Consultation Document on

the Securities and Futures Bill

The Government of the
Hong Kong Special Administrative Region
April 2000

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Foreword

This Consultation Document is prepared to facilitate consideration of the Securities and Futures Bill which has just been published in the form of a White Bill for the purpose of public consultation. It outlines the proposed legislative framework for the securities and futures market and highlights the salient provisions proposed in the Bill. Both documents are published in Chinese and English, and can be found on the website of the Financial Services Bureau at www.info.gov.hk/fsb and that of the Securities and Futures Commission at www.hksfc.org.hk.

Members of the public are invited to submit their views in writing **on or before 30 June 2000** to -

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CONSULTATION DOCUMENT ON THE SECURITIES AND FUTURES BILL

EXECUTIVE SUMMARY

INTRODUCTION

In March 1999 the Financial Secretary announced legislative reform for the securities and futures market. The primary purpose of the reform is to create a modern regulatory and legal framework that–

- promotes market confidence;
- secures appropriate investor protection;
- reduces market malpractice and financial crime; and
- facilitates innovation and competition.

2. The existing legislation for the regulation of the securities and futures market is a patchwork of ten Ordinances written over the course of the last 25 years. Modern advances in technology, markets and financial instruments and practices have highlighted gaps in the legal framework. The existing regulatory approaches have become inadequate for investor protection.

3. Moreover, the existing legislative regime is complex and cumbersome. Hong Kong needs a piece of modern legislation that is purposefully written for the needs of the securities and futures market of the 21st century. The law must be clear, user-friendly and not unnecessarily burdensome.

4. The Government therefore took the decision in 1999 to rewrite, update and combine the existing Ordinances in the form of one single ordinance – the Securities and Futures Bill ("the composite Bill").

5. The composite Bill is built upon an earlier draft that the Securities and Futures Commission ("SFC") issued for public consultation in 1996. In the composite Bill, new proposals have been added to address the new regulatory, legal and policy issues that have arisen as a result of the revolutionary changes in the markets brought about by globalization and rapid advances in technology in the last few years.

6. In July 1999, the Government presented the major proposals to be included into the composite Bill to the Legislative Council Panel on Financial Affairs. Consultation with market organizations, trade and industrial associations and professional bodies on these proposals immediately followed.

7. The Government also sought the views of the Subcommittee on the Securities and Futures Bill of the Legislative Council ("LegCo Subcommittee") on these proposals at four meetings held in September 1999.

8. The Government took into account comments from the LegCo Subcommittee and the market in drafting the composite Bill. Summaries of major comments by the market and the LegCo Subcommittee are at Annexes A and B respectively.

Publication of the White Bill

9. The market supports the general direction of the new legislative initiatives. However, there have been repeated requests for consultation on the detailed provisions of the draft composite Bill before its formal legislative passage through the Legislative Council. Indeed, some respondents remarked that the original legislative timetable was over-ambitious in the light of the scale and complexity of the reform.

10. In view of repeated calls for further consultation, the Government has decided to publish a White Bill for general consultation and, in particular, to seek the public's views on the new elements that have been introduced in the composite Bill since the July 1999 consultation.

11. The White Bill consultation exercise should not delay the legislative reform programme. The Government will adhere to a tight timetable. Consultation on the White Bill

will be for three months, until end June 2000. In the interim, the major subsidiary legislation necessary for bringing the composite Bill into force, and the more important codes and guidelines to be issued by the SFC to accompany the implementation of the new law will be prepared. We aim to have them ready for the market's consideration when the composite Bill is introduced into the Legislative Council at the commencement of its 2000-2001 session.

12. Meanwhile, several new proposals that were originally designated for the composite Bill have been brought forward to fill the more urgent gaps in the present legislative framework. These proposals are embodied in the following amendment Ordinance or Bills -

- the Securities (Margin Financing) (Amendment) Ordinance;
- the Securities (Amendment) Bill (on regulation of short-selling); and
- the Securities and Futures Legislation (Provision of False Information) Bill.

These amendment Ordinance and Bills will be subsumed, as they have been or will be enacted, into the composite Bill at a later stage.

Highlights of Major Proposals under the Composite Bill

13. The composite Bill aims to create a modern regulatory framework capable of effective enforcement by the SFC, and with which market users and intermediaries will be able to comply efficiently. The major proposals are highlighted in the ensuing paragraphs.

Reduced Burden on Intermediaries, More Effective Regulation

(a) Streamlined licensing regime for intermediaries (Parts V-VII of the composite Bill)

14. At present an intermediary must apply to the SFC for separate registrations for undertaking different activities in different products. This multiple-registration regime brings considerable cost and administrative burden to both the registered persons and the regulator.

15. With financial innovation and growing investor sophistication, the traditional wisdom of maintaining multiple licensing categories for different activities has increasingly come under challenge. Intermediaries today are expected to simultaneously deal in and advise on securities, futures, foreign exchange and other investment products. Under the composite Bill, an intermediary will only need one single licence to engage in activities regulated by the SFC. Existing registered persons will be allowed to migrate to the new licensing regime within two years after enactment of the composite Bill.

(b) Proportionate disciplinary sanctions for improper conduct by intermediaries (Part IX of the composite Bill)

16. When a licensed person engages in any improper conduct, the disciplinary sanctions that the SFC may currently administer are public or private reprimands, and suspension or revocation of the intermediary's registration. Reprimands could be too light in many cases, yet suspending or revoking an intermediary's registration might be excessive.

17. In line with US law and regulations, and the proposed legislation in the UK, the composite Bill gives the SFC two additional sanction options -

- civil fines of up to the higher of $10 million or three times the amount gained or loss avoided; and

- suspension or revocation of an intermediary's licence in respect of part of its business only.

Empowering Investors to Protect Themselves

(c) Disclosure of interests in securities (Part XV of the composite Bill)

18. Investors should have equal and timely access to full and accurate data on the shareholdings of listed companies which is price-sensitive, so that they can make informed investment decisions. The composite Bill tightens the disclosure threshold (from 10% to 5%) and time limit for disclosure (from five days to three business days). For greater

transparency, certain disclosure requirements are also extended to securities interests held through derivative products. We have also removed or simplified certain existing disclosure requirements.

(d) A clear statutory private right of action against market misconduct (Parts XIII and XIV of the composite Bill)

19. Under common law, a person who suffers loss as a result of market misconduct may be able to seek redress through civil action against a person responsible for the misconduct. The path to civil redress under common law can be costly and riddled with obstacles. The composite Bill will create a right of civil action in respect of market misconduct for which the plaintiff can claim compensation for loss and other remedies. The circumstances under which a person may sue will be stipulated in the composite Bill.

Minimizing Market Misconduct

(e) A Market Misconduct Tribunal to handle insider dealing and other specified market misconduct (Part XIII of the composite Bill)

20. To ensure market integrity and investor protection, effective action must be taken against market misconduct. Under current law, market manipulation is a criminal offence. Sophisticated market practices and techniques however have made it difficult to obtain sufficient evidence to prove market manipulation to the criminal standard, i.e., beyond a reasonable doubt. The composite Bill seeks to provide an alternative civil route to the existing criminal route in dealing with market manipulation. It will build on the strength of the Insider Dealing Tribunal and expand it into a Market Misconduct Tribunal ("MMT"). The MMT will handle insider dealing and specified market misconduct activities, and will apply the civil standard of proof, i.e., a balance of probabilities in determining whether it is satisfied that cases referred to it have been proved.

21. A judge of the Court of First Instance, assisted by two market practitioners appointed by the Chief Executive, will chair the MMT. It will subsume the work of the Insider Dealing Tribunal. The Financial Secretary will be able to initiate civil proceedings before the MMT.

22. The MMT may –

- order disgorgement of profits plus compound interest thereon;
- order payment of legal costs and investigation expenses;
- issue a "disqualification" order to disqualify a director from being a director of any listed company for a period of up to five years;
- issue a "cold shoulder" order (i.e., a person is denied access to market facilities) for a period of up to five years;
- issue a "cease and desist" order (i.e., an order not to breach the provisions of Part XIII of the composite Bill again); and
- refer to anybody of which the person who has engaged in market misconduct is a member for possible disciplinary action.

23. As an alternative to proceedings before the MMT, the composite Bill provides a criminal route for dealing with market misconduct activities where there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution before the Courts. The maximum penalty under the criminal route is 10 years' imprisonment or a fine of up to $10 million. The rule against double jeopardy applies. A person cannot be tried in the MMT and the Courts for the same market misconduct.

24. Special efforts have been made in drafting these proposals to ensure that the new regime is compatible with the Bill of Rights Ordinance and the Basic Law.

(f) Preliminary inquiry into the management of a listed company (Part VIII of the composite Bill)

25. Current law authorizes the SFC to review the books and records of a listed company or members of its group when it appears to the SFC that there is misconduct in the

management of the company. In practice, however, the SFC has only limited ability to place the entries in those documents in any meaningful context or to check their veracity.

26. The composite Bill seeks to rectify this problem. The SFC will be entitled to seek explanations of an entry from the listed company or a member of its group. It may also access the working papers of such company's auditors. In addition, the SFC may make enquiries of counterparties to transactions that such company has entered into. These enhancements will enable the SFC to inquire more effectively into allegations of fraud or other misconduct in respect of listed companies.

27. Particular efforts have been made to raise the thresholds required for the exercise by the SFC of these new inquiry powers to ensure that they are reasonable and in line with present-day legal conventions in respect of the rights of third parties.

(g) Immunity for auditors who choose to report suspected fraud (Part XVI of the composite Bill)

28. The composite Bill contains provisions to implement an earlier proposal to provide auditors of listed companies who report to the SFC any suspected fraud or misconduct in the management of a listed company with statutory immunity from liability under common law. The choice to report is entirely voluntary. The composite Bill intends only to give immunity from the threat of civil liability to auditors who choose to sound such a warning to the SFC in the course of their auditing work. In drafting the relevant provisions, the Government has taken into consideration the views of the Hong Kong Society of Accountants.

Friendly to Innovation, Meeting New Market Needs

(h) Adopting a flexible and pragmatic approach to regulation of automated trading services (Part III of the composite Bill)

29. Overseas markets have seen rapid growth in electronic trading conducted through a diverse array of automated trading facilities. The activities and services of these technology-driven operators should be subject to regulation for investor protection and

systemic risk management. Yet the diversity and rapid development that mark these services require that the SFC regulate with flexibility. Imposing a set of requirements with universal application would probably leave undesirable loopholes and impede growth and competition.

30. To strike a balance between certainty and flexibility, the composite Bill provides for authorization of automated trading services and sets the criteria for supervision, without stipulating rigid rules. The particular characteristics of a service will determine how it is to be regulated so that its operation is fair, efficient, as well as transparent, and that electronic visits to such a service are properly managed. The SFC will work with members of the industry and other professionals on setting guidelines for potential applicants who wish to offer such services. The aim is to provide for a pragmatic regulatory regime that leaves maximum room for innovation.

31. Under existing law, the Stock Exchange of Hong Kong Limited ("SEHK") has an exclusive right to operate a stock market in Hong Kong. The composite Bill extends this right to SEHK's new holding company, the Hong Kong Exchanges and Clearing Limited ("HKEx") and also any other companies of which HKEx is the controller.

(i) Enhanced transparency in the professional investors markets (Part III of the composite Bill)

32. Persons who act as principals and deal solely with professional investors do not directly pose any investor protection concerns, and are not required to be licensed by the SFC. Nevertheless, their activities can have significant impact on the market, and information about them is essential to proper management of systemic risks. While the best approach in addressing these issues remains a subject of active international discussions following the Asian financial turmoil, the composite Bill will include large position reporting requirements in the futures and options markets. This will bring Hong Kong's reporting standards more in line with those of other major international financial centres.

(j) Allowing SFC to join in litigation between third parties (Part XVI of the composite Bill)

33. As financial markets and their infrastructure become increasingly complex, what appear to be disputes between private parties are more and more likely to have an impact on the rest of the market system. The composite Bill will give the SFC standing to intervene in proceedings (other than criminal proceedings) between third parties in appropriate cases to provide its regulatory perspective and expert opinion. As safeguards, the composite Bill will require that the SFC must satisfy the Court that such intervention is in the public interest; parties to the litigation will have the right to challenge the SFC's intervention; and the intervention will be subject to such terms as the Court considers just.

34. Special attention has been given to delineating this and other intervention powers of the SFC (under Part X of the composite Bill) to ensure that they are compatible with the Bill of Rights Ordinance and the Basic Law.

(k) Investor Compensation (Parts III and XII of the composite Bill)

35. The existing compensation funds for both SEHK and the Hong Kong Futures Exchange ("HKFE") rely in part on deposits paid by members of the exchanges. The compensation ceilings are respectively $8 million per stockbroker and $2 million per futures broker. The per broker ceilings give an uncertain level of investor protection, as it does not communicate to investors the amount of coverage available to them individually. We propose the establishment of a new investor compensation scheme whereby insurance leveraging on the existing compensation fund assets may be used, with a view to minimizing the cost to the industry. We also propose a per investor compensation ceiling to be prescribed by the Chief Executive in Council.

A balanced approach allowing for smooth transition (Parts XI and XVII of the composite Bill)

36. In drafting the composite Bill, the Government has exercised due care that, in vesting new powers in the SFC, enhanced accountability and transparency measures should be introduced to ensure that there are adequate checks and balances on the exercise by the SFC of these powers. These measures take different forms, including statutory thresholds

that the SFC has to satisfy before invoking certain powers; requirement for prior approval by the Financial Secretary, Chief Executive in Council, Legislative Council or the Court before the SFC may take certain actions; and the review of certain SFC decisions by an independent body. Two notable initiatives are the establishment of a Securities and Futures Appeals Tribunal to hear appeals against a wide range of SFC decisions, and a Process Review Panel to review SFC's internal operations including its investigatory process.

37. The Government is also mindful of the need to assist those market participants who will be affected by the changes proposed in the composite Bill in migrating from the existing regime to the new regime. Accordingly the Government has proposed a two-year transitional period after commencement of the proposed legislation for market intermediaries to prepare themselves for a smooth migration to the new licensing regime.

Legislative Timetable

38. In light of public comments, we shall refine the composite Bill with a view to introducing it to the Legislative Council as the 2000-2001 legislative session commences. Our target is to secure enactment by April 2001.

CHAPTER 1

NEED FOR A MODERN REGULATORY FRAMEWORK

INTRODUCTION

1.1 The Financial Secretary announced in his Budget Speech this year the publication of the composite Bill for public consultation. This Consultation Document is published together with the composite Bill and is an integral part of the consultation process. The Government attaches great importance to public comments on the composite Bill, in particular the refinements introduced since the public consultation conducted in July 1999.

1.2 This Consultation Document provides an overview of the composite Bill and highlights the major proposals and their justifications. It also explains the more important refinements made to some of the original proposals exposed to the market in the July 1999 consultation.

BACKGROUND

1.3 In March 1999, the Financial Secretary announced proposals for legislative reform for the securities and futures market. The purpose of the reform is to update Hong Kong's legal and regulatory framework for the relevant market. Building a modern framework is crucial to securing Hong Kong's position as an international financial centre.

1.4 The securities and futures industry is one of the key sectors of Hong Kong's economy. As a high value-added service industry, it serves as a central pillar of Hong Kong's economic success. It is vital for Hong Kong's continued prosperity, stability and international competitiveness. It channels savings and investments into industry and commerce. It provides jobs and helps to promote other related service sectors, such as accounting, law, media, trade, technology, communications, and commerce.

1.5 The economic success of New York and London demonstrates the importance of a vibrant securities and futures market to a city's economy. As an established financial services centre in Asia, Hong Kong has potential to become the premier international city of this "Third Time Zone". Hong Kong also has potential to be the premier capital formation centre for the Mainland of China. However, competition is fierce. Others in and outside the region are working hard at attracting the same business.

1.6 Globalization of financial services, coupled with advances in information technology, mean investors are no longer geographically bound. Cross-border, 24-hour trading is already common practice. If our markets are healthy and vibrant, investors will pick Hong Kong as their base in the region and key hub for the Mainland of China. Conversely, if our markets do not measure up to international standards, investors will bypass Hong Kong and seek quality elsewhere.

1.7 Recent years have also witnessed the arrival of new technologies, new financial products, new market participants, and new trading methods. Such financial innovation reduces costs, enables investors large and small to better manage their money, and should be encouraged. However, it also gives rise to new concerns about investor protection, volatility, and market abuses. There must, therefore, be a balance between facilitating innovation and growth on the one hand, and minimizing market misconduct and systemic risks, together with providing a reasonable degree of investor protection on the other.

NEED FOR LEGISLATIVE REFORM

1.8 The current securities legislation has served Hong Kong well. Yet, reform is needed. The changes brought about by globalization, technological innovations, and the introduction of new products, services and trading methods mandate the creation of a modern and user-friendly regulatory framework that ensures fair, orderly and transparent markets, while promoting competition and innovation. Moreover, the new regime must deliver a high standard of supervision and investor protection that the public has the right to expect. It must also have flexibility and the inherent ability to anticipate and respond to the rapid changes in the market, and to stay in lockstep with the continuing evolution of international regulatory practice.

REFORMS IN OTHER JURISDICTIONS

1.9 In recent years, other jurisdictions have examined the legal and regulatory implications of global markets and considered reforms to meet these challenges.

1.10 The UK recognizes that financial services provide 7% of its GDP and employ over one million people. In order to compete effectively globally, the UK considers that it needs an effective regulatory regime that "provides a high level of market confidence, protection to consumers and the means effectively to tackle malpractice and financial crime, whilst at the same time working with the grain of the financial markets and minimizing compliance costs". The result is the draft Financial Services and Markets Bill which, upon enactment, will provide a comprehensive regulatory regime for an industry that transcends geographical and sectoral boundaries. The UK clearly sees the need for legislation that is coherent and easy to understand, a regulatory framework that is modern and able to evolve with rapid changes in the industry and a regulator that exercises its powers in an accountable manner.

1.11 In the US, debates are ongoing on whether the OTC (over-the-counter) derivatives market should be regulated; whether a tiered regulation of the futures market by reference to the nature of customers and underlying products should be adopted; legal and regulatory issues surrounding the increased fragmentation of markets and proliferation of exchanges; and the need to allow the markets and intermediaries to be competitive and flexible to meet global competition.

1.12 Australia has since 1993 been conducting a comprehensive review of its corporations, securities and futures laws under the Corporations Law Simplification Programme. This has resulted in several Acts that have substantially reformed areas of corporate and securities law. Since 1997, the Corporations Law Economic Reform Programme has resulted in major proposals to reform prospectus and takeovers laws. In 1998, new legislation governing collective investment schemes was passed. Further reforms are proposed.

1.13 The Mainland of China has also seen the need for a comprehensive legal framework to facilitate the development of its securities market. On 29 December 1998, the Mainland passed a national Securities Law which centralizes securities regulatory powers in the China Securities Regulatory Commission and puts "teeth" into the regulation and supervision of the market. One of the main purposes of the Law is to

consolidate and rationalize many of the existing regulations issued by different regulatory bodies so as to address the long standing problem of fragmentation and ineffectiveness of supervision.

MODERNIZING EXISTING LAWS

1.14 Our current set of statutory provisions governing the securities and futures industry is scattered over ten different Ordinances[1]. It is not user-friendly. The core piece of legislation, the Securities Ordinance, is a quarter of a century old. Many of the concepts and definitions in use are out of date. The paradigm shifts that are taking place in the economies and financial markets across the globe have increasingly highlighted gaps in this patchwork of legislation. The existing statutes could be (and have been) amended to patch over the problems but the result would not be very satisfactory. The different statutes would operate largely by reference to an increasing number of other statutes, resulting in an increasingly complex labyrinth of legislative provisions. The decision was therefore taken by the Financial Secretary in 1999 to replace the existing body of different statutes with one composite statute - the composite Bill.

THE COMPOSITE BILL

1.15 The composite Bill is in 17 Parts, with 10 Schedules. They are –

[1] The ten ordinances are –

(a) Securities and Futures Commission Ordinance (Cap. 24) (enacted 1989)
(b) Commodities Trading Ordinance (Cap. 250) (enacted 1976)
(c) Securities Ordinance (Cap. 333) (enacted 1974)
(d) Protection of Investors Ordinance (Cap. 335) (enacted 1974)
(e) Stock Exchanges Unification Ordinance (Cap. 361) (enacted 1980)
(f) Securities (Insider Dealing) Ordinance (Cap. 395) (enacted 1990)
(g) Securities (Disclosure of Interests) Ordinance (Cap. 396) (enacted 1988)
(h) Securities and Futures (Clearing Houses) Ordinance (Cap. 420) (enacted 1992)
(i) Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (enacted 1994)
(j) Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000)

Part	Schedule	Description	Chapter in this Consultation Document
I	1	Preliminary	2
II	2	Securities and Futures Commission	2
III	3	Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services	3
IV	4 & 5	Offers of Investments	4
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1.16 The drafting of the composite Bill has been guided by the following considerations –

(a) the new regime should be on a par with international standards and compatible with international practices, with necessary adjustments to address local characteristics and needs;

(b) in creating this regime, a balance should be struck between certainty and flexibility;

(c) procedures and processes should be simplified and made user-friendly wherever possible to minimize regulatory burden;

(d) investors should be empowered to help themselves;

(e) the regulator should be subject to adequate checks and balances; and

(f) there should be a smooth transition from the existing to the new regime.

1.17 The composite Bill is built upon a consultation document prepared by the SFC, which was exposed to the public for comments in 1996. Under the current reform, new elements have been added, including those announced by the Financial Secretary in March 1999, i.e., clearer regulatory objectives and more effective supervisory and investigative powers for the SFC; the introduction of an independent Market Misconduct Tribunal; new regulation on internet trading; and a streamlined licensing regime for market intermediaries. These new elements were exposed to the market and legislature for views during July 1999. Details of these proposals as well as other major proposals in the composite Bill will be discussed in other Chapters of this Consultation Document.

ECONOMIC IMPLICATIONS

1.18 Measures to enhance the functioning of the securities and futures market through regulatory reforms, in the way as prescribed in the composite Bill, will help boost the vitality and strength of Hong Kong's financial sector as it strives to maintain its place in

the league of the world's major markets, and as the premier fund raising centre for the Mainland of China.

FINANCIAL IMPLICATIONS TO THE SFC AND REGULATEES

1.19 The composite Bill should not have significant financial implications for the SFC. In fact, by providing an enhanced and more modern regulatory framework, the composite Bill should assist the SFC in attaining its objectives more efficiently and effectively. Regulatees, on the other hand, will benefit from the streamlined licensing regime and greater legal certainty under the composite Bill. Some amendments to their compliance systems may be necessary. However, any financial burden that this would impose on regulatees should be off-set by the savings from the more cost effective and flexible licensing structure being introduced under the composite Bill.

ACCOUNTABILITY AND TRANSPARENCY OF THE SFC IN THE NEW REGIME

1.20 As the independent regulator of the securities and futures market, the SFC needs adequate powers and discretion to perform its functions effectively. To this end, the composite Bill has proposed enhancements to the SFC's supervisory powers in respect of the market, participants and intermediaries. The proposed enhancements of these powers under Parts VIII, IX and X of the composite Bill will be discussed in Chapters 6, 7 and 8 of this Consultation Document.

1.21 In exercising its powers and performing its functions, the SFC should be both accountable and transparent, subject to any overriding confidentiality considerations. While the SFC is outside the civil service, it is part of the wider Government machinery and, as such, is fully accountable to the Government and the Legislative Council. The public is rightly entitled to expect that there are measures to ensure that the SFC is performing its functions fairly, properly, efficiently and with due propriety.

EXISTING ACCOUNTABILITY MEASURES

1.22 In establishing the SFC in 1989, the Government exercised due care in prescribing adequate safeguards when vesting powers in the new regulatory watchdog. The main existing accountability measures include –

(a) the Chief Executive appoints the Chairman and all other Executive and Non-Executive Directors of the SFC. The Non-Executive Directors, being equal in number to the Executive Directors, constitute the first line of supervision of the affairs of the SFC (section 5 of the SFC Ordinance);

(b) the Chief Executive may give the SFC directions regarding the performance of its functions and duties (section 11 of the SFC Ordinance);

(c) the Chief Executive approves estimates of the SFC's income and expenditure and the approved estimates are required to be laid on the table of the Legislative Council (section 14 of the SFC Ordinance);

(d) the SFC is to furnish such information to the Financial Secretary as he may specify (section 13 of the SFC Ordinance);

(e) the Director of Audit may at any reasonable time examine any books and records of the SFC (section 16(3) of the SFC Ordinance);

(f) an independent Securities and Futures Appeals Panel ("SFAP") hears appeals from parties aggrieved by certain decisions made by the SFC (section 18 to 22 of the SFC Ordinance);

(g) decisions of the SFC concerning the recognition and closure of the exchanges may be appealed to the Chief Executive in Council;

(h) decisions and actions by the SFC may be judicially reviewed by the Court of First Instance; and

(i) complaints against the actions of the SFC or any of its staff members may be lodged with the Office of the Ombudsman.

