

The Legislative Council Panel on Financial Affairs

Securities and Futures (Amendment) Bill 2004

PURPOSE

Currently, the chairman of the Securities and Futures Commission (C/SFC) heads both the governing body as well as the executive arm of the Commission. In line with good corporate governance practice, we propose to improve SFC's governance structure such that the Commission is led by a non-executive chairman while the executive arm is headed by a chief executive officer (CEO). The purpose of this paper is to brief Members on the proposal and the corresponding proposed amendments to the Securities and Futures Ordinance (Cap. 571) (SFO).

BACKGROUND

Strengthening the internal governance of the SFC

2. The Securities and Futures Commission (SFC) was established in 1989 in the wake of the stock market crash in October 1987. In the past 15 years, the SFC has successfully put in place a regulatory framework which enshrines the principles of competitiveness, fairness and investor protection, and is on a par with international standards.

3. While the Government has the overall responsibility under the Basic Law to provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre, in line with international best practices, we do not involve ourselves in the day-to-day regulatory functions of the SFC. The Government's role is to ensure that the SFC has the necessary statutory powers to carry out its regulatory objectives effectively and independently, and that its powers are checked by sufficient safeguards set out clearly in the legislation. We avoid any act that would, or be perceived to, undermine the independence of the Commission. It is therefore critical that the Commission should have a good internal governance structure in place so that the SFC is, and is seen to be, a credible, effective and independent regulator.

4. As our securities market has grown from principally domestic to being one of the leading international market and a premier capital formation centre for the Mainland, there is a need for us to continually enhance our regulatory structure to ensure the effective functioning of the SFC in order to meet the challenges of the future. As the market regulator, the SFC should set exemplary standard for others to follow. This is also in line with the Government's continued drive to enhance the governance of public bodies, e.g. the Airport Authority, the Kowloon-Canton Railway Corporation and the Mass Transit Railway Corporation.

Local and international experience

5. In formulating the current proposal, the Government has drawn reference to the best governance practice both locally¹ and internationally². For instance, the Hong Kong Institute of Certified Public Accountants published in May 2004 "*Corporate Governance for Public Bodies – A Basic Framework*" and advocated that the roles of chairman and chief executive of public bodies should be separated, and ideally the chairman should be an independent non-executive member. We have also considered the experience of the U.K. Financial Services Authority in splitting the post of its chairman since September 2003.

6. It should be noted that while such separation of functions between the chairman and the CEO is a well established practice among private companies, it is more of a recent phenomenon among regulators. Experience of overseas regulators varies due to their different constitutional/legal background and political process (experience of overseas regulators is set out in **Annex A**).

THE PROPOSAL

Chairman of the SFC

7. The role of C/SFC is pivotal in leading the SFC governing body and ensuring the effective performance of SFC's statutory functions. Given the importance of the role and in line with the trend of good governance

¹ Work of the Standing Committee on Company Law Reform (SCCLR).

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

practice, the role of the chairman should be separate from that of the executive arm to further enhance the internal checks and balances of the SFC. This creates the conditions for enhancing the independence of the governing body and hence its ability to discharge its supervisory functions over senior management.

8. The role of the chairman should be clearly separated from that of the CEO and should focus on the following responsibilities :

- (a) establishing and developing an effective governing body;
- (b) setting agenda and establishing priorities;
- (c) facilitating effective contribution of non-executive directors (NEDs); and
- (d) representing the SFC publicly, in liaison with local and international financial institutions and other stakeholders.

The non-executive chairman will not be involved in day-to-day regulatory work (e.g. reviewing individual listing applications and investigating possible breaches of SFO etc.). He should not influence the decisions of the executive arm on such individual cases.

CEO of the SFC

9. The CEO should have the executive responsibility on the day-to-day running of the SFC. He should implement the strategy agreed by the SFC governing body, and facilitate the effective functioning of the governing body. The key responsibilities include :

- (a) reporting to the governing body regularly with appropriate, timely and quality information;
- (b) informing and consulting the chairman on all matters of significance to the SFC;
- (c) developing and delivering the strategic objectives agreed with the governing body; and
- (d) overseeing the day-to-day regulatory work of the Commission and ensuring that the Commission is equipped with the necessary staffing, financial and risk management systems for its mission.

