directors of the SFC are independent of Government, given that the Government appoints all of them. The appointment system in itself makes it difficult for the SFC to criticise or regulate Government's behaviour in the markets.

In the United States, the Commissioners of the SEC are appointed by the President but only after confirmation by the Senate. This gives them some independence of the executive branch of Government. As I have said in previous submissions, because of the HK Government's continued participation in the securities markets, there needs to be a separation of the SFC by creating a check and balance on the appointment and removal of commissioners. The most appropriate way to do this would require that the appointments and removals are subject to approval by the Legislative Council.

The Government's involvement in the securities markets comes through the Exchange Fund, through occasional intervention as in 1998, and through the privatisation of assets such as the MTR, Link REIT and the Airport Authority. It also holds investment portfolios through other entities such as the Housing Authority.

During the recent Link REIT fiasco, the SFC has been notably silent on the matter, even though it operates the REIT Code and there were questions from the public over whether the prospectus should have been supplemented with disclosure of subsequent litigation during the offer period.

During the 1998 stock market intervention, the SFC was also in a conflicted position over the Government's market manipulation (deliberately forcing up share prices to squeeze those holding

short positions) and failure to disclose its interests in securities (it eventually revealed that it held over 10% of 3 companies). See our article [Market Intervention](#) on *Webb-site.com* and [Investor urges prosecution of Government](#) (*SCMP*, 16-Nov-98). The Government claimed "crown exemption" from the securities laws. It continues to make this claim in respect of its aggregate holdings in the MTRC. See our article [State Securities Above the Law](#) (8-Jun-03).

Independence from Management

The current board of the SFC has five executive directors (including the Chairman) and 7 non-executive directors, all of whom are directly appointed by Government. The Government Briefing suggests that making the Chairman non-executive would *"enhance the independence of the Governing body and... its supervisory functions over senior management"*.

This rather ignores the fact that the senior management are also directors and, in the absence of schizophrenia, one cannot supervise oneself. The structure would be little changed by the proposal. Currently, the law only requires that there be more non-executive than executive directors, so if there is a matter of policy dispute between management and the non-executives, then it may require all of the NEDs to out-vote the management before the so-called "supervision" is effective.

One way to create a separation between board and management would be to have a two-tier board structure, with a Supervisory Board overseeing the Executive Board. However, I am not a fan of such arrangements, because the more layers you have, the less informed the upper layers tend to be. I think that supervision is already adequate in the form of the Process Review Panel, the Securities and Futures Appeal Tribunal (chaired by a judge) and ultimately the courts. Where conflicts of interest arise, such as on the remuneration of executive directors, this can be dealt with by non-executive directors in committee.

Separation of roles

There is, in fact, already a separation of roles within the SFC. There is an executive Chairman and there is a Chief Operations Officer (**COO**) who is tasked with day-to-day operational management such as human resources, finance and administration. I am not opposed to either the creation of an additional executive post, as Chief Executive, or to "upgrading" the current post of COO. Whether there is a need for an additional executive post largely depends on the workload which I am not able to judge externally.

As an aside, at present the COO is doubling up as head of Corporate Finance following the departure of the person filling that role at the expiry of his term. This, in my view, is an unsustainable situation and greater steps should be taken to provide either a new COO or a new head of Corporate Finance. The attraction of being Head of Corporate Finance has undoubtedly diminished with the Government's decision to leave the role of front-end listing regulation with HKEx. As a result, the SFC ends up being accountable for passenger safety while HKEx makes the traffic rules. Many candidates would see this as a poisoned chalice.

Yours faithfully,

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