All these accountability measures will be preserved in the composite Bill, subject to changes to replace the SFAP with a Securities and Futures Appeals Tribunal.

FURTHER SAFEGUARDS TO BE INTRODUCED

1.23 The composite Bill sets out the regulatory objectives of the SFC (see Chapter 2). The SFC is expected to carry out its regulatory functions in a way that is compatible with and appropriate for meeting these objectives. Currently, the SFC Ordinance does not set out the SFC's regulatory objectives. Defining these objectives in the composite Bill is a major step forward. These objectives will serve as benchmarks by which the industry and the public will be able to measure the achievements of the SFC.

1.24 The composite Bill vests certain new regulatory powers in the SFC. At the same time the existing accountability measures are correspondingly enhanced to ensure that they constitute adequate checks and balances. The major enhancements are the establishment of a Securities and Futures Appeals Tribunal to replace the existing SFAP; and the creation of a new administrative review mechanism for the SFC's operations through a Process Review Panel.

Creation of the Securities and Futures Appeals Tribunal

1.25 As an improvement to the current appeal mechanism, the composite Bill expands the remit of the existing SFAP and upgrades it to a full-time, judicial tribunal to become the Securities and Futures Appeals Tribunal ("SFAT").

1.26 The SFAP is a merits review panel. Its jurisdiction is limited to certain but not all decisions by the SFC on licensing and disciplinary matters. As it is operating on a part-time basis, the SFAP does not have the resources for handling a large caseload. Any delay caused by caseload is contrary to the aim of the SFAP being a quick and effective means of merits review.

1.27 The SFAT will be chaired by a judge[2] assisted by lay members who are appointed by the Chief Executive from among well-respected market practitioners in Hong Kong.

[2] A judge or deputy judge of the Court of First Instance, a former Justice of Appeal or a former judge or former deputy judge of the Court of First Instance.

This tribunal will have a wider jurisdiction than the SFAP and may review many important decisions of the SFC including all licensing and disciplinary decisions (including all reprimands) as well as certain matters relating to intermediary supervision, investment products, and registration of prospectuses. The time required for an appeal hearing would be shortened, as the SFAT will operate on a full-time basis.

1.28 A more detailed discussion on the SFAT is set out in Chapter 9 on Part XI of the composite Bill.

Establishment of the Process Review Panel

1.29 It is important for the SFC to continue to earn public confidence and trust. Part of its work is necessarily subject to privacy and confidentiality requirements. Specific, as opposed to general or public, information cannot always be publicly disclosed. This, however, could give the public some doubts as to whether the SFC is taking appropriate action in response to intermediary impropriety, market misconduct, financial crime or other improper activities. To bridge this gap, an independent, non-statutory panel, the Process Review Panel ("PRP"), will be established to review aspects of the SFC's internal operations (including investigative procedures) that, by their nature, cannot be meaningfully scrutinised by the SFAT.

1.30 It is currently envisaged that the PRP will have a membership of about 9 to 12 persons, comprising a majority of independent, prominent public persons, to be appointed by the Chief Executive. To ensure that some Panel members are familiar with the work of the SFC, the Chairman, a Non-Executive Director of the SFC, and a representative of the Secretary for Justice will be appointed as ex-officio members. The PRP will submit its reports to the Financial Secretary.

1.31 To demonstrate the SFC's commitment to operational transparency, we plan to establish the PRP in the third quarter of 2000, ahead of the enactment of the Bill.

1.32 The PRP will essentially conduct audit reviews of files, actions and decisions that the SFC has taken to determine if in handling these files or taking such actions or decisions, the SFC had followed its internal due process procedures, including its procedures for ensuring consistency. The Panel's function is not to conduct any review of merits. It will only focus on process. If the Panel in a particular case finds

that the SFC has failed to follow its relevant procedures, the Panel could send the case to the SFC's Board of Directors and require follow-up action to be taken to the Panel's satisfaction. Through its regular reports to the Financial Secretary on its review findings, and publication of these reports to the fullest extent permitted within the statutory constraints of secrecy and confidentiality, the public will be better able to judge the SFC's performance.

CHAPTER 2

PART I OF THE SECURITIES AND FUTURES BILL

PRELIMINARY

PART II OF THE SECURITIES AND FUTURES BILL

SECURITIES AND FUTURES COMMISSION

CONSTITUTIONAL FRAMEWORK OF THE SFC

2.1 Part I of the composite Bill provides for definitions. Definitions of general application are set out in Part 1 of Schedule 1, while specific definitions applying to particular Parts of the composite Bill are set out in the relevant Part.

2.2 Part II of and Schedule 2 to the composite Bill provide for the operations of the SFC and its constitutional framework. The current constitutional framework of the SFC remains basically unchanged, but a few notable changes have been made to provide clarity and, where necessary, an appropriate degree of flexibility. All these reflect the need to clarify the objectives and functions of a modern securities regulator. Three changes are worth noting, as briefly discussed below –

(a) the introduction of a new Clause 4 setting out the regulatory objectives which the SFC is to pursue. This has no counterpart in the SFC Ordinance;

(b) a new provision,Clause 6, which sets out the general duties of the SFC; and

(c) the terminology used to delineate the ambit of the SFC's jurisdiction has been revised to better reflect the exact parameters and nature of its role.

Regulatory Objectives and Functions (Clauses 4 and 5)

2.3 In October 1998, members of the International Organization of Securities Commissions ("IOSCO") agreed that the core objectives of securities regulation are –

(a) the protection of investors;

(b) ensuring that markets are fair, efficient and transparent; and

(c) the reduction of systemic risks.

IOSCO also emphasized, as a principle of securities regulation, that the responsibilities of the regulator should be clearly stated and that the regulator's exercise of its powers and discharge of its functions should be readily comprehensible and transparent to both the public and those whom it regulates.

2.4 In line with this IOSCO standard, the composite Bill introduces a new provision (Clause 4) setting out the regulatory objectives which the SFC is to pursue. They are –

(a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

(b) to promote the understanding by the public of the operation and functioning of the securities and futures industry;

(c) to secure the appropriate degree of protection for members of the public investing in or holding financial products;

(d) to minimize crime and misconduct in the securities and futures industry;

(e) to reduce systemic risks in the securities and futures industry; and

(f) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

2.5 Additionally, the provisions relating to the SFC's functions (Clause 5) have also been revised to better reflect and facilitate the need to fulfil the regulatory objectives stipulated in Clause 4. Moreover, where appropriate, the opportunity has also been taken to bring these functions up to date with modern regulatory standards and practices.

2.6 Together, these regulatory objectives and functions of the SFC help to –

(a) clarify the SFC's role as a regulator by more precisely delineating the ambit of its jurisdiction and authority; and

(b) increase its transparency and accountability to the public by setting, in the primary legislation itself, the standards and goals in accordance with which the SFC is expected to perform its functions. When performing its functions, the SFC will be required to act in a way that is compatible with its objectives. The public will thus be able to benchmark the performance of the SFC against the objectives.

General Duties (Clause 6)

2.7 A further innovation is the provision, in Clause 6, of general duties of the SFC. Again, this has no counterpart in the SFC Ordinance. The provision comprises two parts –

(a) it imposes a statutory obligation on the SFC to act in a manner which is not only consistent with its regulatory objectives, but which it considers most appropriate for meeting those objectives; and

(b) it requires that in pursuing its regulatory objectives and exercising its functions, the SFC shall have regard to, among other things –

(i) the international character of the securities and futures industry and the desirability of maintaining the international competitiveness of Hong Kong's securities and futures market;

(ii) the imperative that robust regulation must not come at the expense of unnecessarily impeding healthy competition;

(iii) the necessity of facilitating innovation in the development of financial products and the conduct of regulated activities;

(iv) the importance of acting in a transparent manner; and

(v) the need to use its resources in the most efficient manner.

2.8 This provision, together with Clauses 4 to 6, not only provide a sound foundation for effective regulation of the securities and futures industry in these times of rapid change, but also impose sufficient checks and balances on the performance by the SFC of its regulatory functions.

Defining SFC's Regulatory Jurisdiction

2.9 As noted above, Clauses 4 and 5, which set out the regulatory objectives and functions of the SFC, delineate its jurisdiction. Several defined terms play a key role in this delineation, namely –

(a) "securities and futures industry" – it is clear from the regulatory objectives stipulated in Clause 4 that the jurisdiction of the SFC is confined to the "securities and futures industry". This term is therefore crucial to setting out the parameters of the SFC's jurisdiction and is defined in the composite Bill as "the securities and futures market and participants therein, and any activities related to financial products";

(b) "financial product" – this appears in the definition of "securities and futures industry" and delineates the SFC's jurisdiction. It is defined to include any securities, futures contract, collective investment scheme, and leveraged foreign exchange contract;

(c) "securities", "futures contracts" and "investment arrangements" - the composite Bill adds an element of practical flexibility to the definition of "financial product" by vesting in the Financial Secretary a power to specify what constitutes "securities", "futures contracts" and "investment arrangements" (Clause 369 of Part XVI and Clause 101 of Part IV); and

(d) "regulated activities" – the composite Bill also allows for flexibility in defining "regulated activities" for the purpose of licensing by empowering the Financial Secretary to specify the regulated activities (Clause 136 in Part V).

2.10 Flexibility in defining "financial products" is needed to cope with the rapid changes in the securities and futures industry. Modern financial engineering has created and continues to create a proliferation of derivative products as well as arrangements, which often defy clear and unambiguous categorization. This constant innovation demands that the approach to defining "financial products" be clear, yet sufficiently flexible to allow the regulatory framework to catch up with financial innovation. The vesting of power to specify what constitutes "securities", "futures contracts" and "investment arrangements" in the Financial Secretary will ensure flexibility in the regulatory jurisdiction. The ambit of the categories of "financial products" may be revised in a timely manner to accommodate rapid changes in market developments and innovations. A similar rationale applies to the power to specify "regulated activities".

2.11 The provision of such flexibility is in line with international trends and is increasingly a common feature in the modern securities legislation of developed markets. For example, under the Financial Services and Markets Bill[1] in the UK, the Treasury will be empowered to specify any form of investment vehicle or activity which is to be subject to the regulatory regime. Such flexibility is also inherent in the Australian regime. In the US, the need for such flexibility does not arise as the term "securities" is much more widely defined, as confirmed by case law.

[1] The Financial Services and Market Bill was presented to the UK House of Commons on 17 June 1999. It will replace, among other Acts, the Financial Services Act of 1986. Clause 20 of and Schedule 2 to the Bill seek to provide flexibility in adjusting the remit of the regulatory regime.

Facilitating cross-market surveillance

2.12 The Hong Kong financial system is a spectrum of deep and liquid markets comprising the banking, currency, securities and futures, insurance and the new comer mandatory provident funds. While these markets are each subject to a specific regulatory regime under different ordinances, investors and other market participants increasingly view them as one financial market. Globalization and rapid advances in technology and innovation have enabled investors to move rapidly from one market to another, arbitraging between markets, products and transactions.

2.13 Recognizing that the trend of convergence of markets is occurring in Hong Kong and globally, Hong Kong must not only update the legal frameworks for the regulation of individual markets but also, in the course of updating, allow different regulators to cooperate to close any regulatory gaps and ensure the health of the financial system as a whole.

2.14 Events during the Asian financial crisis amply confirmed this necessity. While cross-market activities revealed that investors and participants were increasingly treating the different markets as one market, regulatory laws and jurisdictions remained sectoral and segregated. As a result, no single regulator had all the information required to examine how activities across the different markets could impact on the market that it regulated. This meant that institutions that appeared to have been prudently managed under one regulatory regime could still fail due to risks incurred in another regulatory regime. Moreover, activities in one market could and did have direct and substantial impact on the health and stability of other markets within the financial system.

2.15 This has underscored the importance for the different financial market regulators to co-operate and communicate more closely with one another. In Hong Kong, steps have already been taken in this direction. The Cross-Market Surveillance Committee established in October 1998 under the leadership of the Financial Services Bureau, for instance, facilitates regular discussions and exchange among Hong Kong's financial regulators including the Hong Kong Monetary Authority (HKMA) and the SFC, and market operators including SEHK, HKFE and the Hong Kong Securities Clearing Company. This has enabled them to better monitor and address any cross-market risks and to take action as appropriate in the public interest or for safeguarding the integrity of the markets. To a large extent, the Risk Management Committee under the

newly established HKEx will assume this cross-market surveillance role given its statutory functions and membership[2].

2.16 Internationally, regulatory assistance and closer co-operation are achieved through memoranda of understanding between different regulators. In addition, international fora and working parties organized under the auspices of bodies such as IOSCO also foster better understanding and dialogue among regulators on issues such as the international economic order and financial stability.

2.17 Accordingly, the composite Bill formally recognizes the need for close communication and co-operation among Hong Kong's different financial market regulators. To this end, the regulatory objective referred to in paragraph 2.4(f) above, and the corresponding function in Clause 5(1)(o) of the composite Bill, formally vest in the SFC the role of assisting the Financial Secretary in maintaining the financial stability of Hong Kong. These new provisions provide the SFC with the jurisdiction to exercise its powers appropriately with respect to the sector and activities that it regulates, when so requested by the Financial Secretary to contribute towards more effective cross-market surveillance and regulatory activities. These are enabling provisions, designed to strengthen the SFC's ability as an independent regulator of Hong Kong's securities and futures market to work with other regulators to maintain the financial stability of Hong Kong.

OTHER ISSUES

2.18 Apart from addressing issues relating to the SFC's constitutional framework, Part II of the composite Bill also deals with a number of other related issues. Three of these in particular are worth noting –

(a) provisions aiming to minimize regulatory overlap;

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[2] The duties, powers and functions of the HKEx Risk Management Committee are to formulate policies on risk management matters relating to the activities of HKEx and its subsidiary exchange companies and clearing houses, and to submit such policies to HKEx Board for consideration. According to both the Exchanges and Clearing Houses (Merger) Ordinance and the constitution of HKEx, the Risk Management Committee shall consist of a chairman who is the chairman of the Board of HKEx, two members appointed by the Board (one of whom must also be a director elected by shareholders), and no more than five members appointed by the Financial Secretary.

(b) provisions relating to the SFC's accountability; and

(c) the delegability of the SFC's functions and powers.

Minimizing Regulatory Overlap

2.19 Related to the issue of cross-market surveillance is the potential for regulatory overlap. As noted above, the SFC's jurisdiction is confined to the securities and futures industry. However, the activities of authorized institutions[3] under the Banking Ordinance ("authorized financial institutions") in the securities industry may be caught under more than one regulatory net, that of the HKMA and the SFC. To minimize this regulatory overlap, the composite Bill provides for an exemption mechanism whereby the SFC may, in certain cases, exempt authorized financial institutions from the need to be licensed. Moreover, the composite Bill also introduces a new provision (Clause 5(3)) which provides that the SFC may rely upon the HKMA to conduct such supervision, regulation and surveillance of these exempt authorized financial institutions. The objective is to provide for a level playing field for all licensees and exempt authorized financial institutions under the composite Bill. This subject will be discussed further in Chapter 5 of this Consultation Document on the proposed licensing regime.

2.20 As part of the reform exercise, the SFC will also be updating its Memoranda of Understanding with other regulators with a view to seeking closer co-operation in implementing legislative reform measures and minimizing regulatory overlap.

Re-enacting Existing Accountability Provisions

2.21 The composite Bill reproduces the accountability arrangements currently under Part II of the SFC Ordinance. The more significant of these arrangements are as follows –

(a) the power to appoint the Chairman, Deputy Chairman and other members of the Board of Directors of the SFC shall continue to be vested in the Chief Executive (Clause 1 of Schedule 2 to Part I);

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[3] An "authorized institution" as defined under the Banking Ordinance (Cap. 155) means a bank, a restricted licence bank or a deposit-taking company.

(b) the Board itself shall continue to comprise an equal number of Executive and Non-Executive Directors (Clause 1 of Schedule 2 to Part I);

(c) the Chief Executive shall continue to have the power to give directions to the SFC regarding the furtherance of its objectives and the performance of its duties and functions (Clause 11);

(d) the Chief Executive shall retain the power to approve estimates of the SFC's income and expenditure. Moreover, as before, the Financial Secretary shall cause the estimates to be laid before the Legislative Council (Clause 13);

(e) the Director of Audit may at any reasonable time examine the books and records of the SFC (Clause 16);

(f) the SFC shall remain under a duty to furnish information to the Financial Secretary as specified (Clause 12);

(g) the current system of an advisory committee, comprising members of the securities and futures industry appointed by the Chief Executive, to advise the SFC on policy matters will continue (Clause 7); and

(h) the investment of funds of the SFC which are not immediately required shall continue to be subject to the Financial Secretary's approval (Clause 17).

2.22 In this legislative reform, we have taken the opportunity to review the need to enhance existing checks and balances to ensure proper exercise of both existing and proposed powers of the SFC. In addition to the existing accountability arrangements referred to in this chapter, specific safeguards are introduced for certain powers, like those for the inquiry and investigative powers mentioned in Chapter 6. Some other new accountability arrangements are also highlighted in Chapter 1.

Delegable and Non-Delegable Functions

2.23 Under the composite Bill, the SFC is granted a range of powers and functions. It is necessary that some of these be delegated to its staff and committees. Needless to say, any such delegation should not compromise the high standards of decision-making expected of the SFC. To this end, adequate safeguards must be in place to ensure that any delegations that are made are appropriate, necessary and responsible.

2.24 When the SFC Ordinance was introduced into the Legislative Council in 1989, Members considered that there was a need for adequate safeguards to ensure proper exercise of powers by the SFC. At that time, there was concern about the possibility of excessive delegations by the SFC to its executive in the exercise of important powers. As a result, section 9 of the SFC Ordinance was introduced as a Committee Stage amendment. That section drew out the ambit of the SFC's powers to delegate its functions. It provides for a separate Schedule to the Ordinance to set out the more important SFC powers and functions to be made non-delegable under any circumstances. The Schedule is subject to approval by the Legislative Council.

2.25 Clause 10 of the composite Bill essentially re-enacts section 9 of the SFC Ordinance. As for the non-delegable powers and functions, these are specified in Part 2 of Schedule 2 to the Bill. It will be seen that the list of non-delegable functions has been greatly expanded so as to encompass matters of broad market impact and any functions which involve consultation with the Financial Secretary.

2.26 In the 1989 legislative exercise, the Administration had undertaken to the Legislative Council that all SFC powers would be exercised with great care and that the SFC would establish its own procedures and arrangements for delegation. Currently, all proposals for delegations are subject to approval by the SFC's full Board of Directors (comprising all Executive and Non-Executive Directors). This provides an adequate check on the exercise of the power to delegate. In making a decision on delegation of power, the full Board will take into account factors such as the importance of the power proposed to be delegated, the seniority of the officer to which the delegation is proposed, and the severity of the consequences of the exercise of such power on the persons affected thereby.

CHAPTER 3

PART III OF THE SECURITIES AND FUTURES BILL

EXCHANGE COMPANIES, CLEARING HOUSES, EXCHANGE CONTROLLERS, INVESTOR COMPENSATION COMPANIES AND AUTOMATED TRADING SERVICES

INTRODUCTION

3.1 Part III of the composite Bill deals with market operators who provide exchange and/or clearing functions for transactions in securities and futures contracts. These operators may assume certain public functions governing those who have access to their facilities and services, including market surveillance, intermediaries supervision, compensation arrangement for investors as well as listing activities and relevant conduct of listed corporations. The SFC, being the regulator of the securities and futures market, has the responsibility to ensure proper discharge of such regulatory functions by market operators by coordinating closely with these operators and assuming a regulatory oversight.

3.2 Stemming from the market structure reform[1] announced by the Financial Secretary in the 1999 Budget Speech, the five exchanges and clearing houses[2] were brought under common ownership by a single operator with the formal establishment of HKEx on 6 March 2000. This is an important milestone in the development of our securities and futures market. HKEx is a public company limited by shares and aims to be listed on its subsidiary stock exchange (i.e., SEHK) later this year. Different from its subsidiary exchanges and clearing houses before merger, HKEx is a commercial entity that has profit-making as one of its objectives. To provide a new regulatory

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[1] More details of the market structure reform are set out in the documents entitled "A Policy Paper on Securities and Futures Market Reform" and "Hong Kong Exchanges and Clearing Limited – Reinforcing Hong Kong's Position as a Global Financial Centre" published in March and July 1999 respectively.

[2] The five market operators are the Hong Kong Futures Exchange Limited, the HKFE Clearing Corporation Limited, the Hong Kong Securities Clearing Company Limited, the Stock Exchange of Hong Kong Limited and the SEHK Options Clearing House Limited.

framework for HKEx to operate, the Exchanges and Clearing Houses (Merger) Ordinance ("the Merger Ordinance") was enacted on 24 February 2000. The Merger Ordinance establishes safeguards to ensure an appropriate balance between the commercial interests of the new entity on the one hand and its public duties on the other. These safeguards have been incorporated in Part III of the composite Bill accordingly.

OVERVIEW OF THE PROPOSED REGULATORY FRAMEWORK

3.3 The existing regulatory framework that is primarily provided for in the Stock Exchanges Unification Ordinance, Part III of the Commodities Trading Ordinance and the Securities and Futures (Clearing Houses) Ordinance, has generally been working effectively. We have largely retained the existing framework in the composite Bill. Key features of the proposed regulatory framework are set out below.

(a) **Recognition** (Clauses 19, 38, 59, and 77) : The SFC, with the consent in writing of the Financial Secretary or in consultation with the Financial Secretary as the case may be, recognizes a company as a controller of an exchange company or a clearing house, an exchange company, a clearing house or an investor compensation company (referred to collectively as "recognized companies"); where it is satisfied that so doing is in the interest of the public, and for the proper regulation of markets.

(b) **Statutory duty and immunity** (Clauses 23, 40, 64, and 80) : The recognized companies have certain statutory duties corresponding to their nature of operation. In discharging their duties, they enjoy statutory immunity, provided that they act with reasonable care and in good faith.

(c) **Rule-making powers** (Clauses 24, 25, 36, 41, 42, 66, 67, 81, and 82) : The SFC may make statutory rules for regulating how the recognized companies discharge their functions. The recognized companies may also make non-statutory rules, subject to the approval of the SFC, for such matters as are necessary and desirable for performing their public functions, as specified in the statute.

(d) **Transfer of Regulatory Functions** (Clauses 26, and 78) : The SFC may with the approval of the Chief Executive in Council, transfer to a recognized exchange company or a recognized investor compensation company ("ICC") its functions. For example, the SFC transferred its regulatory functions regarding listing activities to SEHK under section 47 of the SFC Ordinance. This transfer mechanism provides an avenue to minimize regulatory overlap between the SFC and these recognized companies, and allows the SFC to entrust in the recognized companies certain regulatory functions which they are able and willing to perform.

(e) **Authorization of Automated Trading Services** (Clause 94) : Automated Trading Services ("ATS") refer to services provided by means of electronic facilities, whereby securities and futures related transactions can be negotiated, concluded, novated and cleared. The SFC may either license a person under Part V to provide ATS, or authorize a person under Part III to provide ATS where it is satisfied that the authorization is in the interest of the public.

(f) **Safeguards** : The composite Bill preserves the safeguards in the existing legislation and extends their application to the new recognized companies, namely controllers of an exchange company or clearing house, and ICCs. Accordingly, where it is in the interest of the investing public or in the public interest or is required for the proper regulation of recognized companies, the SFC may take any of the following courses of action -

(i) issuance of restriction notices (Clause 91) to require a recognized company to change its memorandum or articles of association or rules and regulations or to take certain action. A restriction notice can also be served prohibiting any such company from doing such things relating to the conduct and operation of its business as specified in the restriction notice;

(ii) issuance of suspension orders (Clause 92) relating to the functions of –

- the board of directors or governing body;

- a director or member of the governing body;

- a committee or sub-committee;

- the Chief Executive Officer;

(iii) application to the Chief Executive in Council for resumption of regulatory functions that have been transferred (Clauses 26, 78 and paragraph (d) above); and

(iv) withdrawal of recognition (paragraph (a) above and Clauses 28, 43, 70, and 83).

The exercise of the powers in (i) to (iv) above by the SFC is itself subject to a series of procedural safeguards. For instance, Clauses 33, 44, 71, and 84 of the composite Bill allow a company affected to lodge an appeal to the Chief Executive in Council. Moreover, these powers are made non-delegable under Clause 10. They are therefore not intended to be used lightly.