Views of the SFC

10. We have consulted the SFC governing body on the proposal. In gist, the Commission agrees to the splitting of the functions of C/SFC and CEO as it is consistent with corporate governance principles. Concerning the question of whether the chairman should be non-executive, members of the Commission have raised several practical implications, as well as possible benefit. The Commission's views and the Government's response are set out at **Annex B**.

11. The Government considers that the chairman of the SFC should be non-executive –

- (a) so that C/SFC can be relieved from day-to-day executive responsibilities, and be suitably detached from the executive arm in order to discharge his supervisory functions effectively; and
- (b) in order to keep the SFC organisational structure lean and cost-effective, and to avoid overlapping responsibilities between an executive chairman and a CEO.

Independence of the non-executive C/SFC

12. It is a fundamental policy objective of the Government to preserve the independence of the Commission. In selecting the future chairman of the SFC, we are keenly aware that he should be, and be perceived as, independent from external influence so as to preserve the integrity, reputation and image of the independent regulator.

13. We consider that the above can be achieved through –

- (a) application of the current provisions in the SFO concerning avoidance of conflict of interests; and
- (b) application of SFC's internal Code of Conduct which requires the highest standards of integrity and conduct from its directors (C/SFC and NEDs included) and staff in carrying out their work properly, impartially and free from any suggestion of improper influence.

14. In addition, given public expectation on the independence of the post of C/SFC, it is our policy intention that during the tenure of the office of C/SFC, he or she should not -

- (a) be a director of any listed company in Hong Kong; or
- (b) have any material interest in any principal business activity of or is involved in any material business dealing with a listed company, or any person or institution engaged in activities regulated by the SFC.

These requirements would be included in the terms of contract of C/SFC.

LEGISLATIVE AMENDMENTS

15. The SFO currently prescribes that C/SFC shall be an executive director (ED) of the Commission. In addition, there is no explicit provision in the SFO for the post of CEO. We propose to amend the SFO in order to implement the proposed changes in paragraph 1 above. A number of consequential amendments would also need to be made, e.g. to maintain the requirement for the number of SFC NEDs to exceed the number of SFC EDs; a SFC NED may also be appointed as the deputy chairman of the Commission or be designated to act as C/SFC.

FINANCIAL IMPLICATIONS

16. There is no financial implication to the Government as the SFC is financed by transaction levies, fees and charges on services rendered to market operators and participants as provided in the SFO.

17. We are keenly aware that the financial and manpower resources of the SFC should be used prudently. If the Government's proposed model is adopted (i.e. non-executive chairman) we expect the financial implications to the SFC as a result of the creation of a CEO post would be minimal. Should the chairman as well as the CEO are both executive, there may be considerable cost implications. In deciding the appropriate level of remuneration for C/SFC and CEO, we will also draw reference from the pay level of other public bodies, as well as the principles governing the

remuneration of senior executives of statutory and other bodies as recommended in the Hay Consultancy Report.

Financial Services Branch
Financial Services and the Treasury Bureau
4 November 2004

Experience of Overseas Regulators

Financial Services Authority (FSA), U.K.

- Separation of duties of chairman and CEO: the Board, appointed by HM Treasury, consists of a chairman, a CEO, three managing directors, and 11 non-executive directors (NEDs) (including a lead non-executive member, the deputy chairman). The Board, led by the chairman, sets overall policy. Day-to-day decisions and management of the staff are the responsibility of the executive arm led by the CEO. The Chairman works a four-day week and undertakes “executive” duties as well¹.

Monetary Authority of Singapore (MAS)

- Separation of duties of chairman and CEO: The Board, appointed by President, consists of a chairman, a deputy chairman, a managing director, and five other members. The MD is responsible for the day-to-day administration. The Chairman is Senior Minister Mr Goh Chok Tong. The Deputy Chairman as well as most members of the Board are government officials².

U.S. Securities and Exchange Commission (SEC)

- No separation of duties of chairman and CEO: The SEC is comprised of five commissioners, appointed by the President, one of whom is the chairman. There is no separation of the duties of the chairman and CEO. Accountability is achieved through the requirement for the Senate to give consent to the appointment of the five commissioners.

