Note to
Panel on Financial Affairs
4 April 2005

Prepared by
Securities and Futures Commission

Re: Agenda V – Proposed amendments to the Securities and Futures Ordinance - Proposals to give statutory backing to major listing requirements

Introduction

1. In early March, the SFC submitted its views to the Government on their Consultation Paper on Proposed Amendments to the Securities and Futures Ordinance to Give Statutory Backing to Major Listing Requirements.

2. Giving statutory backing to certain of the Listing Rules will significantly enhance our listing regulatory regime and the quality of our market. It will also bring the regulatory regime in Hong Kong further into line with international markets.

3. We support the Government's proposals, which, if fully implemented, would provide an effective legal framework under which the SFC may operate.

4. In particular, the Commission agrees with the Government's proposal for introducing a power to impose a range of civil sanctions on issuers, directors and other corporate officers for breaches of the statutory listing rules. Civil sanctions are essential for effective enforcement of statutory disclosure and transaction rules.

SFC fining power

5. Amongst the range of civil sanctions available, it is also essential to have the power to impose civil fines, to enable regulatory action to be tailored proportionately to misconduct. Without fines being available, there is no middle ground between public reprimands for lesser infractions and disqualification of officers of corporations for more serious breaches.

6. Since the advent of the SFO, the SFC has been able to impose disciplinary fines under Part IX of up to $10 million on regulated persons, in addition to its other available sanctions of reprimands, prohibitions, suspensions and revocations. A similar range of civil sanctions is necessary in the listing context.

7. Providing the SFC with the power to impose fines would enable it to take swift action to uphold its regulatory objectives of maintaining a fair and transparent market and protecting members of the public investing in or holding securities. It would also serve to protect and enhance the reputation of the Hong Kong financial market.

8. In view of the nature of breaches under the listing regime, the available sanctions other than civil fines are ineffective against an issuer. Disqualification as a director does not apply to an issuer. Disgorgement does not come into play either as it will be some or all of the shareholders, not the company, who have made the profit or avoided a loss as a result of the breach. The failure of the existing regime shows that public reprimands do not work. Misleading or false disclosures can enable the perpetrators to earn very large sums at the expense of other investors. Hence, the size of the sanctions must be proportional to the profits earned from the misconduct.

9. Reliance on Market Misconduct Tribunal (MMT) fines alone would deny a key enforcement tool to the SFC. As noted above, it would not have available to it medium sanctions in between reprimands and disqualifications. There are likely to be many cases in between, calling for a sanction more severe than a public reprimand but which are not serious enough to merit disqualification. Without the power to levy the most appropriate sanction in these cases, i.e. a fine, the SFC may be compelled to refer a large number of cases to the MMT, which is not equipped to deal with a high volume of cases or to process them at the speed required for the proper regulation of the listing sector. The cost and time involved in taking most cases to the MMT would be prohibitive for both the SFC and offenders (who will also have to bear the SFC's costs if they lose). The practical experience of the Insider Dealing Tribunal illustrates that it works best in dealing with the more important and complex cases involving the serious sanctions.

10. The MMT and SFC civil regimes can operate concurrently as is clearly envisaged in the Government's consultation paper. The legal advice relied on by the Government in their paper also indicates that it is appropriate for human rights purposes for the concurrent civil regimes of SFC discipline and MMT proceedings to provide for sanctions of differing severity. This reflects the intention that the majority of breaches of the SMLR would be dealt with expeditiously by the SFC under the new Part IX provisions proposed for addition to the SFO while more serious breaches would be referred to the MMT with its more elaborate procedures. There would be no double jeopardy here i.e. either the SFC would fine or the MMT would fine but not both.

11. Most other major jurisdictions against which Hong Kong benchmarks itself have a disclosure regime that relies heavily on the ability to impose civil sanctions.

12. In addition to the UK, there are a significant number of jurisdictions, including Canada, France, Spain, and Japan, which have a regime enabling the regulator, rather than the courts, to impose civil fines against public companies and their directors. Recently, the European Union has also directed that all member countries pass legislation to provide for administrative sanctions to be imposed on these persons. The worldwide trend appears to be towards the use of such powers given the complexity of the issues that arise in relation to the securities industry. It is an appropriate model to follow for Hong Kong.

13. We noted from the other submissions received by the Government on their consultation that the respondents appear to be fairly evenly divided on whether both the SFC and the MMT should have fining powers. In particular, the consolidated submission by 9 major investment banks supported the SFC having fining powers. Therefore, there is significant support backed up by sound reasons for proceeding with the proposal to give the SFC a fining power as part of the range of sanctions it needs to regulate listing disclosure effectively.

14. One respondent has argued that civil fines are contrary to human rights. However, this cannot be correct since so many other jurisdictions subject to international human rights treaties have no problem empowering their securities regulators to impose civil fines. Also, the Leading Counsel relied on by the Government has advised that where the persons potentially subject to fines constitute a regulated class, then such fines are rendered civil. This is why the proposed class for civil fines comprises issuers and directors only. Extending the class to include other corporate officers was considered too wide. In the UK, the Financial Services Authority (FSA) may impose unlimited fines against issuers and directors and such fines are not considered criminal in nature there.

15. It has also been argued that giving only the MMT fining power will have advantages for aggrieved investors as they can use an MMT finding as prima facie evidence of misconduct in a private civil action for compensation. While this is true, we do not believe that this is a valid reason to deny a fining power to the SFC.

16. On the contrary, the potential for a civil action by investors is a factor that the SFC should take into account when deciding which route to go with a case i.e. SFC discipline or MMT referral. Where misconduct has been picked up early, there may be no significant prejudice to shareholders, hence no advantage in a MMT referral. If the SFC did not have fines available to it, the case may have to be referred to the MMT even though there was no prospect of a civil action by shareholders.

Checks and balances on SFC disciplinary power

17. Regarding checks and balances on the exercise of the SFC's disciplinary power, we would also like to stress that the right to apply as of right for a review by the Securities and Futures Appeals Tribunal (made up of Government-appointed market practitioners and chaired by a High Court judge) is an important safeguard.

18. Suggestions have been made to establish a committee modelled on the Regulatory Decisions Committee (RDC) of the UK FSA as an additional check and balance on the exercise of the SFC's disciplinary power. However, it is important to be aware that the FSA is currently conducting an in-depth review of the structure and functioning of the RDC, which has been in operation for three years. That review is due to be concluded this summer with a report expected to be issued in July. We should therefore await that before

making any decision on this issue. Since it is something that can be dealt with administratively, it need not hold up the progress of the Bill.

19. In any event, the Commission will study further enhancements to the enforcement decision-making process in the light of international experience and submissions received from the market on this question.

Concluding remark

20. The Commission remains of the view that it needs a fining power for listing discipline. This has found considerable market support from around half of the respondents to the Government's consultation. It is the international best practice for all major markets, of which Hong Kong is one, to have fining power for the statutory regulators.

21. The regime for enforcement of breaches of the statutory listing rules needs to be effective and able to be responsive to the dynamic listed sector. A balance must be struck between the need for effectiveness and the desire for accountability. The Commission will study further measures that can effectively enhance the checks and balances on its new regulatory responsibilities relating to listing, including the RDC proposal.

Securities and Futures Commission
31 March 2005