MARKET DEVELOPMENT AND NEW ELEMENTS INTRODUCED IN THIS LEGISLATIVE REFORM

3.4 This legislative reform seeks to rationalize the discrepancies among existing statutes governing the stock exchange, the futures exchange and the relevant clearing houses. Major changes proposed to the existing regulatory framework, enshrined in Part III of the composite Bill, are primarily to cater for the emergence of new operators in the securities and futures market, namely HKEx, ICCs, ATS providers, as well as overseas exchanges that operate in Hong Kong and target at investors in Hong Kong.

Regulatory interface between the SFC and HKEx (Clauses 59-76)

3.5 As mentioned in paragraph 3.2 above, HKEx is intended to operate as a commercial entity. It is also vested with certain public functions. The design of HKEx's dual public-and-commercial role is deliberate. HKEx's operation will be governed by the existing regulatory framework for market operators, with additional safeguards to make sure that HKEx will strike an appropriate balance between its commercial objectives

and public roles in performing its functions. In particular, the Merger Ordinance requires HKEx to establish a Risk Management Committee to formulate policies on risk management matters relating to its activities as well as the activities of its exchanges and clearing houses and to submit such policies to the HKEx Board for consideration. Please also refer to paragraph 2.15.

3.6 As regards the division of regulatory functions between the SFC and HKEx's subsidiaries, a review is underway in accordance with the policy framework laid down for the merger exercise in July 1999. New arrangements are at different stages of implementation as and when they are ready.

Investor compensation companies

3.7 The concept of establishing the ICC has its origin in the "Consultation Paper on New Investor Compensation Arrangements for Hong Kong" issued by the SFC in 1998. The proposals in the paper have received general support of both the Legislative Council Panel on Financial Affairs and the public. The exercise is a comprehensive review of the compensation arrangements in the securities and futures market. Part III of the composite Bill deals with the institutional framework for implementing the proposed new compensation arrangements. It also provides for the regulatory relationship between the SFC and the ICC, which is largely modeled on the existing framework designed for other market operators as outlined in paragraph 3.3 above. Other elements of the new compensation arrangement, like payments to and out of the compensation funds, are subject matters of Part XII of the composite Bill. Please refer to Chapter 10 of this Consultation Document for more detail.

3.8 Under existing law, the SFC administers the assets held in the Unified Exchange Compensation Fund and the Futures Exchange Compensation Fund, whilst the recognized exchange companies receive and determine claims and make apportionment where necessary. Although this arrangement provides certain checks and balances, it is cumbersome. There is also concern over potential conflicts of interest of the exchanges in relation to their role in the compensation process, both as contributors to the funds and the bodies to determine payment out of the funds. In this legislative reform exercise, an independent company, an ICC, will be recognized by the SFC for dealing with investor compensation matters, where it is in the interest of

the investing public or in the public interest that the company be so recognized. The composite Bill allows for the recognition of more than one ICC. The SFC has already initiated discussions with HKEx on the new investor compensation proposals, given the need to reach suitable arrangements with the underwriters and exchange participants in time for the proposals to be implemented as soon as possible after the composite Bill is enacted. The composite Bill provides for a flexible and broad framework for such discussions and should not restrict the development of these proposals and arrangements.

Automated Trading Services

3.9 Advance in information technology enables the sale and purchase of securities and futures contracts via a network of telephone and computer connection. This effectively could eliminate the need for a physical stock exchange or futures exchange. These new fora for trade create a wide range of new regulatory issues and concerns that are not adequately addressed under current legislation, and pose challenges to the regulator as they become more sophisticated and increasingly popular among investors. The composite Bill acknowledges their presence and seeks to address the new regulatory issues with flexibility.

3.10 It is well recognized that individual ATS can operate very differently, depending on accessibility, target investor group, product range, services provided, size of transactions, total trading volumes, etc. Accordingly, the composite Bill adopts a flexible and pragmatic approach. It empowers the SFC to examine each application for the provision of ATS and, on the basis of the specifics of each application, to determine which rules are to be applied. Providers of ATS will either be licensed as an intermediary under Part V or authorized like other recognized companies operating in the market under Part III of the composite Bill[3]. Through this proposed

[3] Examples of areas covered by rules made by the SFC in respect of authorization of ATS under Part III of the composite Bill include –

(a) the standards of conduct in relation to the provision of automated service;

(b) steps to be taken to avoid and deal with conflicts of interest;

(c) steps to ensure that there is integrity, transparency and fairness in transactions conducted through the service; and

(d) procedures to discourage and identify any money laundering activities.

They are similar to rules governing an exchange for ensuring adequate market surveillance, managing systemic risks, enhancing market liquidity, monitoring system capabilities, regulating user admission standards, etc.

arrangement, the composite Bill seeks to provide an environment that will facilitate the growth of ATS operations in Hong Kong whilst at the same time ensures adequate regulation for investor protection. It is noteworthy that the proposed approach has been adopted elsewhere, including the US and the UK. To provide for clarity and certainty to ATS providers, the SFC has undertaken to promulgate guidelines which set out in greater detail as to how it is going to discharge its statutory functions in respect of ATS. We expect that the guidelines will be ready for market consultation when the composite Bill is introduced into the Legislative Council later this year.

3.11 We have received market comments in the July 1999 consultation exercise on the major proposals to be included in the composite Bill, that the composite Bill should not seek to regulate ATS based largely overseas. After careful consideration, we are not in favour of taking a narrow view of the proposed regulatory scope. For more effective investor protection, the SFC should be allowed to bring into the regulatory net any ATS provider that targets at investors in Hong Kong. This is in line with overseas regulatory regimes for ATS. We do not underestimate the enforcement difficulties arising from extra-territoriality complication. The SFC will seek to overcome them through enhanced cooperation with overseas regulators.

3.12 Another area of concern expressed in the last consultation exercise is how ATS will co-exist with the monopoly currently enjoyed by SEHK. Under the composite Bill, only SEHK, HKEx and any other companies of which HKEx is the controller may, with recognition by the SFC, operate a stock market in Hong Kong. Providers of ATS which constitute a stock market will have to become an exchange participant before it will be authorized by the SFC for provision of such service. The term "stock market" will continue to be defined as in the Securities Ordinance.

Exchanges from outside Hong Kong

3.13 At present, a few overseas exchanges have a small operation in Hong Kong, providing ATS to investors in Hong Kong for investing in overseas markets. This is a natural development of an increasingly globalised market. These exchanges are subject to regulation by the countries in which their operations are based. The composite Bill empowers the SFC to recognize a stock exchange or futures exchange from outside Hong Kong for the purpose of providing ATS to local investors, and equips the SFC

with a clear statutory basis to withdraw the recognition. This regulatory arrangement will put the above exchange operations in Hong Kong on a par with other market operators who are already subject to the SFC's regulation.

CHAPTER 4

PART IV OF THE SECURITIES AND FUTURES BILL

OFFERS OF INVESTMENTS

INTRODUCTION

4.1 Part IV of the composite Bill deals with the regulatory framework for the offering of investment products. In drafting this Part, particular note has been taken of Hong Kong's status as a regional centre for portfolio management activity, evidenced by its integrated network of institutions and markets and the wide range of products and services provided by them to both local and international investors. With a view to maintaining this status, the focus has been on -

(a) providing a favourable environment for the development of the securities and futures industry and for the continued availability of as wide a range of investment options as the market can offer;

(b) ensuring a level playing field for market participants; and

(c) promoting sound business standards and ensuring a reasonable level of investor protection.

4.2 To this end, a number of changes have been introduced under Part IV. The ensuing paragraphs highlight the more significant of these by first setting out an overview of the proposed regulatory framework and then discussing improvements to the existing regime.

OVERVIEW OF PROPOSED REGULATORY FRAMEWORK

4.3 Under the existing law, offers of investments are regulated under –

(a) the Protection of Investors Ordinance (Cap. 335), which provides for the authorization by the SFC of advertisements, invitations and documents relating to

securities and investment arrangements in respect of property other than securities; and

(b) section 15 of the Securities Ordinance (Cap. 333), which provides for the authorization by the SFC of unit trusts and mutual fund corporations.

4.4 The regulatory framework for offers of investments proposed in this legislative reform builds upon these existing legislative provisions. However, changes have been introduced to resolve some of the practical difficulties faced in the past and address potential issues that may arise in the wake of increasing market and product development. The key features of the proposed framework are summarized below.

(a) **Authorization of advertisements, invitations and documents relating to investments (Clauses 102 and 104)**

As under the Protection of Investors Ordinance, the composite Bill imposes a general prohibition on the issue to the public of advertisements, invitations and documents relating to a wide range of investments. A breach of this general prohibition is an offence, but the prohibition is subject to a number of exemptions that are essentially carried down from the current legislation, including –

(i) specified categories of documents, such as –

- advertisements, invitations and documents the issue of which the SFC has authorized; and

- prospectuses which comply with or are exempt from compliance with Part II of the Companies Ordinance (Cap. 32); and

(ii) specified categories of persons issuing such documents, such as –

- mere conduits in the issue of such advertisements, invitations or documents; and

- licensed or exempt securities dealers, or licensed or exempt securities advisers, provided they comply with the relevant requirements prescribed by the SFC.

As already noted, one exception to the general prohibition discussed above is the issue of advertisements, invitations and documents which the SFC has authorized to be issued. The composite Bill specifically confers this power of authorization on the SFC and further provides that, in authorizing such issue, the SFC may impose such conditions as it considers appropriate, including conditions on the matter to which the advertisement, invitation or document relates. The SFC may also, from time to time, amend or cancel the conditions imposed or impose new ones. Where necessary, the SFC may also withdraw any authorization granted.

(b) **Authorization of products (Clause 103)**

Apart from authorizing the issue of advertisements, invitations and documents relating to investments, Part IV also empowers the SFC to authorize the investment products themselves. These are collectively described as "collective investment schemes" and essentially include unit trusts, mutual funds and investment arrangements. As in the case of authorizing the issue of advertisements, invitations and documents relating to investments, in authorizing collective investment schemes, the SFC may –

(i) impose such conditions as it considers appropriate;

(ii) amend or cancel these conditions or impose new ones; and

(iii) in appropriate cases, withdraw any authorization granted.

(c) **Statutory prohibition over use of any fraudulent or reckless misrepresentations to induce others to invest money (Clauses 106 and 107)**

As under the existing legislation, Part IV prohibits and makes it an offence for a person to induce another, by any fraudulent or reckless misrepresentation, to invest money. Also retained under this Part as a further safeguard, is the clear private right of action by investors to recover compensation for any pecuniary loss sustained by any person in consequence of the reliance by that person on any fraudulent, reckless or negligent misrepresentation if the loss was within the reasonable contemplation of that person and the person who made the misrepresentation at the time of reliance.

IMPROVEMENTS TO EXISTING LEGISLATION

4.5 As briefly noted above, a number of changes have been introduced under Part IV. Most of these are aimed at –

(a) removing ambiguities and gaps in the present legislation;

(b) countering practical difficulties faced in the past; and

(c) addressing issues arising from market development and the increasing emergence of new, diverse and complex investment products.

4.6 The following highlights some of the more significant changes introduced under Part IV.

(a) **Authorization of products vs. authorization of marketing material**

Save in the case of unit trusts and mutual fund corporations, the focus under the existing legislation has been on securing authorization for the issue of advertisement, invitation or document (generally referred to as marketing material) relating to an investment product rather than for the product itself. This has raised questions as to the extent to which the SFC, in approving such marketing material, can also impose structural and operational requirements on the product itself. The matter has perhaps been further complicated by the fact that the existing legislation does not confer upon the SFC an express power to authorize the issue of such marketing material but merely implies it by exempting from the general prohibition any issue of marketing material authorized by the SFC. To address these uncertainties, the composite Bill, under Part IV –

(i) retains the SFC's power to approve the issue of marketing material relating to investments but makes such power explicit (Clause 104);

(ii) expressly clarifies that, in authorizing the issue of marketing material relating to an investment product, the SFC may impose such conditions as it considers appropriate including, specifically, conditions on the matter to which the material relates (Clause 104); and

(iii) expressly empowers the SFC to authorize any collective investment scheme, i.e., to authorize the investment product itself (Clause 103).

(b) **Ambit of the SFC's power of authorization**

Under the current legislation, only two categories of investment products are specifically regulated, namely, unit trusts and mutual funds. Other investment products (which may or may not relate to securities) such as investment-linked assurance schemes, pooled retirement funds and immigration-linked investment schemes, are also regulated but only to the extent that their marketing materials are required to be authorized by the SFC. There is no proper basis for this distinction and it may lead to inadequate investor protection. This situation is certainly less than satisfactory. To address this anomaly, the composite Bill, under Part IV, provides the following –

(i) a new term "collective investment schemes" is introduced, which is defined to include familiar market concepts such as unit trusts, mutual funds and investment arrangements;

(ii) the SFC is empowered to authorize any collective investment schemes, including investment arrangements; and

(iii) a new definition for the term "investment arrangements" is also introduced which covers arrangements in respect of any property, not just property other than securities. This is necessary to tally with the scope of the existing general prohibition on marketing material which may relate to securities or investment arrangements in respect of property other than securities. In addition, it is felt necessary to confine the application and scope of the new definition which may otherwise be considered as too wide. Several qualifying factors are inserted in the new definition to better reflect the special nature of these arrangements, notably that investors' contributions are collectively managed by professional managers.

(c) **Withdrawal of authorization (Clause 105)**

Under the existing legislation, the SFC is not expressly empowered to withdraw any authorization granted. This poses problems with an investment product when its operators have breached the conditions for authorization. In such cases, the SFC is left with no express power to withdraw the authorization for investor protection. This deficiency is corrected under Part IV by the inclusion of an express provision

empowering the SFC to withdraw authorization. This power will ensure that operators and sellers of investment products abide by the conditions of any relevant authorization and thus better safeguard the interests of investors.

These changes provide the flexibility necessary to better ensure that the SFC's jurisdiction to authorize investment products keeps pace with developments in the market, thus allowing for better investor protection.

TASKS AHEAD

4.7 This legislative reform does not address the issue of granting exemption on the basis that the "audiences" of advertisements or products are sophisticated or high net worth individuals, generally perceived to be able to protect their own interests. However, we support in principle this distinction for the purposes of regulation. To this end, in November 1999, the SFC formed a working group with market representation to consider the issue and any necessary separate legislative amendment. This review is being undertaken as a separate exercise, given its complexity and the need for extensive market consultation. The working group aims to complete its study and to put forward recommendations to the Government by the end of this year.

4.8 A related issue concerns intermediaries who, under the current law, are not required to be regulated by the SFC in respect of their dealings in certain investment schemes that are not regarded as securities. It is clear that advising upon or dealing in certain types of investment arrangements does not require a licence from the SFC nor from any other regulator in Hong Kong, even though the products advised upon or dealt in are functionally substitutable for unit trusts, mutual funds and certain types of insurance linked products and give rise to exactly the same types of investor protection issues. The Financial Services Bureau, the SFC, the HKMA, the Mandatory Provident Fund Schemes Authority and the Insurance Authority are looking into this issue in parallel with a view to identifying a satisfactory solution that both achieves the regulatory objective and minimizes regulatory overlap.

CHAPTER 5

PARTS V-VII OF THE SECURITIES AND FUTURES BILL

THE NEW LICENSING REGIME

INTRODUCTION

5.1 In June 1999, having undertaken a comprehensive review of the licensing regime governing intermediaries providing services in respect of securities, futures and leveraged foreign exchange trading, the SFC published a consultation document entitled "Consultation Paper on Review of Licensing Regime" ("the 1999 consultation document").

5.2 The 1999 consultation document highlighted the need for reform of the licensing regime if Hong Kong was to maintain and strengthen its competitive advantage as a leading international financial centre. With advances in information technology and communications, geographical distances have become insignificant and competition among global markets has intensified. In these circumstances, the presence in Hong Kong of a pool of competent licensed intermediaries is increasingly vital to the growth and development of the local market and, ultimately, to its competitiveness in the international arena.

5.3 The 1999 consultation document set out proposals for amending existing laws and practices governing the licensing of intermediaries who provide services in respect of securities, futures and leveraged foreign exchange trading, and invited public comments on these proposals. An extract from the consultation document setting out these proposals is at Annex D. The document further noted that the new licensing regime must, among other things –

(a) provide minimum barriers to entry without lowering standards;

(b) give equal and fair access to all suitably qualified applicants for a licence;

(c) establish a streamlined framework that minimizes costs for intermediaries without compromising regulatory objectives; and

(d) set proper standards for internal organization and operational conduct so that there are adequate and appropriate controls over those managing or influencing the management of the "regulated activities" of intermediaries (see paragraph 5.11).

5.4 Equally essential, however, is the need for the new licensing regime to be forward looking and flexible enough to accommodate new products and services, especially as the role of intermediaries and the services provided by them become increasingly sophisticated and versatile.

5.5 Parts V to VII together with Schedule 6 to the composite Bill implement many of the proposals set out in the 1999 consultation document, after taking into account the feedback from the public consultation. Briefly –

(a) Part V and Schedule 6 delineate the activities for which a licence is required. Part V also stipulates who may apply for such licences, setting out the procedures for application and the various criteria and conditions to be met;

(b) Part VI deals with operational requirements and provides for rules to be made by the SFC. These include capital requirements, requirements relating to the treatment and handling of client assets, the keeping of accounts and records by intermediaries and audit requirements; and

(c) Part VII empowers the SFC to make rules and to issue guidelines in respect of standards of business conduct expected of licensed persons. Under this Part, the SFC is also empowered to make rules relating to requirements for options trading.

5.6 What follows is an overview of the new regime, highlighting some of the more significant improvements to the proposals made in the 1999 consultation document. An overview is also given of the exemption status of authorized institutions under the Banking Ordinance ("authorized financial institutions") under these reforms.

OVERVIEW OF THE PROPOSED LICENSING REGIME

5.7 Under the existing registration system, there are eight functional categories of registration relating to three product areas. These are –

(a) dealers and their representatives in securities and futures;

(b) advisers and their representatives in securities and futures;

(c) leveraged foreign exchange traders and their representatives; and

(d) securities margin financiers and their representatives.

5.8 The legal framework governing these eight categories of registration is currently interspersed over four Ordinances, namely the Securities Ordinance, the Commodities Trading Ordinance, the Leveraged Foreign Exchange Trading Ordinance and the SFC Ordinance. The composite Bill consolidates and revises these different provisions and puts in place a modern streamlined framework for the licensing of intermediaries. The key features of the new system are set out below.

Introduction of a single licence

5.9 Under Part V, a new "single licence" concept is introduced whereby existing registrants will be issued a single licence authorizing them to provide a range of specified services. This does away with the need to apply for different categories of registration and the need to file separate and different returns and documents in respect of the various registrations. Registrants can also engage in a number of different "regulated activities" through one corporate vehicle. As a result, costs and administrative burdens are reduced for both the intermediaries and the regulator. Moreover, this benefit of the economies flowing from a single licence does not come at the expense of compromising investor protection.

5.10 There is however an exception to the single licence arrangement. Securities margin financiers and their representatives will have to conduct their business through a separate corporation and will therefore require a separate licence. This separation has been introduced for risk management purposes.

Activities requiring a licence

5.11 The activities that require a licence under Part V (described and referred to in the composite Bill as "regulated activities") are stipulated in Schedule 6 to the composite Bill. They are –

(a) dealing in securities;

(b) dealing in futures contracts;

(c) trading in leveraged foreign exchange contracts;

(d) advising on securities;

(e) advising on futures contracts;

(f) advising on corporate finance;

(g) providing automated trading services;

(h) providing securities margin financing; and

(i) providing asset management.

5.12 Provision is made for the flexibility to amend or add to the above list of "regulated activities" to cater for future developments. This flexibility is built into Clause 136 which empowers the Financial Secretary to revise the list of "regulated activities" by notice in the Gazette.

Persons required to be licensed

5.13 Under Part V, persons engaging in one or more "regulated activities" must apply to the SFC for a licence, unless they have been exempted or have the benefit of one of the exclusions. Essentially two types of licences are created under the composite Bill: corporate licences and representative licences. Persons who may apply for such licences are –

(a) in the case of corporate licences, corporations that carry on business in any of the "regulated activities"; and

(b) in the case of representative licences, individuals who perform or take part in any act which constitutes a "regulated activity" for or on behalf of a licensed corporation.

5.14 Under the new licensing regime, only corporations may be licensed to carry on business in a "regulated activity". Individuals, sole-proprietorships and partnerships shall not be licensed for this purpose. However, transitional arrangements have been made in Part XVII of and Schedule 10 to the composite Bill in respect of existing registrants who are not corporations. This is discussed in Chapter 15.

Obligations of officers and management

5.15 In addition to requiring persons who participate in "regulated activities" to obtain a representative licence, Part V also introduces a "responsible officer" concept. Every licensed corporation has to nominate for the SFC's approval at least two persons as its "responsible officers", responsible for directly supervising the conduct of the "regulated activities" of the licensed corporation. The composite Bill further requires every executive director of a licensed corporation to be approved by the SFC as a "responsible officer". The SFC will not approve a person as a "responsible officer" unless he has the necessary qualifications and experience to discharge his supervisory function and, perhaps more importantly, he has sufficient authority within the corporation to do so. All "responsible officers" are also required to take out a representative licence.

Entry criteria

5.16 Clauses 115, 116, 119 and 121 set out the criteria to be met when a person applies for a corporate or representative licence. The most important of these criteria is that the SFC has to be satisfied that the applicant is a fit and proper person to be licensed. In determining such fitness and properness, the SFC is required to take into account a number of matters. These are set out in Clause 126 and include matters such as the applicant's financial status, qualifications, experience, ability, reputation, character, reliability and financial integrity.

5.17 Apart from an applicant's fitness and properness, the SFC is also required to have regard to a number of other matters. These include –

(a) in the case of corporations applying for a corporate licence, their ability, if licensed, to comply with the Financial Resources Rules, and the adequacy of their insurance coverage in respect of prescribed risks; and

(b) in the case of individuals applying for a representative licence, their competence to carry out their duties to the requisite standard and whether their accreditation to a licensed corporation has been approved.

5.18 As under the existing legislation, a licensed person is required to continue to satisfy the fit and proper criteria to remain licensed. The relevant provisions in this regard are set out in Part IX of the composite Bill, which are discussed in Chapter 7.

Securing public confidence

5.19 In order to secure public confidence in the new licensing regime and, ultimately, in Hong Kong's securities and futures market, it is imperative that the legal framework gives investors the assurance that intermediaries and their representatives are financially sound and honest, and that they will treat their clients fairly. To this end, the composite Bill empowers the SFC to –

(a) make rules on technical details relating to areas of regulatory concern – as provided for in Parts VI and VII;

(b) conduct continuous supervision of its licensees with a view to ensuring their compliance with all relevant legal requirements and licensing conditions – as provided for in Part VIII; and

(c) impose disciplinary sanctions on intermediaries, including revoking or suspending their licence, reprimanding them or imposing a fine on them, in case of misconduct – as provided for in Part IX.

Exemption and exclusions

5.20 Lastly, as briefly noted above, all persons engaging in one or more "regulated activities" must apply to the SFC for a licence unless they have been exempted or have the benefit of one of the exclusions.

5.21 As regards exemptions, Clause 118 empowers the SFC to exempt corporations, which are authorized financial institutions, from the requirement to be licensed under Part V. Currently, exemption is not limited to authorized financial institutions.

5.22 The exemption in relation to authorized financial institutions is intended to minimize regulatory overlap given that authorized financial institutions are already subject to close supervision by the HKMA. The regulatory framework under the composite Bill for exempt authorized financial institutions is discussed in greater detail in paragraphs 5.47 to 5.62 below.

5.23 As under the existing legislation, provision is made for the exclusion from registration of certain groups of persons or activities pertaining to securities, futures contracts, and leveraged foreign exchange contracts conducted under specified circumstances. Several new exclusions have also been introduced in this reform. They are set out in Schedule 6 to the composite Bill.

5.24 As regards exclusions, in view of earlier concerns expressed by the Hong Kong Society of Accountants and the Trustees Association, it is worth noting that the composite Bill continues to exclude professional accountants and practising solicitors from the licensing regime where they are providing advice wholly incidental to their profession. As for trustee companies registered under Part VIII of the Trustee Ordinance (Cap. 29), they will continue to be excluded, albeit to a lesser extent. This is discussed in greater detail in paragraphs 5.41 to 5.44 below.

5.25 In addition, the composite Bill continues to exclude persons who, as principal, trade with another whose business involves the acquisition, disposal or holding of securities whether as principal or agent. This is commonly known as the "professional exemption".

HIGHLIGHT OF NEW REGULATORY ELEMENTS

5.26 While the proposals set out in the 1999 consultation document have been largely incorporated in Parts V to VII of and Schedule 6 to the composite Bill, certain changes to these proposals have been included where appropriate in the light of comments received during the public consultation. The following paragraphs in this section highlight some of the proposals exposed for consultation in June 1999, which attracted greater market concerns and where necessary are refined and modified in the light of such concerns.