Australian Securities and Investment Commission (ASIC)

- No separation of duties between chairman and CEO: The ASIC operates under the direction of three full-time executive Commissioners appointed by the Governor-General on the nomination of the Treasurer. There is no separation of the duties of the chairman and CEO.

¹ The current FSA Chairman, Callum McCarthy, said he took great care in making clear to the outsiders that he wasn't the person running the show, by stating that he works a four-day week (even though he spends more time than that on the job).

² The structure of the MAS may have little reference value to Hong Kong.

Federal Financial Supervisory Authority “BaFin” in Germany

- No separation of duties between Chairman and CEO: BaFin is headed by a full-time executive President. The different departments in BaFin report to the Vice President in BaFin, who in turn reports to the President. The President also focuses on external affairs of the Authority.
- We understand from BaFin that it has no plan to split its President's post and create a CEO post like FSA. Accordingly, this is not in line with the general administrative structure in Germany where the head of the Authority (President) would be accountable for all decisions.

Views of the SFC governing body

The full views of SFC's governing body on the proposal to separate the roles and responsibilities of the chairman and CEO are attached. A summary of SFC's views and the Government's response is set out below.

SFC's governing body's views	Government's response
Agree with the splitting of the functions of C/SFC and CEO, as it was consistent with corporate governance principles.	Note that members support the proposed split.
The Government has not made clear why it was proposed to make this legislative change with tight timetable.	The Government has considered the present proposal carefully, taking into account good governance practice.
The proposal should not be a reflection of the existing governance of the Commission.	The objective is to further enhance the internal governance structure of the Commission.
How actual functions of the Commission should be split between the chairman and CEO.	The division would be along those set out in paragraphs 7 – 9 of this paper. Detailed division would be deliberated and refined by the Commission.
Part-time or full-time.	A “non-executive” chairman is not the same as a “part-time” chairman. He should spend as much time as needed to fulfil the role and responsibilities set out in paragraphs 7 – 8 of this paper.
It might not be easy to find a suitable candidate who had absolutely no real or perceived conflicts of interest if the C/SFC, as a regulator, were to hold other positions.	We agree it is important for C/SFC to maintain its independence from the Government and other interests. There are also safeguards in the SFO dealing with the conflicts of interest issue.

Executive or non-executive.	Please refer to paragraph 10 of this paper.
U.K. model of having the most senior NED as deputy chairman in charge of a non-executive committee could be considered.	We would propose consequential amendment enabling a SFC NED may also be appointed as the deputy chairman of the Commission. The Government would evaluate the operation of the Commission after the proposed split has been put in place, before proposing further changes.
There would be a larger pool of candidates to choose from if C/SFC were to hold a non-executive position.	Agree, provided that the independence of C/SFC is not compromised.
Although not discussed at the Board, it was noted that the FSA experience of having a chairman and CEO increased the costs by at least one additional fully paid director.	Please refer to paragraph 17 of this paper.
Davidson Report concluded that part-time <u>members</u> of the former Securities Commission and Commodities Trading Commission could not function other than in an advisory capacity.	Davidson Report pointed out the problem with part-time <u>bodies</u> . The present proposal was formulated based on the prevalent good governance practices locally and internationally.

Note: The Commission was also consulted on the merits in establishing an internal governance committee comprising C/SFC, all NEDs and the CEO for overseeing the governance of the Commission. The Government would continue to discuss with the Commission on the idea to see whether it is worth pursuing.



SECURITIES AND FUTURES COMMISSION 證券及期貨事務監察委員會

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~~SFC Confidential~~

26 October 2004

Mr. Kevin Ho, JP
Permanent Secretary for Financial Services
and the Treasury (Financial Services)
18th Floor, Admiralty Centre Tower I
18 Harcourt Road
Hong Kong

Dear *Kevin*,

Proposals to further enhance the governance of the SFC

Your letter of 18 September 2004 asked for views from the Commission on the above. A Commission meeting was held on 18 October 2004, at which the full board (except one absent member) deliberated on the Administration's proposals to:

- (i) separate the duties and functions of the Chairman of the SFC (C/SFC) from the executive by creating a new post of Chief Executive Officer (CEO); and
- (ii) create a new Committee on Governance comprising C/SFC, all Non-Executive Directors and the CEO for overseeing the governance of the Commission.