Management responsibility – "responsible officer"

5.27 The "responsible officer" concept (discussed in paragraph 5.15 above) was included among the June 1999 proposals. In response, concerns were raised as to how this concept would be implemented. In particular, it was pointed out that in the case of intermediaries with worldwide operations, it might not be realistic to expect all members of the top management to obtain a licence from the SFC as they may be based overseas or may be making decisions at the global or regional strategic level.

5.28 We appreciate that the introduction of the "responsible officer" concept may place a greater regulatory burden on international intermediaries. However, given that the activities and operations of a licensed corporation are ultimately in the hands of its controlling minds, the introduction of the "responsible officer" concept is necessary for investor protection. Moreover, it is in keeping with international regulatory practice[1].

5.29 While retaining this concept, the composite Bill confers on the SFC a degree of flexibility. Under Clause 129, the SFC may waive or modify requirements relating to the need to nominate and secure approvals for "responsible officers" provided that it is

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[1] In the UK, both the Securities and Futures Authority Limited and the Investment Management Regulatory Organisation Limited require their member firms' accredited senior officers, including the compliance officers, who have responsibility for the firms' management, to seek registration. The Financial Services and Markets Bill contains a provision which empowers the Financial Services Authority ("FSA") to require a person who is able to exercise a significant influence on the conduct of an authorised firm's affairs to seek approval from the FSA prior to that person's employment.

In the US, the National Association of Securities Dealers imposes similar registration requirements on persons having a supervisory or managerial role over a firm's functions (including back office function). Likewise, under the Commodity Exchange Act, registration is required of persons who exercise a controlling influence over a regulated firm's activities.

satisfied that the granting of such wavier or modification would not be contrary to the interest of the investing public.

5.30 The SFC has also undertaken to issue guidelines which will indicate the manner in which it proposes to enforce licensing requirements, including therefore requirements relating to the nomination and approval of "responsible officers" of both local and international intermediaries. Reference will be made to overseas regulatory experience in developing these guidelines. Views are welcome on what should be included in the guidelines to ensure certainty, clarity and equity. The SFC aims to have these guidelines drafted for consultation when the composite Bill is finalised for introduction into the Legislative Council later this year.

Management liability

5.31 Related to the issue of "management responsibility" is the issue of "management liability". The SFC carries out regular inspections of licensed corporations to ensure their compliance with relevant statutory requirements. However, inspections alone do not suffice and the regulator must rely upon the senior personnel of licensed corporations for the purposes of ensuring such compliance at all times. In these circumstances, it is all the more imperative that such senior personnel are held responsible and accountable for their actions and omissions and, where appropriate, for the breaches of the corporation.

5.32 To this end, the composite Bill adopts a "management liability" concept. Under a number of provisions in Parts V to VII, both the "responsible officers" of a licensed corporation and the corporation itself, are liable for breaches by the corporation of certain fundamental regulatory requirements.

5.33 There is a defence available to such officers in this regard. The defence, which is largely based on similar provisions under the Companies Ordinance, is expressly provided for under Part XVI of the composite Bill (Clause 367) and essentially discharges a member of management from liability if he can show that he honestly and reasonably believed the failure would not occur or, upon becoming aware of the breach, acted promptly in notifying the SFC and, until then, honestly and reasonably believed that the failure would not occur.

5.34 The proposals put forward in the June 1999 consultation document did not include the concept of holding "responsible officers" liable for a corporation's breaches. Therefore, it has not benefited from public consultation. Market comments and feedback in this regard would therefore be especially welcome.

Senior management in charge of compliance, settlement and risk management

5.35 The SFC's 1999 consultation document highlighted the need for licensed corporations to put in place and maintain at all times proper and adequate internal controls and suitable risk management systems. It also noted the consequent significance of the role played by staff in charge of compliance, settlement and risk management. Against this background, the 1999 consultation document proposed two options for ensuring that senior staff in charge of these critical functions are fit and proper to hold their positions. These options are –

(a) requiring all senior officers of a licensed corporation, who are in charge of compliance, settlement and risk management, to be licensed by the SFC as representatives; and

(b) setting out in the SFC's "Code of Conduct" the credentials expected of such senior officers and the requirement that management must ensure that senior officers do possess such credentials.

5.36 On the basis of the comments received and the SFC's recommendations, the Government has chosen option (b), which allows for greater flexibility and lower regulatory costs without compromising regulatory standards.

Provisional licences

5.37 In cases where there is nothing adverse known to the SFC about an applicant for a licence, and the applicant can satisfy the SFC's education and experience requirements, the proposal is that the SFC will issue a provisional licence to such applicant. The proposal is generally supported by the market and has been adopted in Part V of the composite Bill (Clause 120).

5.38 The original proposal was that the provisional licence would be valid for one month and would be renewable if necessary. In the composite Bill, the provisional licence would remain valid until determination of the relevant application for a licence.

5.39 On receipt of provisional licences issued by the SFC, persons applying for representative licences may commence working for licensed corporations while their applications are being processed. This will lessen the burden on both the corporations and their representatives.

Temporary licences

5.40 To facilitate overseas corporations and their employees that are licensed by competent overseas regulatory authority in working in Hong Kong on short or temporary assignments, the composite Bill also empowers the SFC to grant temporary licences to them, provided they can satisfy the SFC that they are properly supervised and regulated by their home regulator and that they have not, within the 24 months preceding their application to the SFC, held any temporary licence for a total of six months.

Trustee companies

5.41 Under the current legislation, various categories of persons are exempted or excluded from the requirement to be registered. When these exclusions and exemptions were originally incorporated, they were based on the fact that the activities carried out by these persons were only incidental to their core business and did not constitute the core business itself.

5.42 The current categories of such excluded or exempted persons include (albeit to a limited extent) trustee companies registered under Part VIII of the Trustee Ordinance. Under the Securities Ordinance, such companies –

(a) are not required to be registered as investment advisers; and

(b) may be declared by the SFC to be exempt dealers.

5.43 Under current legislation, exemptions and exclusions for trustee companies only relate to activities concerning securities and not activities concerning futures contracts. Moreover, as regards exemptions, all trustee companies are currently eligible to apply to be exempt dealers. As for exclusions, they are currently unqualified, i.e., there is no requirement that exclusions apply only to the extent that the relevant activities are incidental to the core business of a trustee company.

5.44 However, increasingly, trustee companies are actively participating in advisory businesses beyond their core trustee activities. In order to maintain a level playing field and to better protect investors, the composite Bill qualifies the previously blanket exclusion. It revises the position of such trustee companies to the effect that they will only be excluded from the licensing requirement if the advisory activities which they carry out are wholly incidental to their overall trustee business. As for exempt dealers, the composite Bill no longer renders them eligible to apply for such exempt status. These changes merely reflect the change in circumstances relating to businesses of trustee companies and the need for more comprehensive investor protection measures.

Regulation of the professional investor's market

5.45 The SFC's 1999 consultation document proposed extending the SFC's regulatory net to cover professional dealings, noting that the basis for their current exclusion under the Securities Ordinance, namely that "professional dealings" posed minimal risk to the investing public, was increasingly less compelling given that –

(a) any systemic disruption, or manipulative conduct in the dealings within the professional investor's markets could have an adverse effect on the wider marketplace and thus adversely impact upon the interest of the investing public; and

(b) there existed an information gap in respect of dealings by professional investors which gave rise to integrity and systemic risk concerns.

5.46 However, pending the emergence of an international consensus in this regard, it is considered inappropriate to introduce the regulation of professional investors at this juncture. In any event, the reporting requirements on substantial futures and options positions set out in Part III of the composite Bill will mitigate some of the concerns

described above. That said, the Government and the SFC are continually monitoring developments on the international regulatory front with a view to taking appropriate measures, including introducing changes, when and where necessary.

OVERVIEW OF THE PROPOSED REGULATORY REGIME FOR EXEMPT AUTHORIZED FINANCIAL INSTITUTIONS

5.47 The granting of exempt status to authorized institutions under the Banking Ordinance ("authorized financial institutions") is a recognition of the fact that they are already subject to the existing statutory provisions of the Banking Ordinance and to the close regulation and supervision of the HKMA in respect of the whole of their business. The supervision of authorized financial institutions by the HKMA is exercised on a consolidated basis so that the "regulated activities" of these institutions, as set out in paragraph 5.11 above, are supervised in the context of the business of an authorized financial institution as a whole. The HKMA is therefore well placed to assess the extent to which problems elsewhere in a bank (or the group of which it is a part) might adversely affect the interests of individual investors or the market as a whole.

5.48 The proposed regulatory framework for exempt authorized financial institutions is principally enshrined in the composite Bill with necessary amendments to the Banking Ordinance. Its implementation is to be underpinned by the existing Memorandum of Understanding between the SFC and the HKMA, which will be updated to make provisions for the new arrangements contemplated. In developing the framework, the following guiding principles have been followed –

(a) the importance of putting in place a regulatory mechanism that provides adequate protection to investors, minimizes regulatory overlap, and thus, regulatory cost; and

(b) the objective of levelling the playing field, as far as possible, between exempt authorized financial institutions and corporations licensed by the SFC.

5.49 The proposed framework builds on the existing regulatory arrangement that is largely achieved through the Banking Ordinance, as supplemented by specific provisions in the Securities Ordinance. In practice, with its knowledge of the authorized financial institutions' operation and daily supervision, the HKMA currently assumes the role of

ensuring that only those authorized financial institutions that are fit and proper for carrying out the "regulated activities" are allowed to do so, and that they comply with the requirements under the Securities Ordinance which are applicable to them. This practice will be continued under the framework for exempt authorized financial institutions proposed under the composite Bill. The key features of the new framework are outlined in the ensuing paragraphs.

HKMA as the front-line regulator

5.50 For the authorized financial institutions, exempt status means that regulatory overlap is minimized and that so far as the day-to-day supervision of their "regulated activities" is concerned, they need only to deal with one regulator. It is intended that the HKMA will be the front-line regulator in respect of the "regulated activities" of the authorized financial institutions. The two regulators will maintain close liaison and update the present Memorandum of Understanding in the light of the new regulatory framework.

5.51 Institutions wishing to carry on "regulated activities" as exempt authorized financial institutions will need to satisfy the HKMA that they are fit and proper to do so. The criteria for fitness and properness will be equivalent to those applied by the SFC to its licensees under Part V of the composite Bill in the light of the recommendations of the HKMA. The SFC will then make the declaration of exempt status under Clause 118.

5.52 The HKMA will be responsible for the routine supervision of exempt authorized financial institutions. That supervision will be carried out in a manner and according to standards that are consistent with those applicable to persons licensed by the SFC. The HKMA will be designated as a responsible authority in relation to exempt authorized financial institutions for the purpose of vesting the inspection powers set out in Part VIII of the composite Bill, for the supervision of exempt authorized financial institutions in respect of their conduct of "regulated activities". In order to fulfil this commitment, the HKMA will increase the number of its specialist securities supervision teams. It will also make available its supervisory findings to the SFC under the Memorandum of Understanding between them. To this end, we plan to relax the existing secrecy provisions in the Banking Ordinance to facilitate the exchange of information between the HKMA and the SFC in respect of the "regulated activities" of exempt authorized financial institutions. Additionally, the composite Bill (Clause 5) also

provides for the reliance by the SFC in whole or in part on the supervision of exempt authorized financial institutions by the HKMA.

Regulatory requirements

5.53 As already noted above, the HKMA's supervisory powers already extend over the business of an authorized financial institution as a whole. To make this more explicit in relation to their "regulated activities", it is proposed that the initial and continuing authorization criteria in the Seventh Schedule of the Banking Ordinance be amended to include a provision to the effect that an authorized financial institution which also carries on "regulated activities" should be fit and proper to do so. The rationale for this is that if an institution is not properly qualified and equipped to conduct "regulated activities", this may damage the reputation of the institution as a whole and/or its financial position, and thus damage the interests of its depositors or potential depositors.

5.54 In order to safeguard the interests of investors, and to ensure as far as possible a level playing field for all market participants, the supervision by the HKMA of the "regulated activities" of exempt authorized financial institutions should as far as possible parallel the supervision by the SFC of persons licensed with it. However, the requirements that apply to exempt authorized financial institutions and persons licensed by the SFC cannot and should not be exactly the same – otherwise there would be a risk of over-regulation of exempt authorized financial institutions and the concept of exempt status would have little real meaning. In some cases, for instance, the regulatory requirements applicable to persons licensed by the SFC may have to be adjusted, before they are applied to exempt authorized financial institutions, in the light of the prudential regulation to which they are already subject under the Banking Ordinance.

5.55 Bearing in mind the above broad principles, it follows that exempt authorized financial institutions will be subject to some but not all statutory requirements relating to "regulated activities". To this end –

(a) authorized financial institutions will be subject to the requirements relating to the handling of clients' securities, the preparation of contract notes, receipts and statement of accounts, the keeping of accounts and records, as well as business conduct rules under Parts VI and VII of the composite Bill; but

(b) they are not subject to those requirements under the composite Bill that relate to the maintenance of financial resources, the handling of client money and auditing, as these are adequately covered under the Banking Ordinance.

5.56 Moreover, the HKMA will also expect exempt authorized financial institutions to adhere to the standards of conduct set out in the Codes of Conduct and Guidelines issued by the SFC as well as any relevant rules made under Parts VI to VII of the composite Bill. The SFC will consult the HKMA when preparing such rules, codes and guidelines with a view to ensuring the introduction of appropriate requirements vis-à-vis exempt authorized financial institutions.

5.57 The "responsible officer" concept discussed in paragraph 5.27 above will be mirrored in the Banking Ordinance. We plan to amend the Banking Ordinance to give the HKMA the power to approve "executive officers" below the level of directors and chief executives (the latter being already subject to the HKMA's powers of approval). Exempt authorized financial institutions should nominate the "executive officers" who will be responsible for directly supervising the conduct of their "regulated activities" and seek the HKMA's approval of such persons under the Banking Ordinance.

5.58 It is also important that there should be measures in place to ensure that the individuals within exempt authorized financial institutions who deal with members of the public are fit and proper to do that job. The primary responsibility for this will rest with the senior management of exempt authorized financial institutions on the basis of criteria set down by the HKMA. Additionally, an exempt authorized financial institution will be required by the HKMA to accredit employees to act on its behalf, to maintain records of such employees and to notify their names and addresses to the HKMA. Only persons who have been accredited by an exempt authorized financial institution will be allowed to carry out "regulated activities" on its behalf. The HKMA will maintain a register of such employees, which will be open for public inspection. We plan to amend the Banking Ordinance to incorporate these requirements.

5.59 The HKMA will conduct background checks on employees accredited by exempt authorized financial institutions with law enforcement authorities and the SFC. Exempt authorized financial institutions will also be required to demonstrate that suitable arrangements have been put in place to ensure that employees on the register receive appropriate training in line with the expectations of the SFC for licensed persons.

Measures to ensure compliance with regulatory requirements

5.60 The composite Bill, together with the Banking Ordinance, makes available a range of enforcement actions that may be taken against exempt authorized financial institutions which fail to comply with regulatory requirements applicable to them in respect of their "regulated activities". These enforcement actions include the following.

(a) Criminal sanctions

In the case of serious misconduct involving breaches of statutory requirements imposed under the composite Bill and applicable to exempt authorized financial institutions, the exempt authorized financial institution concerned will be liable to criminal sanctions in the same way as persons licensed by the SFC. This liability extends to "executive officers" who are responsible for directly supervising the conduct of the "regulated activities" of the exempt authorized financial institution. The defence available to "responsible officers" under Clause 367 (described in paragraph 5.33 above) will also be available to "executive officers" of an exempt authorized financial institution.

(b) Remedial action

The HKMA is empowered under the Banking Ordinance to require an exempt authorized financial institution to take a wide range of remedial action. As noted in paragraph 5.53 above, we plan to amend the Seventh Schedule of the Banking Ordinance[2]. This will give the HKMA the flexibility to impose restrictions of varying degrees of severity to ensure proportionality of response. Breach of such a requirement imposed by the HKMA is an offence under the Banking Ordinance.

[2] The Seventh Schedule of the Banking Ordinance sets out the authorization criteria that have continued application over both existing and newly authorized financial institutions. The HKMA proposes to amend this Schedule to include a provision to the effect that an authorized financial institution which carries on "regulated activities" should be fit and proper to do so. A breach of any one of the authorization criteria means that the HKMA may exercise the powers to revoke or suspend the authorization of the institution concerned as well as the power under section 52 of the Banking Ordinance to require remedial action.

(c) Disciplinary sanctions

Irrespective of whether a criminal offence is involved, serious misconduct also raises the question of whether the SFC should revoke (or impose conditions on) the exempt status of a particular authorized financial institution. Where the exempt status is revoked, the authorized financial institution concerned will have to cease carrying on any "regulated activity".

5.61 In addition to routine supervision by the HKMA as set out in paragraph 5.52, where there is a concern relating to the fitness and properness of an exempt authorized financial institution in conducting any "regulated activities", the SFC may upon consultation with the HKMA, investigate into the fitness and properness and may revoke its exempt status. Similarly, where there is a concern relating to the fitness and properness of any designated "executive officers" and employees of an exempt authorized financial institution in respect of "regulated activities", the HKMA may require appropriate action from the authorized financial institution. This may include revoking the individual's accreditation to that institution to perform "regulated activities". An authorized financial institution's failure to take the required action will itself call into question its fitness and properness and, in turn, the propriety of the continuation of its own exempt status. Where there is a concern relating to the fitness and properness of designated "executive officers", the HKMA can withdraw their approval under the Banking Ordinance.

5.62 As a further step to ensuring a level playing field and for greater protection to investors, it is proposed that the Banking Ordinance will be amended to expand the HKMA's powers so that it may impose a wider range of sanctions. In particular, the HKMA will be empowered to issue public reprimands to authorized financial institutions which have committed breaches or other misconduct in their "regulated activities". Apart from creating the deterrent effect, this will enable investors to better assess the quality of the institutions with which they are dealing. The criteria for issuing reprimands will be similar to those adopted by the SFC in respect of persons licensed by it (see Chapter 7).

CHAPTER 6

PART VIII OF THE SECURITIES AND FUTURES BILL

SUPERVISION AND INVESTIGATIONS

INTRODUCTION

6.1 As its title suggests, Part VIII of the composite Bill deals with the SFC's supervisory and investigatory functions and essentially confers a variety of inquiry, supervisory and investigatory powers to enable the SFC to discharge such functions. These include powers to –

(a) inquire into possible misconduct in relation to listed corporations;

(b) supervise licensed or exempt corporations and their associates;

(c) request information concerning transactions in financial instruments;

(d) investigate possible contraventions of the composite Bill;

(e) investigate a variety of improper conduct involving financial instruments or licensed or exempt corporations; and

(f) assist overseas regulators in their investigations.

6.2 The above powers are essentially carried from the existing legislation. A number of changes have however been introduced. These seek to clarify and, where necessary, enhance the SFC's existing inquiry, supervisory and investigatory powers so as to correct deficiencies, which have been identified by the SFC through the exercise of its powers over the past ten years, as well as having full regard to current developments on the international scene. In introducing these changes, checks and balances have been added, where appropriate, to match present-day legal convention.

6.3 The ensuing paragraphs set out first the SFC's powers under the current law and then

discuss some of the more significant improvements introduced under Part VIII. An overview is also given of some of the checks and balances provided in the composite Bill in respect of such powers.

POWERS CONFERRED UNDER THE CURRENT LAW

6.4 The SFC's powers of inquiry, supervision and investigation under the current legislation are set out in sections 29A, 30, 31, 32, 33 and 36 of the SFC Ordinance (and the corresponding sections 41, 42, 44, and 47 of the Leveraged Foreign Exchange Trading Ordinance ("LFETO"). The specific powers are as follows.

(a) Section 29A of the SFC Ordinance concerns inquiries relating to listed companies. The provision allows the SFC to require production of and make limited inquiries about the records and documents of a listed company and its group companies where there are reasons to suspect fraud, misfeasance or other misconduct in relation to the formation, management or business of that listed company or to suspect that there has not been proper disclosure to shareholders. This power enables the SFC to conduct a limited, fast and discreet inquiry into the possibility of such misconduct but does not enable a full company inspection.

(b) Section 30 of the SFC Ordinance concerns inspections of licensed persons. The provision allows the SFC to enter the premises of licensed persons to inspect and take copies of documents to ensure that the licensed persons comply with all relevant legal requirements and licence conditions. The SFC typically exercises this power routinely on a periodic basis and in special circumstances. (Section 41 of the LFETO confers similar powers in relation to persons licensed under that Ordinance.)

(c) Section 31 of the SFC Ordinance concerns inquiries into financial transactions. The provision allows the SFC to obtain certain information relating to transactions concerning securities, futures contracts or interests in property investment arrangements. This power may be exercised against licensed and exempt persons as well as those with an interest in the relevant transaction. It is exercised mainly for purposes of market surveillance. (Section 42 of the LFETO confers similar powers in relation to transactions concerning leveraged foreign exchange trading contracts and interests in leveraged foreign exchange trading arrangements.)

(d) Section 33 of the SFC Ordinance concerns investigations into misconduct and wrongdoing. The provision allows the SFC to investigate possible offences, breaches of trust, fraud, misfeasance and a wide range of other misconduct concerning activities relating to securities and futures transactions and property investment arrangements. This section also empowers the SFC to lend investigatory assistance to foreign regulators. (Section 44 of the LFETO confers similar powers in respect of activities relating to leveraged foreign exchange trading.)

(e) The above powers are complemented by two further powers conferred under sections 32, 33 and 36 of the SFC Ordinance, as follows –

(i) Sections 32 and 33 of the SFC Ordinance empower the SFC to seek assistance from the Courts, where necessary, to counter any unreasonable refusal or failure to comply with a request by the SFC made pursuant to a proper exercise of its powers under sections 29A, 30, 31 and 33 of the SFC Ordinance. (A similar power is conferred under section 44 of the LFETO.)

(ii) Section 36 of the SFC Ordinance empowers the SFC to apply to a Magistrate for a warrant to enter and search premises and seize relevant evidence. (A similar power is conferred under section 47 of the LFETO.)

6.5 While these powers have generally proven to be satisfactory, the SFC's experience of the last ten years has also brought to light a number of deficiencies and inadequacies in the wording of the existing provisions, which has caused practical problems. In particular, the SFC has encountered enforcement difficulties with the scope of sections 29A and 30 of the SFC Ordinance.

6.6 Accordingly, Part VIII essentially preserves the SFC's existing powers of inquiry, supervision and investigation, but at the same time also introduces a number of changes which aim to rectify existing deficiencies and inadequacies and thereby enable the SFC to perform its functions more effectively. To adequately balance any new powers the SFC is given, safeguards have been, where appropriate, added to ensure that the powers are exercised only in appropriate circumstances and only to the extent necessary. The changes and the policy rationale behind them are discussed in the following paragraphs.

MODIFICATIONS AND IMPROVEMENTS TO THE CURRENT LAW – PRELIMINARY INQUIRY INTO LISTED COMPANIES (Clause 165)

6.7 Section 29A was introduced by the SFC (Amendment) Ordinance in 1994 and its purpose was to give the SFC a power to conduct preliminary inspections of the records and documents of listed companies. The power was intended to enable the SFC to conduct cost-effective, relatively quick and discreet inquiries into listed companies before the Financial Secretary decided to appoint inspectors under the Companies Ordinance. On the basis of findings pursuant to preliminary inspections, the SFC may also apply to the Court for a variety of orders to prevent contraventions or wrongdoings and to seek appropriate remedial action, including appointing a receiver or manager over the whole or a part of the listed company's business. To this end, section 29A empowers the SFC to not only direct listed companies and their related companies to produce their records and documents but also to ask present or past officers of such companies to explain the records or documents. There are however the following ambiguities and limitations.

(a) The power may be interpreted as only requiring an explanation of what an entry in a record or document relates to and not an explanation of the circumstances in which the entry was made. Clause 165 of the composite Bill cures this ambiguity by putting beyond doubt the SFC's power to ask for an explanation of not only an entry in a record or document but also the reasons for which it was made, the circumstances under which it was prepared or created and the details of any instructions given in connection with the making of that entry.

(b) Secondly, under section 29A of the SFC Ordinance, the SFC does not have the power to supplement or verify information obtained from records or documents produced by a listed company or its group companies, or explanations of them. This often prevents the SFC from ascertaining the real nature of a company's transactions or purported transactions as recorded in its own books and documents. The composite Bill enhances the SFC's powers in this regard by enabling it to seek records and documents relating to the affairs of a listed company or its group companies from third parties, namely such companies' auditors, bankers, persons who have dealt with such companies ("transaction counterparties") and persons in possession of such records and documents.

6.8 The proposal to enable the SFC to obtain such records or documents from third parties was incorporated into the composite Bill after much careful consideration. The proposal was also exposed to the market in July 1999 when the SFC issued its "Overview Guide to the Proposed Securities and Futures Bill" and its "Guide to Legislative Proposals on Supervision and Investigation of Listed Companies and Intermediaries". A number of issues and concerns raised as a result of that public consultation exercise have now been addressed in the composite Bill. Given the significance of this proposal, it is worth noting here the rationale for conferring this power on the SFC, the market's concerns in this regard and the manner in which these concerns have been addressed in the composite Bill. These are discussed below.

(a) **Auditors** : In the case of auditors, it was noted that they perform an important role in corporate regulation. In particular, they are required to form an opinion on a company's financial affairs and in doing so will have performed certain verification checks. Access to an auditor's records and documents therefore can assist the SFC in conducting a preliminary listed company inquiry. More specifically, such access may forestall the need to pursue certain avenues of inquiry, supplement the information obtained from a listed company and its group companies, and confirm the veracity of such information. When the proposal to include auditors among the list of third parties was exposed to the market in July 1999, a number of comments and suggestions were received in this regard. Two in particular are worth noting here -

(i) First, the market noted that any such power to obtain records and documents from auditors should be sufficiently and clearly restricted. To address this concern, Clause 165(9) now provides that to obtain records or documents from an auditor, the SFC must first have reasonable cause to believe that –

- the auditor possesses any record or document which is in the nature of "audit working papers" relating to the affairs of the listed company under inquiry or one of its group companies – as requested by the accountancy profession, this provides a term with which auditors are familiar;

- again, pursuant to representations from and discussions with the accountancy profession, "audit working papers" is defined to refer to only documents and records prepared by or on behalf of or obtained and retained by, an auditor for or in connection with the performance of any of his functions relating to the conduct of any audit of the accounts of a company (Clause 164);

- the record or document sought relates to the affairs of the listed company or one of its group companies; and

- the record or document sought is relevant to the grounds for the inquiry,

and the SFC must certify in writing that each of these requirements has been satisfied.

(ii) A further submission received was the suggestion that the SFC should be required to obtain a Court order permitting access to "audit working papers" before requiring their production. However, after careful consideration, it was concluded that, for a number of reasons, such a requirement was neither necessary nor appropriate.

- First, there are adequate safeguards in that, as already noted, a number of requirements have to be satisfied before the SFC can exercise the power to require production of audit working papers.

- Secondly, Part VIII preserves the SFC's current powers to seek assistance from the Courts in cases where it encounters unreasonable resistance or failure to comply with a proper direction for the production of records or documents. The Court's involvement in this regard is intended as a last resort rather than a first hurdle to the SFC's fulfilling its inquiry functions. Obliging the SFC to apply for a Court order as a first step in the case of audit working papers would in fact be more restrictive than the SFC's existing inquiry powers. More importantly, it would place auditors in a privileged position over other persons required to produce records or documents even though auditors are not traditionally accorded any such privilege under common law.

- Thirdly, comparable overseas regulators in the US, the UK and Australia can obtain documents from auditors on the basis of similar or fewer safeguards than those placed on the SFC under Part VIII. They also do not need to seek the approval of the Courts first.

(b) **Banks** : In the case of banks, it was intended that Section 29A of the SFC Ordinance would give the SFC the power to obtain records and documents from the banks of listed companies and their group companies. Indeed this has been the actual practice. However, doubts on whether the existing wording of the relevant provisions achieved this intention have been expressed. This is rectified by Clause 165 of the composite Bill, which also provides for adequate safeguards. In particular, under Clause 165(8), the SFC must have reasonable cause to believe that –

(i) the bank is in possession of records or documents relating to the affairs of the listed company under inquiry or one of its group companies;

(ii) the record or document sought relates to the affairs of such a company; and

(iii) the record or document sought is relevant to the grounds for the inquiry,

and the SFC must certify in writing that each of the above requirements has been satisfied.

(c) **Transaction counterparties** : To date, inquiries conducted by the SFC under section 29A of the SFC Ordinance have been hampered by the SFC's inability to verify the propriety or genuineness of transactions reflected in the books and records of a listed company or one of its group companies by examining records or documents of the person with whom those companies have allegedly transacted. Clause 165 rectifies this by empowering the SFC to obtain documents and records from such persons. The proposal to confer such a power on the SFC was also exposed in July 1999. In response, concerns were raised about the ambit of this power and the need to set clear parameters. Clause 165(10) addresses these concerns by requiring that the SFC must, as a prerequisite, have reasonable cause to believe that –

(i) the person required to produce the record or document has or has had dealings with the listed company under inquiry or one of its group companies;

(ii) the record or document sought relates to the affairs of such a company; and

(iii) the record or document sought is relevant to the grounds for the inquiry,

and the SFC must certify in writing that each of these requirements has been satisfied.

(d) **Persons in possession** : The last category of persons from whom the SFC is empowered to obtain records or documents relating to the affairs of a listed company or its group companies are persons in possession of such records or documents. This power, which already exists under section 29A of the SFC Ordinance, is preserved in Clause 165. Again, there are safeguards to the SFC's exercise of this power. These are essentially the same as those that apply in the case of transaction counterparties, save for one exception. This is that the SFC must have reasonable cause to believe the person required to produce records or documents is in possession of records or documents relating to the affairs of the listed company under inquiry or one of its group companies, rather than that such person has or has had dealings with such listed company or with one of its group companies.

6.9 In addition, in relation to transaction counterparties and persons in possession of records or documents relating to the affairs of the listed company under inquiry or one of its group companies, the SFC must first have reasonable cause to believe that the record or document sought cannot be obtained from the listed company under inquiry or any of its group companies, or any bank or auditor of such a company (Clause 165(10)). The SFC must also certify in writing that this requirement is satisfied.

IMPROVEMENTS TO THE CURRENT LAW – SUPERVISION OF INTERMEDIARIES AND THEIR ASSOCIATES (Clause 166)

6.10 The SFC's existing powers under section 30 of the SFC Ordinance and section 41 of the

LFETO enable it to monitor registered persons and to ensure that they at all times meet the fit and proper criteria and comply with all relevant laws, requirements and conditions of licence. This particular power plays a critical role in ensuring proper investor protection. There are however a few deficiencies in the existing provision, particularly in the following areas.

(a) The failure of the CA Pacific Group has highlighted how problems in one part of a group's enterprise can trigger problems for the entire group. This experience has demonstrated the need to ensure that the SFC is empowered to inspect companies which are within the same group as a licensed person and which can have an impact on the business of that licensed person. In this regard, it has been argued that the power under section 30 of the SFC Ordinance (and section 41 of the LFETO) does not extend to inspections of related companies of licensed persons in such circumstances. This is now rectified by Clause 166 of the composite Bill. That provision expressly empowers an SFC authorized inspector to enter the premises of not only the licensed or exempt person but also those of its related companies and companies that are under the same control as the licensed or exempt person.

(b) At present, section 30 of the SFC Ordinance does not expressly empower the SFC or its authorized inspectors to ask questions about records or documents which it has inspected. Such a power is crucial if an inspection is to be effective and meaningful. Again Clause 166 of the composite Bill rectifies this by expressly empowering inspectors to make enquiries about records and documents inspected. Additionally, it also empowers inspectors to make enquiries about transactions or activities which may affect the business of the person being inspected, or which may have been undertaken in the course of such business.

IMPROVEMENTS TO THE CURRENT LAW – INVESTIGATORY POWERS (Clauses 168 and 169)

6.11 The SFC's investigatory powers under section 33 of the SFC Ordinance have proven effective and are generally accepted. They are preserved in the composite Bill, without substantial changes, in Clauses 168 and 169.

6.12 One change however, which is worth noting, is the addition of a new provision in Clause

168 empowering the SFC to conduct an investigation into whether any licensed person (including therefore any "responsible officer") or a person involved in the management of a licensed corporation has committed misconduct or is otherwise no longer fit and proper to remain licensed. The rationale for introducing such a provision is discussed below.

(a) Under section 56 of the Securities Ordinance, section 36 of the Commodities Trading Ordinance and section 12 of the LFETO, the SFC is empowered to inquire into the conduct and activities of licensed persons and persons involved in their management. Those provisions also empower the SFC to, where appropriate, take disciplinary action against them. (The SFC's disciplinary powers are set out in Part IX of the composite Bill and discussed in Chapter 7. They are therefore not discussed at length here.)

(b) It is clear that under the existing legislation, the conduct of such an "inquiry" is a necessary prerequisite to taking any decision to discipline such persons. However, except in the case of section 12 of the LFETO, there is no provision obliging licensed persons or any other person to assist the SFC in its inquiry. In exercising its powers under section 56 of the Securities Ordinance and section 36 of the Commodities Trading Ordinance, the SFC has to rely upon the voluntary co-operation of such persons.

(c) The inclusion of this new provision effectively empowers the SFC to require the necessary co-operation needed when inquiring into possible misconduct by or the fitness and properness of licensed persons and members of their management.

CHECKS AND BALANCES

6.13 Given possible market concern about the proposals to enhance the SFC's inquiry, supervisory and investigatory powers, particular care has been taken to ensure that any extension of the existing powers is prudent and then only to the extent necessary. Care has also been taken to ensure that in extending the SFC's powers in this regard, the high standards of procedural fairness expected of an independent, professional, fair and transparent regulator have not been compromised. It is recognized that this balance is crucial to maintaining the integrity of the securities and futures market and ensuring that the SFC has the continued trust and confidence of market participants and the investing public.

6.14 To this end, apart from the avenues of redress available under the general law, such as judicial review and complaints through the Office of the Ombudsman, it is important to note here that a number of checks and balances have been incorporated under Part VIII and elsewhere in the composite Bill. The more notable of these are set out below.

(a) **Statutory thresholds** : Under the current law, the SFC can only exercise its inquiry, supervisory and investigatory powers in certain very specific circumstances. Under the composite Bill, these "thresholds" have either been preserved or raised. For example, under section 29A(3) of the SFC Ordinance, the SFC may presently require any person who "appears to be" in possession of documents relating to the affairs of a listed company or one of its group companies to produce those documents. However, under Clause 165(10) of the Bill, the person authorized to inquire will be required to "have a reasonable cause to believe" that : the person is in possession of those documents; the documents sought relate to the affairs of the listed company or one of its group companies or a transaction with such a company; the documents sought are relevant to the grounds for the inquiry; and the documents sought cannot be obtained from the listed company itself, one of its group companies or the auditors or banks of those companies. Moreover, each of these requirements must be certified by the SFC as having been satisfied.

(b) **Right to legal representation** : At present a person compulsorily interviewed by the SFC has the right to have a lawyer present. However, the SFC is also currently expressly empowered to impose certain restrictions on such a lawyer's activities during the interview. The composite Bill removes this power.

(c) **Privilege against self-incrimination** : The privilege against self-incrimination is preserved under Part VIII. To this end, Clauses 165(4) and 170 provide that where a person is asked to answer written or oral questions, he must first be reminded of his right to claim privilege against self-incrimination. However, as is the case under the current law, the privilege –

(i) only applies in respect of the SFC's powers under Clause 165 (relating to the production of records and documents concerning listed corporations) and Clause 169 (relating to the SFC's conduct of investigations); and

(ii) does not apply in respect of the SFC's supervisory powers under Clause 166 or its powers to inquire about transactions under Clause 166.

This distinction recognizes the different nature and purpose of the powers under Part VIII. A listed company inquiry under Clause 165 or an investigation under Clause 168 is conducted to determine whether specific wrongdoing has occurred. Either is conducted with a view to possible sanctioning or prosecution. In these circumstances, it is appropriate to remind a person of his right to claim privilege against self-incrimination as it is possible that compelled incriminating answers to questions may otherwise be admitted against him in criminal proceedings.

However, a supervisory inspection of an intermediary under Clause 166 or a request for information about a transaction under Clause 167 is usually exercised in very different circumstances and for very different reasons. In the case of Clause 166, the power is exercised on a routine basis and with a view to establishing whether there are any defects in regulatory compliance that need remedial action. In the case of Clause 167, the power is again exercised on a routine basis and if the inquiry suggests that there are suspicious circumstances, then the SFC will have to consider whether or not to commence a formal investigation under Clause 168. In these circumstances, it would be inappropriate to require the SFC to remind persons of their right to claim privilege against self-incrimination. It is perhaps also worth noting in this regard that where, as a result of any inspection or request under Clause 166 or Clause 167, wrongdoing is suspected, the SFC always starts an inquiry or investigation under Clause 165 or Clause 168.

(d) **Secrecy and confidentiality obligations** : Clause 358 (discussed at greater length in Chapter 14) preserves the stringent secrecy and confidentiality obligations to which the SFC and its staff are subject under section 59 of the SFC Ordinance. Except in very limited circumstances, there can be no disclosure of information obtained in the course of or as a result of any exercise of the inquiry, supervisory or investigatory powers conferred under Part VIII.

(e) **Magistrate's warrants** : As in section 36 of the SFC Ordinance and section 47 of the LFETO, the SFC is not empowered to forcibly enter any premises unless it has first obtained a warrant from a Magistrate.

(f) **Process Review Panel** : The SFC's adherence to standards of proper administration, due process and impartiality in the exercise of its inquiry, supervisory and investigatory powers will be audited on a regular basis by an independent Process Review Panel. The Panel's role is described in Chapter 1.

CHAPTER 7

PART IX OF THE SECURITIES AND FUTURES BILL

DISCIPLINE

INTRODUCTION

7.1 Part IX of the composite Bill concerns the SFC's disciplinary functions. It sets out a list of sanctions that the SFC may impose, and the categories of persons on whom such sanctions may be imposed.

7.2 In delineating the ambit of the SFC's disciplinary powers, the following considerations have been borne in mind.

(a) The principal objective of imposing disciplinary sanctions is to protect investors by ensuring that intermediaries licensed by the SFC conduct themselves properly and do not abuse their privileged position.

(b) In granting the SFC disciplinary powers, adequate safeguards must be in place to ensure that the powers are exercised fairly, transparently and consistently.

7.3 To this end, Part IX builds upon the SFC's existing disciplinary powers (found in the SFC Ordinance, the Securities Ordinance, the Commodities Trading Ordinance and the Leveraged Foreign Exchange Trading Ordinance ("LFETO")) and introduces a number of changes in the light of the SFC's experience over the last 10 years, as well as current international practices. The changes are aimed at enabling the SFC to discharge its regulatory functions more effectively but without compromising high standards of procedural fairness. In particular, Part IX –

(a) makes available a wider range of disciplinary sanctions than that found in the current legislation, including sanctions such as disciplinary fines, partial suspensions and revocations and prohibition orders;

(b) retains the SFC's existing powers to discipline licensed corporations, their licensed representatives (including their responsible officers) and other persons involved in their management; and

(c) expands the range of safeguards found in the current legislation to better ensure that the disciplinary process is fair, transparent and consistent.

7.4 The following section highlights the significant changes introduced under Part IX and explains their rationale.

A BROADER RANGE OF SANCTIONS

7.5 Under the current legislation, the SFC is empowered to take disciplinary action against licensed persons and individuals involved in their management where such persons or individuals have been guilty of misconduct; or their fitness and properness to remain licensed, or to continue to be involved in the management of a licensed person, has been impugned. However, the existing legislation allows for only one of three sanctions to be imposed –

(a) revocation of a licence;

(b) suspension of a licence; and

(c) issue of a public or a private reprimand.

7.6 Individuals who are not licensed by the SFC, but who are involved in the management of a licensed person, may only be reprimanded publicly or privately.

7.7 Experience of the SFC has shown that this range of disciplinary penalties is too limited and does not provide the flexibility needed to deal with the wide range of improper conduct and circumstances that arise in different cases. For example, reprimanding a corporate intermediary might be too light a sanction to impose and yet a revocation or suspension might be too severe, especially given the adverse effects the latter may have on innocent third parties such as clients, employees and shareholders.

7.8 In order to address these inadequacies and to enable the SFC to discharge its disciplinary functions more effectively, the composite Bill expands the range of sanctions and introduces a degree of flexibility to allow the SFC to better tailor sanctions to suit specific circumstances and to determine the most appropriate sanction in a particular case. These are discussed in the ensuing paragraphs.

Fines

7.9 Clause 180 empowers the SFC to impose fines on licensed corporations, its licensed representatives and other persons involved in its management. Under this provision, fines may be imposed either in addition or as an alternative to imposing certain other sanctions. Where a person has been convicted by the Court of an offence for the misconduct, the SFC would not impose a fine on it for the same misconduct.

7.10 Additionally, Clause 180 places a cap on the amount that the SFC may fine, i.e., the higher of $10 million or three times the profit made or loss avoided as a result of the misconduct. These figures set the maximum level. Most fines imposed by the SFC are expected to fall below this maximum.

7.11 The link to the profit or loss is considered appropriate as a means to relate the level of the fine to the gravity of the misconduct in respect of which it is imposed. It is also intended that the maximum fine must be set high enough to have a deterrent effect adequate for the protection of investors. At the same time, it is recognized that some instances of improper conduct may not lead to a profit being made or loss avoided. Consequently, there is an alternative maximum of $10 million, which is expected to be adequate to cover most instances of improper conduct.

7.12 In granting the SFC the power to fine and fixing maximum fines, we have had regard to the approach in comparable jurisdictions.

(a) In the US, both the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have the power to impose disciplinary fines. The SEC may impose fines of up to US$100,000 on a natural person and US$500,000 on a corporation if the contravention concerned involves

fraud, recklessness or a significant risk of substantial loss to others. Fines may also be imposed for each disciplinary contravention and, in certain instances, each day that a contravention continues could constitute a separate violation for purposes of calculating the total amount of fines. The CFTC may impose fines of up to US$100,000 or up to three times the monetary gain for each contravention.

(b) In the UK, it is proposed to give the Financial Services Authority the power to impose disciplinary fines under the Financial Services and Markets Bill. However, there is currently no proposal to cap the amount that the Financial Services Authority may fine.

7.13 In deciding whether to fine and if so, how much, the SFC must consider all the circumstances of the case. The circumstances that may lead the SFC to determine that a person is not fit and proper or had engaged in misconduct and so should be fined are so diverse that it is not possible to draw up an exhaustive list. Moreover, given the evolving nature of the market and trading and investment activities and products, drawing up any list may result in ambiguities as to whether or not a particular conduct falls within the list. Also, the choice of a list of maximum fines for certain specified forms of conduct can only be arbitrary, given the very varied circumstances each disciplinary case presents.

7.14 For these reasons, the composite Bill does not provide a pre-set tariff structure. Rather, it requires the SFC to publish guidelines indicating the manner in which it proposes to exercise the power to impose fines.

7.15 These guidelines will give the public guidance on the factors that the SFC may consider in determining whether or not to impose a fine and the size of any such fine. It is noted that in the UK, the Financial Services Authority is similarly required under the Financial Services and Markets Bill to publish guidelines on the factors it will take into consideration in determining disciplinary sanctions.

7.16 The exercise of the power to impose fines is, as is the case with all other SFC disciplinary sanctions, subject to robust procedural fairness requirements, as explained in paragraphs 7.26 to 7.31 below.

Partial suspensions and revocations

7.17 Another new sanction introduced under Part IX is the power to impose partial suspensions or partial revocations.

7.18 The SFC's existing power to revoke or suspend a licence is framed in such a way that the SFC can only suspend or revoke a licence completely or not at all. There is no option for suspending or revoking a licence in part only. As a result, any suspension or revocation of a licence necessarily constitutes a drastic action with far-reaching implications for the licensed intermediary's clients, employees and creditors. We believe that there should be greater flexibility for the SFC in crafting a revocation or suspension sanction. Intermediaries are increasingly conducting a diverse range of activities and improper conduct may affect only one or a few sectors of an intermediary's business activities. So a blanket revocation or suspension may not be warranted.

7.19 The power to partially suspend, or partially revoke, a licence will enable the SFC to impose the most appropriate sanction for a particular case while also minimising, to the extent practicable, the adverse effect on innocent third parties of a full suspension or revocation.

Prohibition orders

7.20 Clause 180 of the composite Bill empowers the SFC to prohibit a person from applying to be licensed by the SFC, or to be approved as a "responsible officer", for a specified period. The power to determine the period of the prohibition enables the SFC to impose a sanction which is commensurate with the severity of the misconduct and to the significance of the role or involvement of the person to be disciplined.

Revocation of exempt status

7.21 The existing legislation exempts various categories of persons from the requirement to be registered or licensed with the SFC. As discussed in Chapter 5, this power is essentially preserved under Part V of the composite Bill. There is however no express power in the existing legislation for the SFC to revoke any exemption granted. This is

unsatisfactory in that the circumstances of a particular case may change such that an exemption is no longer justified or appropriate. The composite Bill rectifies this inadequacy by empowering the SFC to revoke any exemptions granted. Please also refer to paragraph 5.61.

7.22 Under the composite Bill, fines and prohibition orders may be imposed against not only licensed persons but also those involved in their management. This effectively widens the range of sanctions that the SFC may impose on such people, so that it is not left with the sole option of issuing a reprimand.

CLOSING EXISTING DISCIPLINARY GAPS

7.23 Part IX also confers two further powers to enable the SFC to discharge its disciplinary functions more effectively –

(a) the explicit power to enter into negotiated settlements with persons proposed to be disciplined; and

(b) the power to issue incidental directions to those whose licence or exemption is revoked.

7.24 As regards negotiated settlements, the SFC already from time to time settles some of its disciplinary actions by agreement where the particular circumstances of a case render it appropriate to do so. Clause 186 of the composite Bill formally recognizes this practice.

7.25 As for the power to issue incidental directions, this has been introduced to address a limitation on the SFC's existing powers where a revocation has been issued. The issue of a revocation does not bring a disciplinary matter to an end. Thereafter, appropriate arrangements must be made to ensure the orderly cessation of the business of a licensed person whose licence has been revoked. This is crucial if the interests of clients are to be adequately protected. The current legislation does not address this need in an effective manner and hence in the absence of cooperation from relevant persons, the SFC's powers to ensure such orderly cessation are limited. Clause 187 of the composite Bill rectifies this by expressly empowering the SFC to direct a formerly licensed or exempt person to transfer clients' records.

CHECKS AND BALANCES

7.26 The SFC's powers under Part IX have the potential for far reaching consequences for those that are the subject of disciplinary decisions and the investing public. Accordingly, care has been taken to ensure that there are adequate checks and balances on the SFC's powers in this regard. The following paragraphs set out two notable examples of safeguards proposed in this reform exercise.

Decision-making process

7.27 The composite Bill provides for a fair and transparent disciplinary decision-making process, based on the process found in the existing legislation. In particular, the SFC may impose a disciplinary sanction only after giving the person on whom the sanction is proposed to be imposed an opportunity to be heard. Secondly, the SFC must also issue disciplinary decisions in writing together with a written statement of the reasons for the decisions. Moreover, both the decision and the statement of reasons must be given to the person who is the subject of the disciplinary decision.

7.28 In this context, it should be borne in mind that the proposed independent Process Review Panel will also provide an added safeguard in ensuring that the SFC's decision-making process in disciplinary cases is fair, proper and consistent (see Chapter 1 of this Consultation Document).

Right to appeal

7.29 The current legislation gives the subject of an SFC disciplinary decision the right to appeal against all SFC disciplinary decisions other than those to reprimand. The composite Bill however, under Part XI, confers the right to appeal against any disciplinary decision of the SFC, including reprimands and decisions to impose any of the new sanctions proposed.

7.30 As explained in Chapter 1, appeals will be heard before an independent tribunal, i.e., the Securities and Futures Appeals Tribunal. These are full merits reviews where the

independent Tribunal may affirm, vary or substitute the SFC's decision. The Tribunal's constitution and procedures are discussed in Chapter 9.

7.31 As for enforcement of an appealed disciplinary decision, the composite Bill (Clause 212) provides that such decision will not be effective until the withdrawal or determination of the appeal. Provision is however made for dealing with exceptional circumstances (see Chapter 9).

CHAPTER 8

PART X OF THE SECURITIES AND FUTURES BILL

POWERS OF INTERVENTION AND PROCEEDINGS

INTRODUCTION

8.1 Part X of the composite Bill sets out the SFC's powers for taking action against licensed persons, listed corporations and other persons who have contravened provisions of the law falling under the SFC's purview. The powers may essentially be classified into two categories. These are –

(a) powers that enable the SFC to intervene in the business and operations of certain licensed persons, which are dealt with in Clauses 189 to 196; and

(b) powers that enable the SFC to apply to the Court for a range of orders and other relief against licensed persons, listed corporations and certain other persons, which are dealt with in Clauses 197 to 200.