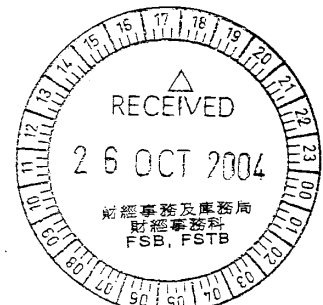
There were two aspects of the proposals that members of the Commission were unanimous about:-

- First, the splitting of the functions of the C/SFC and the CEO was agreed in principle, as it was consistent with corporate governance principles. There were however differing views on whether the Chairman should be full-time and executive.
- Second, as the Administration has not made clear why it was proposed to make this legislative change with this tight timetable, members felt that it was important that the ensuing debate and handling of this proposal, which will be led by the Administration, should not end up undermining the reputation or authority of the Commission. Any proposal should not be a reflection of the existing governance of the Commission, which has been working well and is transparent and well respected by the market, both domestically and internationally.

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There were different views on various issues on the proposals of the Administration, and I summarise below the members' views and the issues raised in the Commission discussion paper under the following headings.

The need for a change now

We note that the Administration plans to present to the Legislative Council the draft Bill (with the proposed necessary amendments to the SFO to allow for the split of the functions between the C/SFC and the CEO) before the end of the year. A Financial Affairs Panel session has also been fixed for 10 November 2004 in order to discuss this. It therefore appears that the Administration has a very tight timetable to work on.

Some members questioned why a change needed to be brought about in a short timeframe, given that the existing governance structure of the Commission had been working well. If the answer was to impose more checks and balances on the Commission, we needed to know what was wrong with the current structure of the Board and the way the Chairman interacted with the Board. It was noted that the Commission was already subject to lots of checks and balances. It would be important for the public to know what objectives we were trying to achieve with the proposed changes.

Other members also recognized that the current governance structure of the Commission was working well, and any change to that structure would be for the future. It was pointed out that the split would be to align the Commission with almost all other public bodies in Hong Kong, which split the functions between a non-executive chairman and a CEO. Any change was not a reflection of the existing governance structure of the Commission.

Practical considerations for a split

Whilst almost all members agreed that the concept of a split was non-controversial, the real practical issue was how the actual functions of the Commission should be split between the C/SFC and the CEO. For profit making bodies, the concept of a split between the Chairman and the CEO is that the interests of the shareholders (the Government in the case of public enterprises) and the management may not be aligned. In the case of a statutory regulator, the public interest objectives are clearly set out in the legislation and there should be no difference in interests between the Chairman and the CEO, since both are accountable for the public interest. However, a split in role would raise the issue as to who is the public face of the statutory regulator.



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Part-time or full-time

A majority of the members doubted that the Chairman of a regulatory body like the Commission could be part-time, given the complexity and range of the policy and regulatory issues. It was considered that if the C/SFC were made a part-time position, we would be sending a wrong message to the market and this would adversely affect the image of the Commission both domestically and internationally. It was also noted that the UK FSA experience was quite young and we were not sure if it was a successful model. Although the FSA Chairman was not called executive Chairman, he received a substantial pay and had to spend most of his time answering to the British Parliament, representing the FSA in various meetings and being the public face of the FSA both domestically and internationally. It was de facto a full time job for the FSA Chairman.

In terms of accountability, public image and perception, the C/SFC would still be the public face of the Commission and would be accountable for the Commission's policy and management issues. This would call for the full-time attention of the C/SFC.

Two members considered that it would be feasible, and desirable, to have a part-time C/SFC who would not be concerned with the day-to-day management of the Commission, and who may hold other positions which had no conflict with his/her role as the C/SFC. It was noted that part-time Chairmen seemed to be working well in other public bodies in Hong Kong, e.g. the KCRC, MTRC and the HKEx. The members took the view that if the position of C/SFC were made part-time, there would be a larger pool of talent to draw from. On the other hand, the demand for a full-time C/SFC would limit the pool and it would be more difficult to find a suitable candidate. It was therefore important to have the flexibility of having a part-time C/SFC in order to find the right person to be the C/SFC.

Other members, on the other hand, took the view that it might not be easy to find a suitable candidate who had absolutely no real or perceived conflicts of interest if the C/SFC, as a regulator, were to hold other positions. It was noted that, in the case of HKEx, its Chairman has minimum involvement in the HKEx's regulatory functions.