8.2 The two categories of powers supplement one another. The SFC's powers to intervene enable it to take immediate action to protect the interests of the investing public generally as well as those of a licensed person's clients and, to a limited extent, its creditors. However, where –

(a) more drastic measures are called for (for instance, an injunction is required to enjoin any breach of the relevant Ordinances); or

(b) the SFC encounters resistance or obstruction in exercising its powers of intervention; or

(c) it is appropriate or necessary to take steps which have a more permanent or long lasting effect (for instance, where for the preservation of a licensed person's assets for the protection of its clients and creditors, a winding up order should be made),

the SFC's powers to intervene may not suffice and recourse to the Courts provides a critical means of protecting the interest of investors and creditors. The SFC's ability to apply to the Court for a range of orders and other relief in such circumstances is therefore crucial.

8.3 The powers, as set out in Part X, are primarily based on the current legislation, with amendments introduced to address existing inadequacies and to bring the legislation up to par with developments introduced in other international financial centres. The ensuing paragraphs give an overview of the SFC's powers under Part X, with the focus being on improvements to the existing law.

POWERS OF INTERVENTION – OVERVIEW (Clauses 189 to 196)

8.4 The SFC's powers of intervention under Part X build on its existing powers under sections 38 to 43 of the SFC Ordinance (and the corresponding sections 49 to 54 of the Leveraged Foreign Exchange Trading Ordinance). To this end, Part X –

(a) preserves the SFC's powers to issue notices which require certain licensed persons to –

(i) take, or refrain from taking, certain action in respect of their business (Clause 189);

(ii) deal or refrain from dealing with property in a specified manner (Clause 190); or

(iii) maintain property in the place and manner specified (Clause 191);

(b) confers upon the SFC a new power, namely the power to issue notices which require certain persons to transfer custody of certain property to the SFC or to any person appointed by the SFC for such purpose (Clause 192);

(c) extends the existing threshold for the exercise of the aforesaid powers so that such powers may be exercised where the SFC is of the view that –

(i) property connected with the regulated business of the particular licensed person may be dissipated, transferred or otherwise dealt with in a manner prejudicial to the interest of its clients or creditors;

(ii) the particular licensed person is no longer fit and proper to remain licensed;

(iii) the particular licensed person has failed to comply with the laws, requirements or conditions relevant to his licence, or has furnished false or misleading information to the SFC;

(iv) the grounds specified for revoking or suspending the licensed person's licence exist; or

(v) it is otherwise desirable in the interest of the investing public to do so (Clause 193);

(d) retains the SFC's existing powers to withdraw, substitute or vary any notice issued pursuant to the aforesaid powers, either on its own volition or at the request of any person affected by the notice, including the person to whom it is issued (Clause 194); and

(e) retains the existing safeguards for ensuring a fair and transparent exercise of these powers by the SFC, including in particular the requirements that –

(i) any notice issued pursuant to such powers cannot take effect before it has been served on the particular licensed person against whom it is issued;

(ii) such notice must be served together with the SFC's statement of reasons for its issue; and

(iii) where the reasons for the issue of such notice relate to matters that are prejudicial to a third party and such third party is identified in the statement of reasons, the SFC must take all reasonable steps to serve a copy of such notice and statement of reasons on that third party.

8.5 The composite Bill introduces essentially two significant changes to the SFC's existing powers to intervene in a licensed person's business. The more significant of these is the addition of the new power, under Clause 192, enabling the SFC to require certain persons to transfer custody of certain property. The second change is the introduction of a certification procedure under Clause 196, which enables the SFC to seek the assistance of the Court in compelling compliance with any restriction notice issued under Clauses 189 to 192 or Clause 194. Each of these is discussed below.

POWERS OF INTERVENTION – IMPROVEMENTS TO EXISTING LAW

Power to require transfer of property

8.6 As noted above, Clause 192 empowers the SFC to intervene in a licensed person's business by requiring that custody of certain property be transferred to it or to its appointee. The reasons for conferring such a power are as follows –

(a) there is a danger that a licensed person may not comply with the terms of a notice prohibiting or requiring him to handle or deal with client property, or property forming part of the licensed person's regulated business, in the manner specified by the SFC; and

(b) in such cases, both the clients and creditors of the licensed person are left in a vulnerable position, and risk losing their property or recourse to recovery.

8.7 The power under Clause 192 is crucial where client property or property forming part of a licensed person's regulated business is under threat of being dissipated, misappropriated or otherwise dealt with improperly. In drafting Clause 192, we have taken due care to strike a suitable balance between protecting individual property rights (a right enshrined in Articles 6 and 105 of the Basic Law) and protecting the wider interest of the investing public (a function designated to the SFC). There are a number of points to be noted as regards the ambit of the power conferred under this clause.

(a) The scope of the provision is limited. The SFC will only be allowed to act in relation to property which it reasonably believes to be connected with the business of a licensed person acting within the capacity for which he is licensed.

(b) Clause 192 only empowers the SFC to require transfer of custody of the property and to thereafter apply to the Court for an order as to how to deal with the property. The provision does not empower the SFC to require transfer of any title to or interest in the property, or to deal with the property on its own accord. Accordingly –

(i) an exercise of this power obliges the SFC to do affirmatively the following –

- as soon as reasonably practicable, apply to the Court for an order as to how the property is to be dealt with (Clause 192);
- take all reasonable steps to preserve the property until determination of the matter by the Court (Clause 192); and
- as soon as reasonably practicable, take all reasonable steps to ascertain who has a claim to or an interest in the property and to serve a copy of the relevant restriction notice and accompanying statement of reasons (Clause 195); and

(ii) the provision does not involve any transfer of legal or equitable title in the property nor does it affect any third party claims or rights in respect of such property (Clause 192).

(c) It requires the SFC to notify affected third parties of the SFC's exercise of its powers under Clause 192 and empowers the Court to make a final determination as regards the property.

Certification to Court relating to non-compliance

8.8 The second new power conferred in relation to the SFC's powers to intervene is found in Clause 196. This provision enables the SFC to seek the Court's assistance in compelling compliance with the terms of a notice issued under any of Clauses 189 to 192 or Clause 194 where there is an unreasonable failure to do so.

8.9 Clause 196 is drafted along the lines of the existing sections 32 and 33(13) of the SFC Ordinance, which provide similar recourse in respect of persons who without

reasonable excuse fail or refuse to comply with notices issued by the SFC in the context of discharging its supervisory or investigatory functions. Accordingly, the inclusion of this new provision will facilitate the effective discharge of the SFC's functions under Part X in the same way as sections 32 and 33(13) facilitate the SFC's discharge of its supervisory and investigatory functions.

POWERS TO SEEK COURT ORDERS – OVERVIEW (Clauses 197 to 199)

8.10 Under the existing law, the SFC is empowered to –

(a) initiate proceedings to petition for the winding up or bankruptcy of licensed persons where it is desirable in the public interest to do so;

(b) apply for a variety of injunctive orders against persons who have contravened or are about to contravene certain provisions of the existing legislation or requirements issued pursuant thereto – such orders ranging from restraining orders to orders appointing an administrator over a registered person's property and orders declaring certain contracts void or voidable; and

(c) seek remedial measures against listed corporations where it appears that its affairs are being or have been conducted in a manner unfairly prejudicial to its members – such measures ranging from obtaining restraining orders, to requiring proceedings to be brought in the corporation's name and appointing a receiver or manager of the corporation's property.

These powers are currently set out in sections 37A, 45, 46 and 55 of the SFC Ordinance, and section 144 of the Securities Ordinance respectively (and the corresponding sections 13, 55, 59 and 60 of the Leverage Foreign Exchange Trading Ordinance).

8.11 While the existing powers to seek Court orders are fairly wide and allow a relatively extensive range of orders to be sought, the SFC's experience of the last 10 years has revealed a number of limitations. The composite Bill seeks to rectify these. To this end, Part X preserves each of the existing powers described in paragraph 8.10 above and, where appropriate, expands them to allow for a more effective discharge of the SFC's functions. More specifically –

(a) in the case of the power to seek injunctive orders, Part X expands the SFC's existing powers so that the SFC may initiate proceedings for such orders against not only licensed persons, but also other persons who have assisted or participated in the offending act; and

(b) the range of orders that may be sought in such cases, and in cases where the SFC is seeking remedial measures against listed corporations, is also expanded.

Additionally, a new provision is added imposing civil liability for public misstatements. Each of these changes, and the rationale behind them, are discussed in greater detail below.

POWERS TO SEEK COURT ORDERS – IMPROVEMENTS TO EXISTING LAW

8.12 Under Clause 198, the SFC's power to seek injunctions and other orders is expanded so that such orders may be sought against not only licensed persons or persons who have contravened any relevant law, requirement or condition applicable to their licence, but also other persons who have assisted or been involved in such contravention. These are persons who have –

(a) aided, abetted, or otherwise assisted, counselled or procured the commission of any such contravention;

(b) induced any such contravention;

(c) been knowingly involved, directly or indirectly, in any such contravention; or

(d) attempted or conspired with others to commit any such contravention.

8.13 This extension allows the SFC to take appropriate action as specified in the Court orders against all relevant persons involved in a contravention. Any order thus made by the Court will be more effective in restricting a contravention and, in turn, will allow for more effective investor protection. The extension is also consistent with the approach in other jurisdictions, such as Australia where section 1324 of the Australian Corporations Law is of similar effect to Clause 198 of the composite Bill.

8.14 Secondly, under Clause 198, the range of orders that may be sought is also expanded. These have essentially been introduced to tally with the expanded range of persons against whom such orders may be sought.

8.15 Likewise, Clause 199 expands the range of orders that may be sought against listed corporations as currently provided under section 37A of the SFC Ordinance. This expansion is, in part, a response to judicial comment that the scope of section 37A is unnecessarily limited. In particular, the provision now expressly empowers the SFC to seek an order disqualifying a person from being involved in the management of any corporation. Again, this allows a more effective discharge of the SFC's function of ensuring investor protection. The proposal to apply for such a disqualification order was exposed to the market in July 1999. Representations received suggested that the proposed disqualification period should be extended from five years to 15 years as in section 168E(3) of the Companies Ordinance[1]. It is felt that extending the maximum period of disqualification to 15 years is appropriate as it gives the Courts greater flexibility in tailoring the disqualification to fit the conduct and circumstances. This suggestion has therefore been adopted in Clause 199.

PRIVATE ACTION AGAINST FALSE PUBLIC COMMUNICATION (Clause 200)

8.16 A new provision has been added under Part X (Clause 200), which expressly provides for a claim for damages where a person has suffered pecuniary loss as a result of relying on any public communication (relating to securities or futures contracts), which is false or misleading. This proposal was not included in the July 1999 consultation exercise.

8.17 In including this provision, the intention is to ensure that persons responsible for issuing public communications exercise all due care and diligence. Such persons may not necessarily fall within the SFC's purview as they may not be licensed with the SFC in any capacity. However, their actions have the potential for serious and far-reaching impact on the investing public and, hence there should be no doubt as to their accountability for their action. Clause 200 therefore serves to give formal recognition

[1] Section 168E of the Companies Ordinance provides for a disqualification order against a person where he is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of a company; or in connection with the receivership or management of a company's property; or any other indictable offence which necessarily involves a finding that he acted fraudulently or dishonestly.

to the standards expected of persons responsible for issuing statements to the investing public.

8.18 Under the common law, a person is liable in damages for negligent misstatements made by him where the plaintiff can prove that he had relied on the misstatement, and the loss or damage he suffered was a reasonably foreseeable consequence of such reliance. The intention in Clause 200 is to recognize that a person responsible for making any public communication relating to securities or futures contracts owes a duty of care to all those who may reasonably rely on it to ensure that the communication is not false or misleading. If it is, the person responsible for the communication will be liable for all loss or damage as a result of the reliance.

8.19 In determining questions of proximity, and the measure of damages, the common law principles applicable to negligent misstatements are intended to apply to statutory action created under Clause 200.

8.20 Given the implications that this provision could have for both persons issuing advertisements as well as investors relying on them, the Government would like to invite comments on whether and if so how Clause 200 should give further articulation to the common law principles.

ENFORCEMENT OF THE LISTING RULES AND CODES ON TAKEOVERS AND MERGERS AND SHARE REPURCHASES

8.21 There is one last issue to note in respect of Part X. This concerns the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") and the Hong Kong Codes on Takeovers and Mergers and Share Repurchases ("Codes"). These do not have the force of law at present. The Listing Rules have the status of a contract between the Exchange and issuers listed on it. As regards the Codes, these simply represent a consensus of opinion of those who participate in Hong Kong's financial markets and the SFC, regarding standards of commercial conduct and behaviour considered acceptable for takeover and merger transactions and share repurchases in Hong Kong.

8.22 The major proposals under the composite Bill, which were exposed to the public in July 1999, included a proposal to empower the SFC to apply to the Court for orders compelling compliance with the Listing Rules or the Codes in the event of non-

compliance, and disqualifying directors of listed corporations who have wilfully or persistently failed to discharge their duties under the Listing Rules or the Codes. At the time, it was also proposed that any disclosures made under either the Listing Rules or the Codes, which were false or misleading should be made the subject of possible civil claim for damages under the composite Bill.

8.23 These proposals were put forward with a view to strengthening the enforceability of the Listing Rules and the Codes. The market responded by noting that any proposal to give statutory backing to the Listing Rules and the Codes should not come at the cost of rendering their application unduly legalistic. In particular, the market stressed the need to maintain the non-statutory nature of the Listing Rules and Codes and the need to retain flexibility in both their content and interpretation so that they may evolve in keeping with market developments and innovations.

8.24 In light of these market sentiments, the Government sought extensive legal advice in developing the proposal. The advice received confirmed that if the proposal of conferring statutory backing on the Listing Rules and the Codes were implemented, and the SFC were to be empowered to enforce compliance with the Listing Rules and the Codes, such rules and codes would have the status of law and effectively became statutory provisions. These documents would thus be subject to normal rules of legislative interpretation and procedures for amendment. They would lose the flexibility and expeditious interpretation that are considered to be so vital for the market.

8.25 In view of the foregoing, we have decided not to pursue the original proposal to provide statutory backing to the Listing Rules and the Codes. That notwithstanding, both the Government and the SFC remain committed to improving the quality of disclosures made to the investing public, and in particular disclosures made pursuant to the Listing Rules and the Codes. To this end, it is believed that the Securities and Futures Legislation (Provision of False Information) Bill, which was introduced into the Legislative Council in March 2000, will go some way in enhancing the accuracy of disclosures by making the provision of false or misleading reports to the SFC or other relevant regulators a criminal offence. Also, Clause 200 of the composite Bill will go some way in serving the same purpose as that provision essentially aims to ensure the accuracy of disclosures to the public.

CHAPTER 9

PART XI OF THE SECURITIES AND FUTURES BILL

SECURITIES AND FUTURES APPEALS TRIBUNAL

INTRODUCTION

9.1 Part XI of the composite Bill establishes a tribunal, to be called the Securities and Futures Appeals Tribunal ("SFAT"), which will have the jurisdiction to review a wide range of the SFC decisions that may affect a person's rights or interests. The SFAT will be independent of the SFC, headed by a judge assisted by two lay members with relevant experience. Its review of any SFC decision will be on the full merits of the case, and it will have the power to affirm, vary, or substitute that decision. The SFAT will be a powerful safeguard in ensuring that the SFC decisions are correct, proper and fair.

CHALLENGING SFC DECISIONS

9.2 There is in the current system an effective set of external checks and balances on SFC's use of its powers. The Non-Executive Directors of the SFC oversee its work on a regular basis and act as the first line of independent supervision. Intermediaries who are disciplined or refused a licence have the right of appeal to an independent Securities and Futures Appeals Panel ("SFAP") created under Part III of the SFC Ordinance for full merits review. Certain specific areas have specialised review procedures (e.g. appeals to the Takeovers and Merger Panel or Takeovers Appeal Committee in takeover matters, or to the Chief Executive in Council for certain major decisions relating to the exchanges). In addition, parties affected by any SFC decision can always seek judicial review. Those dissatisfied with the way the SFC has handled any particular matter can complain to the Ombudsman. The SFC is also subject to the scrutiny of the Independent Commission Against Corruption.

9.3 These channels of redress will continue to be available under the composite Bill. Moreover, the scope of merits review will be broadened as an added measure of enhancing the accountability of the SFC.

9.4 The Government considers that merits review provides a real and effective remedy for those aggrieved by a decision of the SFC. The composite Bill will broaden the scope for merits review, and strengthen the review body. In particular, the main deficiencies of the SFAP will be rectified. These deficiencies are as follows –

(a) it has a limited jurisdiction;

(b) it is a part-time body, sitting mostly outside business hours and on weekends, so justice for an applicant may be slow, and timely SFC regulatory action may be hindered; and

(c) its procedural rules are unclear, which slows pre-hearing preparation and impairs its ability to move quickly towards resolution of a matter.

9.5 The Bill proposes to address these deficiencies by upgrading the SFAP to a statutory tribunal ("SFAT"). The key features of the SFAT are –

(a) a full-time judge[1] will preside at tribunal hearings, assisted by two lay members selected on account of their expertise in relevant fields. All of them will be independent of the SFC and appointments will be made by the Chief Executive (Clause 202);

(b) the jurisdiction of the SFAT will be expanded beyond that of the SFAP. Schedule 7 sets out a list of SFC decisions appealable to the SFAT. This list may be amended by the Chief Executive in Council (Part 2 of Schedule 7 and Clause 219). As presently proposed, the SFAT will be able to review the following SFC decisions –

(i) in relation to the operation of SFC licensees,

- disciplinary decisions including decisions to revoke or suspend a licence, reprimand, fine or impose prohibition orders;

[1] A judge or deputy judge of the Court of First Instance, a former Justice of Appeal, or a former judge or former deputy judge of the Court of First Instance.

- decisions not to exempt a person from the operation of any provisions of the Financial Resources Rules;

- decisions to appoint auditors to examine, audit and report on the affairs of licensed intermediaries;

(ii) in relation to offers of investments,

- decisions in relation to unlisted corporation prospectuses, including decisions refusing registration or refusing to grant a waiver from the prospectus requirements;

- authorization decisions in relation to securities, other property or collective investment schemes including decisions refusing to authorize advertisements, invitations, or other documents relating to offerings;

(iii) in relation to disclosure of interests,

- decisions not to exempt a person from certain disclosure requirements;

(c) the SFAT will continue to be a merits review body and will be able to confirm or vary an SFC decision or substitute that with its own decision (Clause 204). The SFAT will also continue to be able to award legal costs as it considers appropriate (Clause 208); and

(d) the SFAT will have a detailed set of procedures for effective conduct of hearings, including a power to hold preliminary conferences and to make consent orders settling matters (Clauses 204, 205, 209, and 218 and Schedule 7, Part 1, sections 10 to 24).

9.6 Any party aggrieved by an SFC decision made in respect of that party, as long as the decision is within the jurisdiction of the SFAT, may lodge an appeal within 21 days of the SFC decision being communicated in writing (Clause 203). Generally, an SFC decision that is appealable to the SFAT will not take effect until the time for appeal has lapsed or, if an appeal is lodged, until such is withdrawn or determined. There are exceptions for

certain decisions to which provisions in the composite Bill will give immediate effect, or where the SFC may decide that the public interest requires the decisions to have immediate effect. However, the composite Bill provides a safeguard whereby an aggrieved party may apply to the SFAT for a stay of execution pending determination of an appeal (Clause 212).

9.7 Appeals will be heard in public unless the interests of justice favour it being heard in private (Schedule 7, Part 1, section 14). A party dissatisfied with a finding or determination of the SFAT may appeal to the Court of Appeal on points of law (Clause 214).

JURISDICTION OF THE SFAT

9.8 As detailed above, the SFAT will have jurisdiction over a wide range of the SFC decisions. However, not all decisions are amenable to merits review by a body such as the SFAT. The Government has carefully considered with the SFC as to which of the SFC decisions should be appealable to the SFAT, with a view to striking a reasonable balance between providing sufficient remedies to a person whose rights or interests may be affected and ensuring that the SFC can effectively perform its regulatory functions. The following factors are of particular relevance –

(a) whether a decision has significant conclusive implications for an affected person;

(b) whether a decision involves broader policy considerations;

(c) whether a decision is subject to other specialised review mechanisms, e.g. the Takeovers and Mergers Panel; and

(d) whether allowing for merits review in addition to other review mechanisms would hamper effective regulation or would impair timely action to protect investors, e.g. the exercise of inspection and investigation powers.

Guided by these considerations, we have arrived at the list of appealable decisions in Schedule 7 of the Bill.

PROCESS REVIEW PANEL

9.9 In addition to upgrading the merits review body, we also propose to create a Process Review Panel ("PRP") that will audit SFC's actions and decisions to determine if the SFC has observed its internal processes. This will provide a powerful check on SFC's exercise of its powers. (The role and other aspects of the PRP are explained in more detail in Chapter 1.) Together, the PRP and the SFAT will help ensure that the SFC makes its decisions fairly, properly and consistently and will enhance the SFC's accountability and transparency.

SUGGESTIONS RECEIVED DURING PUBLIC CONSULTATION

9.10 A number of respondents to the July 1999 public consultation submitted constructive comments on the SFAT proposal. We have followed these comments in improving the proposals in Part XI. First, the appeal period has been extended from 14 days to 21 days. Second, having regard to concerns expressed by members of the Legislative Council over the ability of the SFC to give some decisions immediate effect, we have, as mentioned in paragraph 9.6 above, introduced an arrangement whereby a person who is the subject of an SFC decision may apply to the SFAT for a stay of execution of that decision pending determination of an appeal.

9.11 We also appreciate market concerns that the enhanced status of the SFAT may increase appeal costs. We believe that the proposals in Part XI will not by themselves increase costs, as the improved resources of the SFAT, its full time operation and more detailed procedures should allow appeals to be dealt with more expeditiously and hence more cost effectively. In addition, the SFAT will retain the current power of the SFAP to award costs to an applicant.

CHAPTER 10

PART XII OF THE SECURITIES AND FUTURES BILL

INVESTOR COMPENSATION

INTRODUCTION

10.1 As mentioned in Chapter 3, the composite Bill sets up a framework for new investor compensation arrangements to provide compensation to investors in the event of defaults by exchange participants of SEHK or HKFE and potentially by other persons providing services to investors. Part XII of the composite Bill provides the legal structure that will enable the establishment of a new compensation fund. Other aspects of the framework include power of the SFC to recognize a company or companies to manage and administer the whole or a part of the new fund (Part III of the composite Bill), and certain transitional arrangements in relation to matters after the repeal of existing legislation (Part XVII of the composite Bill). Parts III and XII of the composite Bill together provide the necessary framework to facilitate the implementation of the new investor compensation proposals set out in the "Consultation Paper on New Investor Compensation Arrangements for Hong Kong", which the SFC issued in September 1998.

NEED FOR IMPROVEMENTS

10.2 The existing compensation funds namely the Unified Exchange Compensation Fund ("UECF") for SEHK, and the Commodity Exchange Compensation Fund ("CECF") for HKFE, rely in part on deposits paid by members of the exchanges. They also derive part of their reserve from statutory transaction levies. The compensation ceilings are respectively $8 million per stockbroker and $2 million per futures broker. The per broker ceilings give an uncertain level of investor protection, as it does not communicate to investors the amount of coverage available to them individually. Although this has been partly addressed in respect of the UECF by the introduction of a per claimant ceiling under the amendments to the Securities Ordinance in 1998, the basic structure of the UECF remains one that operates on the basis of a per broker

ceiling. We propose the establishment of a new investor compensation scheme to address these shortcomings.

10.3 The main objectives of the new compensation proposals are as follows –

(a) to enhance the existing investor compensation arrangements and increase investor confidence;

(b) to provide a "per investor level" of compensation for retail investors;

(c) to provide the compensation arrangements through a new and independent entity that includes industry and public interest representatives and is subject to appropriate checks and balances;

(d) to protect and leverage existing compensation fund assets, including possible use of insurance, while minimizing any additional costs to the industry;

(e) to employ market-based commercial risk management mechanisms and incentives within the arrangements; and

(f) to provide a flexible structure that will allow additional arrangements to be developed for other existing or emerging segments of the market.

PROPOSED REGIME

10.4 The salient points of the new compensation proposals are as follows –

(a) Sources of funds for compensation –

(i) the remaining funds in the UECF and the CECF after satisfying claims lodged with them and payments as mentioned in paragraph 10.6 below to be transferred to the new investor compensation fund;

(ii) the possible introduction of an insurance policy covering the excess risk, with premiums funded by the monies in the new investor compensation fund; and

(iii) the introduction of a back-up credit facility that may be repaid by the institution of a market levy to be prescribed by the Chief Executive in Council.

(b) Scope of compensation – The SFC, in consultation with the Financial Secretary, will make rules to prescribe the various circumstances under which investor compensation is available.

(c) Level of compensation – A "per investor" compensation limit will be prescribed by the Chief Executive in Council.

LEGAL PROVISIONS

10.5 Part III of the composite Bill provides that the SFC may, after consultation with the Financial Secretary, recognize one or more companies as investor compensation companies ("ICCs") to facilitate the management and administration of the compensation fund (Clause 77). The SFC may request the Chief Executive in Council to transfer part of its investor compensation functions to one or more ICCs (Clause 78). The transferable functions include maintenance of the fund covering both payments to and out of it, keeping of accounts, etc. The SFC, however, may resume responsibility over any function so transferred under certain specified circumstances (Clause 78). The ICCs may promulgate rules and operational procedures that will be subject to the SFC's approval before implementation (Clauses 81 and 82).

10.6 Part XII of the composite Bill provides that the SFC shall establish a compensation fund (Clause 221). The monies in the compensation fund shall include all amounts paid to the SFC or the ICC in accordance with rules to be made under Clause 228, together with the balance of the monies in the UECF and the CECF that are not needed to satisfy outstanding claims (Clause 222). The SFC shall maintain separate accounts in respect of the amounts that are respectively paid into the compensation fund from the UECF and the CECF. The SFC may, with the written consent of the Financial Secretary, borrow for the compensation fund from any authorized financial institution (Clause 222). The SFC shall submit to the Financial Secretary the audited financial statements of the compensation fund annually (Clause 224). The SFC (Clause 227) and the ICC (Clause 85) shall be subrogated to the rights of the claimants to the extent of compensation payments made to the claimants.

10.7 The Chief Executive in Council may make rules to provide for the means of funding the compensation fund and the maximum amount of compensation that may be paid to a claimant (Clause 228). The SFC may make rules to provide for matters relating to the claims, including the entitlements of claims and the manner in which a claim is to be made and the circumstances and the manner in which the SFC may call for, determine and pay claims (Clause 228).

IMPLEMENTATION PLAN

10.8 We have included in Parts III and XII of the composite Bill a flexible framework to enable the SFC to consult HKEx on the establishment and operation of the new compensation scheme. The SFC has already initiated discussions with HKEx on the new investor compensation proposals, given the need to reach suitable arrangements with the underwriters and exchange participants in time for the proposals to be implemented as soon as possible after the composite Bill is enacted. The composite Bill provides for a flexible and broad framework for such discussions and should not restrict the development of these proposals and arrangements.

CHAPTER 11

PART XIII OF THE SECURITIES AND FUTURES BILL

MARKET MISCONDUCT TRIBUNAL

INTRODUCTION

11.1 Part XIII of the composite Bill establishes a civil system to address market misconduct that undermines the integrity of Hong Kong's securities and futures market and prejudices the interest of the investing public. To this end, the new system will introduce a tribunal, to be called the Market Misconduct Tribunal ("MMT"), to hear market misconduct cases relatively quickly using efficient civil procedures and to impose comprehensive civil sanctions on offenders.

11.2 Part XIII also creates a private cause of action for those who suffer pecuniary loss as a result of market misconduct. This will simplify proceedings for those seeking civil redress and complement the civil tribunal system so that together they form the underpinning of an effective civil regime for the protection of investors.

OVERVIEW OF THE PROPOSED REGULATORY FRAMEWORK

Background

11.3 Hong Kong has introduced a tribunal system since 1991 to inquire into and to impose civil sanctions against insider dealing. The Insider Dealing Tribunal ("IDT"), established under the Securities (Insider Dealing) Ordinance, hears insider dealing cases on the civil standard of proof.

11.4 To date, the IDT has completed nine inquiries into suspected insider dealing and imposed sanctions on 15 insider dealers. The IDT's success is attributable to its ability to consider all relevant and logically probative evidence without being bound by the restrictive criminal laws of evidence, to its power to conduct further inquiries to

supplement the evidence presented by the parties, and to its ability to apply the civil standard of proof, i.e., a balance of probabilities in determining whether it is satisfied that cases referred to it have been proved.

11.5 Building on the strengths of the IDT in combating insider dealing, the Bill extends the civil tribunal system and establishes an MMT to cover not only insider dealing but also other instances of market misconduct (such as market manipulation). It clearly spells out what constitutes market misconduct in respect of which the MMT will have jurisdiction to inquire into and impose civil sanctions. As specifically set out in the composite Bill, market misconduct comprises –

(a) insider dealing (Clause 253);

(b) stock market manipulation (Clause 260);

(c) false trading in securities or futures contracts (Clauses 257 and 262);

(d) price rigging in securities or futures markets (Clauses 258 and 263);

(e) disclosure of information about prohibited transactions in securities or futures contracts (Clauses 259 and 264); and

(f) disclosure of false or misleading information inducing transactions in securities or futures contracts (Clauses 261 and 265).

11.6 Clause 253 will re-enact the definition of insider dealing currently in the Securities (Insider Dealing) Ordinance with one change. Under the Securities (Insider Dealing) Ordinance, the definition of "substantial shareholder" for purposes of the insider dealing provisions refers to a person who holds shares with voting rights with an aggregate nominal value of "10% or more" of the total nominal value of a listed company's shares with voting rights. This will be lowered to "5% or more" so as to reflect the change to the definition of "substantial shareholder" for purposes of disclosure of interests under Part XV (see Chapter 13).

11.7 The provisions governing other acts of market misconduct set out in paragraph 11.5 (b) to (f) above will be based on long established offences in the Australian Corporations

Law (sections 997- 999, 1001, 1259-1261 and 1263). These provisions carry with them a body of case law, which will be helpful in interpreting the provisions.

Civil Sanctions

11.8 The MMT will be able to impose a range of civil sanctions under Clause 241, including –

(a) disgorgement of profits made or loss avoided, subject to compound interest thereon;

(b) disqualification of a person from being a director or otherwise involved in the management of a listed company for up to 5 years;

(c) a "cold shoulder" order[1] on a person (i.e., the person is deprived of access to market facilities) for up to 5 years;

(d) a "cease and desist" order[2] (i.e., an order not to breach any of the market misconduct provisions in Part XIII again);

(e) to refer a person found to have engaged in market misconduct to a body of which that person is a member for disciplinary action by that body; and

(f) payment of the costs of the MMT inquiry and/or SFC investigation.

This range of orders will enable the MMT to deal comprehensively and relatively swiftly with market misconduct with all the attendant benefits of simpler evidentiary and procedural rules.

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[1] Under the Codes on Takeovers and Mergers Code and Share Repurchases, the Takeovers and Mergers Panel has the power to issue a "cold shoulder" order which requires licensed persons not to act or continue to act for a person who is the subject of an order for a period.

[2] The US Securities and Exchange Commission has the power to issue "cease and desist" orders as administrative acts. Proceedings for breach of an order are brought before a Court and may be punished by a civil penalty and/or a mandatory injunction directing compliance with the order.

A DUAL ROUTE

11.9 At present, the IDT has the power to impose pecuniary fine orders of up to three times the profit made or loss avoided. Other market misconduct (such as market manipulation) may only be dealt with through criminal prosecution.

11.10 It was initially proposed that the MMT would have the power to impose pecuniary fine orders of the same gravity as those within the jurisdiction of the IDT, and that all forms of market misconduct be decriminalised. The advantages of this model are that a civil system, where on a civil standard of proof there would be better prospects of securing a finding of market misconduct having been committed and where adequate sanctions could be imposed, would be a more effective system to reduce and minimize market misconduct. The proposal that the MMT could impose pecuniary fines of up to three times the profit made or loss avoided was seen as an effective sanction.

11.11 In the course of developing this proposal, the Government has been advised that the jurisprudence developing before the European Court of Human Rights involving human rights protections similar to those under the Basic Law and the Hong Kong Bill of Rights Ordinance cautions that pecuniary fine orders could, in certain cases, be "criminal" for human rights purposes. In light of such advice, the Government has decided that, while the original imperatives behind the creation of the MMT remain, a more prudent way forward would be not to pursue the original proposal to give the MMT the power to impose pecuniary fine orders, but to build in a series of effective civil measures to protect investors.

11.12 The decision is therefore to continue with extending the effective civil tribunal inquiry system beyond insider dealing to market manipulation and other types of market misconduct. As the MMT will no longer impose heavy pecuniary fine orders, the range of civil sanctions available will be enriched by the addition of new powers such as imposing "cold shoulder" orders and "cease and desist" orders. These sanctions, which have been carefully considered both for compliance with human rights protection and for their credibility as sanctions, will enable the MMT to deal appropriately and flexibly with those who engage in market misconduct.

11.13 Not pursuing the proposed power for the MMT to impose the more severe pecuniary fine orders may leave some doubt as to whether serious improper conduct will be dealt

with adequately. The Government believes that the legislation must clearly articulate to the market that market misconduct is unacceptable. A decision has therefore been made to provide for parallel civil and criminal regimes to deter market misconduct. Provisions criminalising market misconduct appear in Part XIV and are further discussed in Chapter 12.

11.14 Insider dealing has not been treated as a criminal offence in Hong Kong. However it is commonly defined as such in other comparable jurisdictions including the US, the UK and Australia. The insider dealing provisions in the Securities (Insider Dealing) Ordinance have become well accepted and familiar to participants over the past nine years. The market in Hong Kong is now experienced enough with these provisions, which are adopted and adapted in Part XIV for criminalising insider dealing (in parallel with the MMT civil route). This would be an appropriate time to introduce criminal sanctions to send a clear message that insider dealing would not be tolerated. Indeed, it would be inconsistent to subject other instances of market misconduct to both civil and criminal regimes and leave insider dealing to be dealt with under a civil regime only.

11.15 The US, the UK and Australia all have dual criminal and civil routes for dealing with activities amounting to market misconduct. This consideration has weighed with the Government in choosing this option.

11.16 The decision of whether to refer a case of potential market misconduct to the Financial Secretary for inquiry by the MMT or to pursue criminal prosecution is an important one with serious consequences for those whose conduct is implicated as well as for the public interest. In determining how such decisions should be made under the composite Bill, the Government has had careful regard to the way similar decisions are made in comparable foreign jurisdictions with dual civil and criminal systems.

11.17 The initial decision on whether to refer a matter to the Financial Secretary for possible referral to the MMT or to refer the matter to the Secretary for Justice for criminal prosecution under Part XIV will be made by the SFC. However, both the Financial Secretary and the Secretary for Justice will have the power to re-direct that matter to the other regime if he or she disagrees with the SFC's decision (Clause 236). It is also important to note that the SFC will be able to prosecute less serious offences under Part XIV in summary actions in a Magistrate Court as it can for any other offence under the Bill (Clause 365).

11.18 The Secretary for Justice and senior officers of the Department of Justice Prosecution Division decide whether to institute a criminal prosecution on the basis of the "Department of Justice Prosecution Policy : Guidance for Government Counsel" ("Prosecution Policy"). The Prosecution Policy requires that two basic factors be considered –

(a) the sufficiency of evidence – there must be admissible, substantial and reliable evidence that an offence has been committed and there is a reasonable prospect of a conviction; and

(b) the public interest – whether the public interest requires a criminal prosecution, taking into account the circumstances of a particular case.

If these two tests are satisfied, then a decision may be made to pursue criminal prosecution.

11.19 The SFC will make its decisions on whether to refer a matter to the Financial Secretary or the Secretary for Justice in accordance with the Prosecution Policy. In addition, it is proposed that the SFC will publish guidelines on those matters that it considers specifically relevant when deciding whether to recommend civil or criminal prosecution.

11.20 It is necessary to enable the SFC to take appropriate action to protect investors against market misconduct. The composite Bill will vest in the SFC regulatory powers in addition to its powers to refer suspected market misconduct to the Financial Secretary or to the Secretary for Justice, or to prosecute in summary action before a Magistrate, including –

(a) obtaining injunctions and other orders (Clause 198);

(b) disciplining licensed intermediaries (Part IX); and

(c) restricting the business of licensed intermediaries (Clauses 189 to 195).

The SFC may take regulatory action under these powers where neither a referral to the Financial Secretary or to the Secretary for Justice, nor summary prosecution, is

warranted according to the Prosecution Policy and any other relevant guidelines. There may also be instances where the SFC may need to take regulatory action by exercising some of these powers in addition to recommending civil or criminal prosecution or undertaking a summary prosecution, for example, by seeking an injunction to restrain an ongoing contravention of the composite Bill or an order to freeze the proceeds of misconduct or a crime. In deciding what regulatory action to take in any particular case, the SFC will examine all the circumstances.

11.21 The composite Bill includes provisions making it clear that a person will not be subject to double jeopardy by being prosecuted both civilly and criminally in respect of the same conduct (Clause 270). In addition, the SFC will not be able to fine a licensed intermediary under Part IX when that intermediary has also been prosecuted for an offence under Part XIV.

"SAFE HARBOUR" RULES

11.22 We are mindful of the need to ensure that legislation designed to deter market misconduct would not inadvertently prohibit legitimate and internationally acceptable market activities and practices as this may stifle market development. Certain submissions received during the July 1999 public consultation suggested a need to protect certain legitimate market activities from being outlawed by the new market misconduct provisions. Accordingly, the composite Bill proposes (Clause 269) that the SFC be empowered to make "safe harbour" (i.e., exemptions) rules for exempting conduct from the provisions in Part XIII. The making of these rules will be subject to consultation with the public and the Financial Secretary, and the rules will have to be tabled in the Legislative Council.

11.23 A few submissions contained specific proposals[3] for activities such as market stabilisation to be exempted. The Government has invited the SFC to consider these proposals and relevant overseas experience in drafting any "safe harbour" rules.

[3] It has been suggested by some market participants that the SFC should consider adopting rules permitting stabilisation of share prices during initial public offerings by the underwriters of those offerings. In addition, there has also been suggestion that activities conducted on different sides of a Chinese Wall should be taken into account in drawing up rules on exemptions (for example, if a research analyst at an institution issued a research report about a company in good faith, but unknown to that analyst, a staff member in another part of that same institution separated by a Chinese Wall had obtained confidential information about the company which indicated that some of the information issued by the analyst was false, the institution should not be treated as knowing that the research report contained false information so as to be guilty of an offence).

Further market views as to the desirability and potential articulation of such exemptions would be welcome.

OPERATION OF THE MMT
(Clauses 235 to 252)

11.24 The composition and procedures of the MMT will largely emulate those of the IDT. The MMT will be chaired by a Judge[4] assisted by two market practitioners, who will be appointed for a particular hearing by the Chief Executive.

11.25 The Financial Secretary may, where he considers appropriate upon reviewing any matter referred to him by the SFC under Part XIII, initiate proceedings before the MMT to hear and determine whether certain market misconduct has taken place. The composite Bill also implements certain procedural reforms. In particular, the role of the counsel presently appointed by the Secretary for Justice to assist the IDT in conducting a hearing will be changed. To be called the Presenting Officer, his role will be closer to that of a prosecuting counsel. Other revisions to the existing IDT set-up will also be made to accommodate this new role of the counsel.

PRIVATE CAUSE OF ACTION
(Clause 268)

11.26 Under the common law, a person who has suffered loss as a result of market misconduct may be able to seek redress through a civil action against the person responsible for that misconduct. The path to civil redress under the common law can be costly and riddled with obstacles. The victim will generally need to fit his cause of action into an action in contract or tort, such as negligence, and may not be aware of his legal position at common law. The composite Bill will bring Hong Kong more into line with international practice by creating an express private statutory right of civil action for damages or other remedies.

[4] Including a Judge or Deputy Judge of the Court of First Instance, a former Justice of Appeal, or a former Judge or Deputy Judge of the Court of First Instance.

11.27 Clause 268 seeks to assist investors in obtaining damages for loss as a result of market misconduct. Specifically, the clause will –

(a) clarify the circumstances under which a person may sue or be sued. No person against whom the action is brought will be liable to pay compensation unless the Court is satisfied that it is fair, just and reasonable in the circumstances; and

(b) allow finding by the MMT that a person has engaged in market misconduct to be admitted into evidence in a private civil action. This is similar to operation of section 62 of the Evidence Ordinance[5]. Though the person bringing the civil suit will still have to prove that the MMT finding is probative and relevant to his suit, the admissibility of the MMT findings is likely to be of considerable assistance.

The threat of potential civil liability should bolster the effectiveness of the civil market misconduct regime in conferring adequate protection to the market. Similar provisions are also incorporated in Clause 295 in the criminal regime for addressing market misconduct.

[5] Section 62 of the Evidence Ordinance (Cap. 8) provides that, in any civil proceedings, the fact that a person has been convicted of an offence by or before any Court is admissible in evidence for the purpose of proving that the person has committed that offence, where to do so is relevant to any issue in those proceedings.

CHAPTER 12

PART XIV OF THE SECURITIES AND FUTURES BILL

OFFENCES RELATING TO SECURITIES AND FUTURES CONTRACTS

INTRODUCTION

12.1 Part XIV of the composite Bill contains offences relating to securities, futures contracts and leveraged foreign exchange contracts. The purpose of Part XIV is to modernise the existing offences in Part XII of the Securities Ordinance, sections 62 to 65 of the Commodities Trading Ordinance and section 40 of the Leveraged Foreign Exchange Trading Ordinance ("LFETO") and to supplement the civil regime for market misconduct in Part XIII with parallel criminal offences. In particular, Part XIV contains provisions that –

(a) set out criminal offences mirroring the civil provisions in Part XIII;

(b) unify and standardise certain existing offences in the Securities Ordinance (sections 136 and 138), the Commodities Trading Ordinance (sections 63 and 64) and the LFETO (section 40) relating to acts of fraud or deception or false or misleading representations made in relation to transactions in securities, futures or leveraged foreign exchange contracts;

(c) create an offence against "bucketing", i.e., representing that futures contracts will be executed on an exchange or a regulated trading system when they are not or will not be; and

(d) create a right of civil action for those who suffer loss as a result of an offence under Part XIV.

MARKET MISCONDUCT OFFENCES

Mirroring the Civil Regime

12.2 As explained in Chapter 11 in the context of Part XIII, market misconduct will not be fully decriminalised. In parallel with the civil Market Misconduct Tribunal (MMT) regime, criminal provisions are set out in Part XIV against –

(a) insider dealing (Clause 279);

(b) stock market manipulation (Clause 286);

(c) false trading in securities or futures contracts (Clauses 283 and 288);

(d) price rigging in securities or futures markets (Clauses 284 and 289);

(e) disclosure of information about unlawful transactions in securities or futures contracts (Clauses 285 and 290); and

(f) disclosure of false or misleading information inducing transactions in securities or futures contracts (Clauses 287 and 291).

Many of the points made in Chapter 11 relating to the civil provisions apply equally to the criminal provisions.

12.3 As is the case with the civil provisions in Part XIII defining market misconduct, the provisions in Part XIV will clearly define those activities that will constitute offences. In most instances, the provisions in Parts XIII and XIV will be substantially identical, with differences owing only to the respective civil and criminal nature of the provisions. Hence concerned parties, like market intermediaries, in designing compliance systems to deal with potential liability under the Bill will not have to make duplicate arrangements for the criminal and civil provisions.

Fraudulent or Deceptive Conduct Offences

12.4 The existing Ordinances contain a variety of similar offences outlawing fraudulent or deceptive conduct in relation to transactions in securities, futures contracts or leveraged foreign exchange contracts. These provisions are slightly inconsistent in their wording. Clause 292 of the composite Bill will re-enact the existing offences but in a single harmonised provision. Specifically, it deals with (a) fraudulent or deceptive conduct, and (b) disclosure of false or misleading information, in relation to securities, futures contracts or leveraged foreign exchange contract transactions.

Bucketing

12.5 Clause 293 creates a new offence that outlaws the practice of "bucketing". Bucketing occurs when an intermediary, whether licensed or not, represents that futures transactions executed through it are executed on a futures exchange or some form of regulated electronic trading system when they are not, or will not be, so executed. Bucketing usually occurs as part of a fraudulent scheme commonly called a "bucket shop". In whatever context bucketing occurs, it is harmful not only because of the deception involved but also because extra risks are unknowingly assumed by those dealing through the bucket shop.

MENTAL ELEMENT AND DEFENCES

12.6 The market misconduct offences are clearly defined so that intermediaries and investors will know what conduct is outlawed. Often the person's intention in undertaking a course of conduct is the only guide in discerning legitimate from illegitimate conduct. However, intention is very difficult to establish, since such is usually not evidenced by the direct conduct. Drawing from the experience of the SFC and overseas regulators, it is sometimes appropriate, in establishing specific market misconduct, to infer a wrongful intention from facts, when such intention is suggested by the circumstances, i.e., where the facts speak for themselves. Similarly, if an activity is very damaging, it may be desirable to require market participants to adopt precautionary measures to ensure that they do not inadvertently engage in the activity. This is achieved by outlawing the activity while simultaneously providing for adequate defences, for example, offences with due diligence defences.

12.7 We have carefully considered the need to adequately deter market misconduct, particularly with regard to its damaging effects and the difficulties of proving such conduct. In doing so, we also took into account the need to protect those engaging in legitimate securities or futures trading, and the different approaches adopted in comparable foreign jurisdictions. The offences proposed for inclusion in Part XIV have been crafted with these considerations and the actual regulatory experience of the SFC in mind –

(a) most offences will require that a mental element be established. These include insider dealing (Clause 279), false trading in securities and futures (Clauses 283 and 288), stock market manipulation (Clause 286), fraud and deception (Clause 292);

(b) some provisions will deem certain blatantly manipulative trading (for example, trading with no change in beneficial ownership, matching buy and sell orders by related parties, trading involving any artificial or fictitious transaction or device) to be wrongful. However, a defence is provided for the defendant to establish that none of his or her purposes was a prohibited purpose (Clauses 283, 284 and 289);

(c) offences concerning the disclosure of false or misleading information (including the offence against bucketing, which is a species of false or misleading representation) will contain a defence for the defendants to prove that they acted in good faith and did not know and could not have known that the information they disclosed was false or misleading (Clauses 287, 291, 292 and 293)[1]; and

(d) offences of disclosing information about illegal transactions in securities or futures, for those who are a party to the transactions and for their associates, will be strict liability offences as such conduct speaks for itself and should be strictly outlawed (Clauses 285 and 290). The same offences for those who have received or expect to receive a benefit will contain a defence of good faith. This

[1] We are concerned that some of these offences may inadvertently catch publishers, printers and other people who act as mere conduits for information without exercising any real control over its content. We have therefore included specific defences for those who act as a mere conduit for information without exercising any real control over its content and who did not know that the information was false or misleading.

will protect those innocently reporting or commenting on such transactions, or printing, publishing or transmitting such reports or commentary.

PENALTY MAXIMA

12.8 The maximum penalties for the existing offences under the Securities Ordinance, the Commodities Trading Ordinance and the LFETO are inconsistent –

(a) 2 years' imprisonment or $50,000 or both for offences under Part XII of the Securities Ordinance;

(b) 7 years' imprisonment or $1 million or both for offences under sections 62 to 64 of the Commodities Trading Ordinance and section 40 of the LFETO.

12.9 By way of contrast, serious "white collar" crimes of fraud or deception under the Theft Ordinance typically carry maximum punishments of between 10 and 14 years' imprisonment (for example, sections 16A, 17 to 19 and 21).

12.10 The offences in Part XIV constitute serious acts akin to deception or fraud. Insider dealing, various forms of market manipulation and related conduct, disclosure of false or misleading information, and deception or fraud in connection with financial instruments all potentially cause serious loss to the investing public as well as damage public confidence in the integrity of Hong Kong's markets. The existing maximum penalties are inadequate and the composite Bill should increase the levels to reflect the serious criminality involved. Accordingly, the maximum penalties under Part XIV will be fines of $10 million and 10 years' imprisonment.

ENHANCING INTERNATIONAL COOPERATION

12.11 With the accelerating trend of globalisation and interconnection of securities and futures markets, borders are becoming increasingly irrelevant for trades in securities and futures. Advanced telecommunications technology has made international securities and futures trading cheaper, faster and easier. Exchanges worldwide are linking their markets and forming strategic alliances. Corporations look to foreign as well as domestic markets for

capital; investors are doing the same in their search for new investment opportunities and in order to diversify risks. Where trade goes, crime follows. Persons located in other jurisdictions can perpetrate crimes affecting Hong Kong's securities and futures market. Likewise persons located in Hong Kong can perpetrate crimes affecting securities and futures markets overseas.

12.12 Given these realities and a high degree of external participation in our market, it is not appropriate for Hong Kong's securities and futures laws to prohibit only criminal activities in Hong Kong that affect securities or futures contracts traded in Hong Kong. Such limited coverage fails to recognize the reality that the world's markets are converging, and that criminal acts committed in Hong Kong that affect overseas markets would eventually damage the integrity of the Hong Kong market. Moreover, in aspiring to be a world financial centre, Hong Kong must bear its share of combating transnational crime that undermines global financial markets.