Executive or non-executive

We have seen a draft Bill on the proposed changes to the SFO. As explained in your covering letter dated 13 October 2004, the draft Bill has not specified that the C/SFC has to be a non-executive director. The issue of whether the C/SFC is intended to be an executive or non-executive director has several practical implications. First of all, as stated in our earlier letter, the law makes no distinction between the legal responsibilities and liabilities owed between



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executive and non-executive directors. Currently, the SFO provides that non-executive directors should outnumber the executive directors, and the non-executive directors chair the Remuneration, Audit and Budget Committees.

It was noted by members that although the FSA Chairman had no executive responsibility for the day-to-day running of the FSA, he was "executive" in the sense that he was substantially remunerated and spent effectively full time as the public face of the FSA. Also, the FSA Chairman had a list of defined duties and was tantamount to a full-time executive.

It was also noted that the major overseas regulators like the Australian ASIC, US SEC and China Securities Regulatory Commission (CSRC) all had executive Chairmen. By having an executive Chairman, SFC could be represented at the IOSCO Technical Committee with other executive Chairmen as equals.

Some members considered that the FSA model of having the most senior non-executive director as Deputy Chairman in charge of a non-executive committee could be considered.

The other side of the argument was that there would be a larger pool of candidates to choose from if the C/SFC were to hold a non-executive position.

The need for a governance committee

Whilst recognizing that the existing checks and balances of the Commission had worked well, some members considered that it would be a good idea to have a special committee to discuss governance issues of the Commission. With all non-executive directors and only one executive being the CEO on the committee, it was believed that the committee would be much more open to new ideas and changes.

It was noted that the Administration had drawn reference to the non-executive committee (NedCo) of the FSA, and proposed that the governance committee be non-statutory in Hong Kong. The FSA NedCo's statutory functions are as follows:-

- "keeping under review whether the FSA is using its resources efficiently and economically;
- keeping under review whether the FSA's internal financial controls secure the proper conduct of its financial affairs;
- determining the remuneration of the Chairman and other executive directors; and
- making a report each year, for inclusion in the FSA's Annual Report to the Treasury, on the discharge of the functions listed above."



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In the Commission, these functions are all made by the existing Remuneration, Budget and Audit Committees, which are chaired by non-executive directors and comprise solely non-executive directors (except for the Budget Committee). The C/SFC attends these meetings by invitation. The annual report is made by the unitary board. Consequently, some members expressed that it was not clear what the justification for establishing a governance committee was, what governance issues were to be looked at by such a committee, how it was going to relate to the Board and how it was going to fit into the existing structure of checks and balances (e.g. the PRP). If the governance committee were to oversee good corporate practices, there would be conflicts to include the CEO in the committee given his role of managing the day-to-day operations of the Commission. Most members felt that there was insufficient information at this stage for them to deliberate on the current proposal and would wish the Administration to clarify further.

Financial Implications

Although this was not discussed at the Board, it should be noted that the FSA experience of having a Chairman and a CEO increased the costs by at least one additional fully paid director.

Concluding Remarks

As you can see from the above discussion, based upon the recommendations of best practice in corporate governance of public bodies, members had no problem with splitting the job between a Chairman and a CEO. However, it would be important to point out that in practice, a fundamental difference between the SFC and other public bodies is that the institution is essentially a regulator, with considerable responsibilities that involved daily market movements, incidents and complex regulatory issues. It was this complexity and rapid market changes that caused the Davison Report of 1989, which recommended the establishment of the SFC, and to conclude that part-time members of the former Securities Commission and Commodities Trading Commission could not function other than in an advisory capacity.

The Commission appreciates that it is the prerogative of the Administration to make a policy choice on how the governance of the Commission should be framed. The Commission is of the view that any change or handling of that change should not undermine the reputation or the authority of the Commission domestically and internationally, which could affect Hong Kong's standing as an international financial center.



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The purpose of this letter is simply to set out the members' views, based on their current and international experience, for the Administration's careful consideration of this important issue.

We would be happy to answer any further questions you may have on the subject.

Yours sincerely,

Peter Au-Yang

cc. AA/FS
AA/SFST
C/SFC

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