12.13 In considering the regulatory issues arising from globalisation and market interconnection, the Government has also looked to the approach of comparable foreign jurisdictions. The US criminalise both the acts of those abroad that affect US markets and those in the US that affect foreign markets. The existing UK criminal insider dealing provisions apply to those in the UK who trade on insider information and deal in securities traded in other European jurisdictions. Provisions of the UK Financial Services and Markets Bill can apply to the acts of those abroad in relation to foreign traded securities or futures if that conduct has an effect on the UK, or if the market on which those financial instruments are traded is electronically accessible from the UK. The Australian insider dealing provisions and market manipulation offences (on which the provisions proposed for Parts XIII and XIV are based) generally apply to both conduct outside Australia in relation to Australian traded securities and futures, and conduct in Australia in relation to foreign traded securities and futures.

12.14 The composite Bill follows international practice. The proposed market misconduct offences, other than insider dealing, apply to –

(a) conduct outside Hong Kong with respect to Hong Kong traded securities and futures; and

(b) conduct in Hong Kong with respect to foreign traded securities and futures.

12.15 The first prong is essential for adequate protection of the Hong Kong investing public and the Hong Kong market against those abroad who may attempt to manipulate or engage in other misconduct in relation to Hong Kong traded securities or futures. The legal provisions must cover such activities so that the Hong Kong regulatory regime is able to punish and deter any misconduct affecting the Hong Kong market. The second prong of the proposed coverage is important so as to ensure that Hong Kong does not become a haven for manipulators and is in line with international comity. As described in paragraph 12.13, this proposed approach is generally accepted in other comparable jurisdictions. It demonstrates that Hong Kong abides by international norms and allows the SFC to cooperate with overseas regulators in stamping out financial markets crime.

12.16 In proposing that the market manipulation offences operate in this way, the Government has been careful that Hong Kong does not legislate for or enforce the laws of other jurisdictions. Conduct in Hong Kong that affects a foreign market will only be criminalised if it is also an offence in the foreign market alleged to be affected were it to be committed there (Clause 296).

12.17 The existing insider dealing provisions in the Securities (Insider Dealing) Ordinance apply to any insider dealer who counsels, procures or tips another person to insider deal in securities which are listed both in Hong Kong and an overseas jurisdiction (section 9(2)). Clause 279 will similarly make this conduct an offence. As we have noted, the insider dealing laws of the US, the UK and Australia apply to conduct in those jurisdictions that affects another jurisdiction. It appears logical that the Hong Kong insider dealing offences should also have the same operational coverage. Indeed, SFC investigations have on several occasions suggested that people in Hong Kong insider dealt in shares listed in other jurisdictions. Comments are specifically invited on whether the insider dealing offences and the equivalent civil provisions in Part XIII should apply to those in Hong Kong who deal in foreign traded securities or derivatives of such securities on insider information.

"SAFE HARBOUR" RULES

12.18 As with Part XIII, Part XIV will contain a provision that enables the SFC to make rules to exempt certain transactions from the defined scope of prohibited conduct. The objective

is to give the market comfort that legitimate and internationally acceptable market conduct that might possibly otherwise be an offence can be exempted from the offence provisions where this is appropriate. The provision will be substantially similar to that in Part XIII (see Chapter 11, section on "safe harbour" rules). Rules made under Part XIV are intended to mirror those made under Part XIII, so that conduct exempt from Part XIII would also be exempt from Part XIV. We welcome market views on the inclusion of the exemptions and the activities to be exempted.

DUAL ROUTE

12.19 We have discussed the proposal for a dual route to address market misconduct at length in Chapter 11. The SFC will make the initial determination on whether to refer suspected market misconduct to –

(a) the Financial Secretary, who will decide whether to instigate an MMT inquiry under Part XIII; or

(b) the Secretary for Justice, who will decide whether to pursue criminal prosecution under Part XIV.

The SFC will follow the "Department of Justice Prosecution Policy: Guidance for Government Counsel", together with any supplementary guidelines it issues in determining whether to recommend proceedings before the MMT or criminal prosecution. Criminal prosecution will be initiated where there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution against the most serious instances of market misconduct. The Financial Secretary or the Secretary for Justice can re-direct a matter to the other if he or she disagrees with the SFC's initial determination. In addition, the SFC will be given standing to prosecute less serious offences under Part XIV in summary action in a Magistrate Court (see Chapter 11, section on "dual route").

NO DOUBLE JEOPARDY

12.20 The composite Bill contains provisions to ensure that there is no double jeopardy of MMT inquiry under Part XIII and criminal prosecution under Part XIV. A person who has been

acquitted or convicted of an offence under Part XIV cannot be made subject of an MMT hearing in respect of the same conduct. Similarly, someone who is the subject of an MMT order or who has been exonerated at the end of an MMT inquiry into suspected market misconduct under Part XIII cannot be prosecuted under Part XIV in respect of the same conduct.

PRIVATE CAUSE OF ACTION

12.21 As with Part XIII, Part XIV will create a right of civil action for those who suffer loss owing to an offence committed under Part XIV (Clause 295). The provision is substantially similar to that in Part XIII (see Chapter 11, section on "private cause of action").

CHAPTER 13

PART XV OF THE SECURITIES AND FUTURES BILL

DISCLOSURE OF INTERESTS

INTRODUCTION

13.1 Part XV of the composite Bill seeks to modernise the regime for the disclosure of interests in securities. The overriding objective of the new disclosure regime is to provide investors with more complete information of better quality on a timely basis to enable them to make informed investment decisions. This includes requiring the disclosure of information that can affect perceptions of the value of listed corporations. The regime is designed to enable investors to identify the persons who control, or are in a position to control, interests in shares in listed corporations. It will bring the disclosure requirements in Hong Kong in line with international standards while minimizing the cost for compliance.

13.2 In April 1999, the SFC published its conclusions following an extensive consultation exercise[1] conducted in 1998 on enhancements to the present disclosure regime, which is enshrined in the Securities (Disclosure of Interests) Ordinance. These conclusions form the basis for the changes to the Securities (Disclosure of Interests) Ordinance, which are to be found in Part XV. The present proposals take into account further market comments received after the publication of the consultation conclusions. Part XV also seeks to address views expressed at the Legislative Council Subcommittee on the Securities and Futures Bill at its meetings with the Administration and the SFC held in September 1999.

PRINCIPAL OBJECTIVES

13.3 The principal objectives of modernising the disclosure regime are –

[1] The consultation period ran from June to September 1998. A total of 37 responses were received from representative bodies and market participants and conclusions of the consultation were published in April 1999.

(a) to remove unnecessary and unduly burdensome requirements in the current legislation and to streamline the reporting of interests in shares;

(b) to bring Hong Kong's securities disclosure regime in line with international disclosure standards;

(c) to bring the Securities (Disclosure of Interests) Ordinance in step with recent developments of the Hong Kong securities market; and

(d) to enhance transparency in the Hong Kong market by improving the extent of information available on price, securities dealings and persons having interests in shares.

13.4 The market is generally supportive of these objectives and the consultation conclusions. There is a consensus that for Hong Kong to maintain its competitiveness as an international financial centre, its disclosure regime must be kept up-to-date with market developments and be compatible with international standards.

13.5 Whilst seeking to achieve the above objectives, we appreciate that any amendments to the current disclosure regime should be weighed against the cost of complying with the additional disclosure requirements and the risk of the market being burdened with excessive information. It would not be helpful, and may even be confusing, to investors if too much information is generated. The present proposal enshrined in Part XV seeks to strike a balance between enhancing market transparency and avoiding excessive disclosure.

13.6 The following paragraphs briefly outline the new features of the proposed disclosure regime for achieving the above objectives and, where appropriate, explain how they address the market comments received.

APPROACH AND METHODOLOGY

13.7 Since the enactment of the Securities (Disclosure of Interests) Ordinance in 1988, market participants have become familiar with the current disclosure methodology. We recognize the need to avoid any confusion which may be caused by a radical change of the disclosure regime. The composite Bill has largely retained the same methodology. The provisions in Part XV have also followed in general the drafting conventions used in

the Securities (Disclosure of Interests) Ordinance as far as possible to make the new disclosure regime easier for the market to understand. The sequence of some of the provisions in that Ordinance has been re-arranged so that they now follow a more logical order. The circumstances in which a duty of disclosure arises, for both substantial shareholders[2] and directors, are set out in Part XV as are the circumstances in which they have interests by attribution. However, the detailed rules for determining whether a substantial shareholder or a director has an interest in shares, or a short position in shares, and interests to be disregarded, are included in Schedule 9 to the composite Bill, as are the particulars which must be contained in the notification.

MEETING INTERNATIONAL STANDARDS

13.8 To bring Hong Kong in line with international disclosure and regulatory standards, the composite Bill proposes -

(a) to reduce substantial shareholding disclosure threshold from 10% to 5% (Clause 306); and

(b) to shorten the notification period for disclosure from 5 days to 3 business days (Clause 308).

The suggested disclosure threshold of 5% in (a) above is comparable to that in the US, Australia, Japan and Singapore. In respect of the shortening of notification period referred to in (b) above, the majority of market comments received are not in favour of the original proposed period of 2 days (which is adopted in Australia, Singapore and the UK). We believe the revised proposal of 3 business days will achieve the purpose of an expedient and efficient disclosure regime without placing too much pressure on the market. A table comparing the disclosure threshold and notification period in Hong Kong and major international economies is at Annex E.

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[2] The term "substantial shareholder" is used in this document as a convenient label to refer to a person holding more than 5% of the shares in the relevant share capital of a listed corporation. The term "substantial shareholder" is not used in Part XV as it was not a defined term in the Securities (Disclosure of Interests) Ordinance and it is used in other parts of the composite Bill with different meanings. This also avoids potential confusion with the definition of "substantial shareholder" under the Stock Exchange of Hong Kong Listing Rules where this term has a further meaning.

INCREASING MARKET TRANSPARENCY

Consideration and terms of agreements

13.9 Clause 24 of Schedule 9 to the composite Bill requires substantial shareholders to disclose the consideration payable or receivable by them in acquiring or disposing of interests in shares, whether the transactions take place on-exchange or off-exchange. Similar provisions applying to directors are set out in Clause 54 of Schedule 9. In response to market comments, substantial shareholders and directors will not be required to disclose agreements or the terms of agreements relating to off-exchange transactions, as originally proposed by the SFC.

Disclosure of persons who control corporate substantial shareholders

13.10 Clause 27 of Schedule 9 to the composite Bill requires that an unlisted corporate substantial shareholder, when performing a duty of disclosure, disclose details of any person in accordance with whose directions or instructions its directors are accustomed to act. The original proposal requiring substantial shareholders to disclose details of their shareholding structure, and of persons holding 10% or more shares in their issued share capital, has been dropped as the market commented that such disclosure would be of limited value.

Discretionary trusts (Clauses 5 and 33 of Schedule 9)

13.11 In SFC's original proposal exposed in 1998, when performing a duty of disclosure, a "settlor" of a discretionary trust would have been deemed to be interested in the shares held by the trust and, as a result, may have had a separate duty of disclosure. To address the market comments that the original definition for "settlor" might be too wide, a revised definition of "settlor" has been adopted (Clause 1 of Schedule 9) which, when read with Clauses 5 and 20 of Schedule 9, deems a settlor of a discretionary trust to be interested in shares held by the trust where the settlor retains a power to influence the discretion of the trustees.

13.12 In line with the objective to increase market transparency, the proposal seeks to ensure that discretionary trusts could not be abused by a settlor who in practice has the power to control or influence the handling of trust assets. These persons will be brought within the

disclosure regime as they in effect "control" the listed shares through their influence on the trustees managing the discretionary trusts holding the shares, and should therefore be subject to the same disclosure requirements as substantial shareholders. We welcome further comments from the market as to how such policy intent may be better reflected in the composite Bill.

Concert party agreements (Clause 310)

13.13 The present proposal in Clause 310 extends the scope of a concert party agreement under section 9 of the Securities (Disclosure of Interests) Ordinance to include any arrangement under which a controlling shareholder of a listed corporation provides a loan, or security for a loan, to another person on the understanding, or with the knowledge, that the loan will be used or applied to facilitate the acquisition of an interest in shares of the same listed corporation by that other person. We recognize that there should be exceptions for loans made in the ordinary course of certain businesses (for example, a bank or a licensed money lender). These exceptions are specified in Clause 310. The market has expressed support for this proposal.

Investment managers and trust companies

13.14 To create a level playing field for all market participants, the exemption currently made available to SFC registered investment managers and to trust companies under the Securities (Disclosure of Interests) (Exclusions) Regulations will be removed. The market is generally in support of the proposal.

Disclosure for derivatives

13.15 The composite Bill proposes to extend the scope of disclosure in respect of equity derivatives to require disclosure of shares in listed corporations in which a substantial shareholder is interested through his holding, writing or issuing equity derivatives (including interests in unissued shares and interests in shares which are the underlying shares of cash settled derivatives). Disclosure of short positions in shares in listed corporations will also be required in certain circumstances.

13.16 We have included a number of new definitions in Clause 298 to establish the framework for a comprehensive disclosure regime for interests in shares in listed corporations held through derivatives, and short positions in such shares. Specifically, three new definitions of significance – "equity derivatives", "underlying shares" and "short position" - have been added[3]. The definition of "relevant share capital" in the Securities (Disclosure of Interests) Ordinance has also been extended to include unissued shares. This will operate to require disclosure where the underlying shares of equity derivatives are unissued shares.

13.17 In view of its different nature, separate provisions have been drafted which require disclosure of short positions in shares. These follow the same approach as in the Securities (Disclosure of Interests) Ordinance with the events prompting disclosure being set out in Clause 300 and the circumstances giving rise to the duty of disclosure in Clause 304.

13.18 The proposed disclosure regime will not permit netting-off of long and short positions for the purpose of calculating the percentage level of notifiable interests. A person who has a notifiable interest in shares of 5% or more has to include in his disclosure particulars of any short position which he has. An independent duty of disclosure arises if a person with a notifiable interest in shares (i.e., 5% or more) acquires a short position of more than 1%, if the percentage level of the short position subsequently changes by more than a whole percentage level, or if the percentage level of his short position drops below 1% (see Clauses 300 to 304). Specific clauses of Part XV have been drafted to accommodate the requirement for separate disclosure of short positions.

13.19 In the earlier consultation exercise, some market participants expressed concern about the increase in the workload necessary to cater for the revised duty of disclosure for derivatives. Having weighed the different considerations, we believe the regime proposed by the SFC is worth supporting for the maintenance of a fair and transparent market. In fact, it is more consistent in its application than the existing regime.

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[3] The term "underlying shares" provides a link between the new term "equity derivatives" and the familiar term "shares in the relevant share capital of a listed corporation" used in the current Securities (Disclosure of Interests) Ordinance. A separate definition of "underlying shares" is included in Division 3 of Part XV to clarify the interests which must be disclosed by directors under this Part.

It should be noted that the disclosure required under Part XV is not the interest in derivatives, but rather the interest, through the holding, writing or issuing of derivatives, in the underlying shares. Underlying shares are the shares in the relevant share capital of a listed corporation which may be required to be delivered under the equity derivatives, or by reference to the price of which the value of the equity derivatives is determined. Linking the term "equity derivatives" to "shares in the relevant share capital of a listed corporation" means that the provisions prompting disclosure under the Securities (Disclosure of Interests) Ordinance can largely be retained.

13.20 The SFC originally proposed to require disclosure of consideration in relation to dealings in derivatives, including strike price, option premium and option price. In the consultation exercise, market participants expressed concern about the proposal because it might require disclosure of commercially sensitive information and constrain market participants' ability to effect hedging transactions. Having considered market views, the SFC is mindful that the proposal might stifle the development of the derivatives market in Hong Kong and has come to the view that the adverse consequences outweigh the benefit of disclosure. We have therefore withdrawn the proposal that substantial shareholders disclose these commercially sensitive information in relation to derivatives to preserve the competitiveness of individual market players. The Government welcomes any further views from market participants on these proposals.

Disclosure of pledges of shares

13.21 Under the existing disclosure regime, lenders who hold shares pledged as security for loans are exempt from the requirement to disclose interests in the shares which are subject to the pledges unless the borrower has defaulted on the loans, and the lenders have enforced the security under the pledge. Such action will result in the lender acquiring an interest in the shares which have been pledged and possibly the borrower ceasing to be interested in those shares.

13.22 Having considered the market comments for and against requiring disclosure of pledges of shares before the enforcement of security by lenders, we have taken steps to clarify in the composite Bill the point at which interests in shares pledged to a lender cease to be exempt from disclosure. The draft provisions are now included as Clause 22 of Schedule 9. We hope the draft provisions will address comments raised by the Hong Kong Association of Banks on the consultation conclusions. Further comments and suggestions from the market, in particular the banking sector, on this proposal are welcome.

Obligation to disclose changes in the nature of an interest in shares

13.23 Clause 304 of the composite Bill requires the disclosure of any change in the nature of an interest in shares in which a substantial shareholder has a notifiable interest, in addition to his duty to disclose a change in the percentage level of his interest. Examples of a

change in nature of interest include stock borrowing and lending situations and the exercise of rights under derivatives. Unless a change in the nature of an interest in shares is also disclosed, the market may be misinformed and there may be confusion. Where, for instance, a substantial shareholder converts his derivative interest in shares into a direct interest in shares (by exercising an option) and is not required to disclose that change, public investors are not given a full and complete picture to enable them to make informed investment decisions.

REDUCING THE COMPLIANCE BURDEN

13.24 As one of the major objectives of the new disclosure regime, the composite Bill also suggests several amendments to reduce the compliance burden for disclosure. These include -

(a) removing requirements to disclose particulars of registered shareholders and changes in those particulars (formerly sections 7(6) and (7) of the Securities (Disclosure of Interests) Ordinance);

(b) exempting substantial shareholders from disclosing small changes in their interests in shares (Clause 304); and

(c) introducing more structured notification forms to facilitate disclosure and dissemination of information (Clause 377).

The majority of comments received are supportive of the above proposals.

Disaggregation of group interests for investment managers, custodians and trustees

13.25 We recognize that substantial shareholders whose interests in shares derive from their business of managing the investments of other persons, or safeguarding the assets belonging to other persons, should be treated differently from shareholders who control, or seek to influence the control of, interests in shares. Accordingly, the present proposal provides that where shares are held by a subsidiary company in the ordinary course of its business of an investment manager, custodian, or trustee, and it exercises its voting rights independently from its holding company, then the holding company is not required to aggregate interests in shares held by the subsidiary for the purpose of disclosure. The

main purpose of this proposal is to reduce the compliance burden of the holding company concerned which may have a number of subsidiaries whose main business is in the management of other people's assets. We welcome suggestions in particular from investment managers, custodians and trustees on refinements to Clause 309.

WELCOME FURTHER COMMENTS

13.26 This part of the composite Bill is generally considered to be complex and technical both in terms of regulatory concepts and law drafting. We believe that the proposed disclosure regime expressed in the form of draft provisions provides a much more concrete and clearer basis for discussion than the proposals first exposed by the SFC in 1998. We welcome further comments from market participants and practitioners, who are best positioned to assess the practical aspects of compliance, for further refining the draft provisions.

CHAPTER 14

PART XVI OF THE SECURITIES AND FUTURES BILL

MISCELLANEOUS

INTRODUCTION

14.1 Various types of provisions have common application to the exercise of a number of regulatory powers, as well as certain statutory requirements under the composite Bill. These provisions, in the current law, are replicated and spread across the various Ordinances administered by the SFC. As the several Ordinances were enacted over the years, there are inevitably minor differences and inconsistencies in these common provisions. As part of the process of rationalizing differing provisions in the various Ordinances which will be repealed upon enactment of the composite Bill, Part XVI of the composite Bill will consolidate these provisions and, for consistency of application, eliminate any such differences in wording. In addition, this Part also includes certain provisions which may not be suitably grouped together with the specific subject matters dealt with in other parts of the composite Bill. This Chapter highlights the more important clauses in Part XVI of the composite Bill, making reference to any changes made to the existing regime where appropriate.

SECRECY AND IMMUNITY PROVISIONS

14.2 There are a number of provisions spreading across relevant Ordinances that are designed to govern the performance of certain functions of the SFC. Of major concern is how the secrecy of information, gathered in the course of performing statutory functions by the SFC and other designated parties, can be preserved (Clause 358). In this regard, while no substantial changes have been introduced in this legislative reform, it is reassuring to note that the requirements imposed on the SFC and other designated parties under the existing regime are stringent and have been working well. Also, the composite Bill will continue to grant statutory immunity to specified persons in the performance in good faith of the statutory functions of the SFC. Both the secrecy and immunity provisions are in line with international standards.

LEVIES AND FEES

14.3 Clauses 370, 371 and 372 govern the levies for transactions in securities or futures contracts and the fees that the SFC may charge for various matters . The power to prescribe any levies and fees is vested in the Chief Executive in Council and the relevant subsidiary legislation is to be tabled before the Legislative Council. We have not introduced major changes to this approval mechanism, save for empowering the Chief Executive in Council to prescribe levies in respect of transactions conducted through Automated Trading Services ("ATS") authorized under Clause 94 of the composite Bill. This provision corresponds to the introduction of new regulatory arrangements for ATS and accommodates future developments in electronic trading.

CRIMINAL PROSECUTION AND PROCEDURAL MATTERS

14.4 Clauses 365 and 366 provide for matters in relation to criminal proceedings. By virtue of Clause 365, the SFC may prosecute before a Magistrate an offence under any of the relevant provisions and an offence of conspiracy to commit such an offence. Clause 366 specifies that any information or complaint relating to an offence under the composite Bill, other than an indictable offence, may be tried if it is laid or made at any time within 3 years after the commission of that offence.

STANDARD OF PROOF

14.5 As set out in Clause 364, other than in relation to criminal proceedings or to an offence, where it is necessary for a Court or the SFC to establish or be satisfied of certain specified matters, for the purposes of any of the relevant provisions, the standard of proof should be on the balance of probabilities. This clause is mainly a consolidation and re-enactment of relevant provisions in the existing Ordinances.

IMMUNITY FOR AUDITORS OF LISTED CORPORATIONS

14.6 The Government is acutely conscious of the rapid development of the financial markets and the increasing complexities of financial transactions, which provide greater scope for persons responsible for fraud or other questionable practices to disguise the true nature

of their activities. Auditors identifying the possible existence of fraud or irregularity may wish to serve the public interest by reporting their concerns to the regulatory authority. However, in doing so they could face a civil claim for, among other things, breach of confidentiality and consequently suffer professional embarrassment and perhaps financial penalty.

14.7 To remove the risk of such adverse consequences, Clause 360 of the composite Bill replicates and improves upon an earlier proposal by the Government in 1996[1] to provide auditors of listed corporations with a statutory immunity from liability under the common law, if they choose to report to the SFC suspected fraud and other fraudulent or improper practices of which they become aware in the course of their auditing work. The clause stipulates the circumstances under which an auditor may wish to make a report to the SFC. Basically they mirror the grounds specified in Clause 165. The intention remains that such a proposal is to provide auditors with immunity in the event that they choose to make such a report, not to impose upon them any duty to report.

14.8 After the announcement in July 1999 of the intention to re-introduce this proposal in the composite Bill, the Government has been working with the accountancy profession on possible refinements to the earlier proposal. The accountancy profession has suggested that unless an auditor is personally involved in or possesses first hand knowledge of fraud, misfeasance or other misconduct, he must necessarily rely on his own judgement or interpretation of circumstantial evidence such as books and records of the listed corporation in determining whether to make a report to the regulator. Consequently, in determining whether there are circumstances suggesting that fraud, misfeasance or other misconduct has been committed, a subjective test should be used. We agree with this, and have drafted Clause 360 to reflect this.

14.9 The accountancy profession also considered that the reference in the 1996 proposal to "any liability" might not be wide enough to clearly cover liabilities arising from all areas of common law, particularly those for defamation. We believe that the immunity accorded by the clause should extend to all appropriate types of liability so as to provide auditors with adequate protection. The suggestion by the accountancy profession to clarify that the liabilities to be covered are those arising whether in contract, tort, defamation, equity or otherwise is now reflected in Clause 360.

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[1] The original proposal was included in the Securities and Futures Commission (Amendment) Bill 1996 which was introduced into the Legislative Council on 11 December 1996 but lapsed upon dissolution of the Legislative Council on 1 July 1997.

14.10 The accountancy profession further suggested that there should be an "avoidance of doubt" provision specifying expressly that the proposal would not impose upon auditors a duty to report to the regulatory authority. We have been advised by counsel that no such provision is necessary as the wording of the provision clearly does not impose any duty upon auditors. In fact, we have been advised that by inserting such a disclaimer, it might provoke debate in relation to other statutory provisions which provide for permissive powers and immunities without a similar explicit "avoidance of doubt" provision. Such a provision is therefore not considered to be necessary or appropriate.

14.11 In addition, the accountancy profession suggested that the proposed immunity should be extended to others like the company secretaries and directors of listed corporations. The issue of responsibilities of company directors and officers and their accountability to shareholders will form part of a separate initiative to review the subject of corporate governance. As unveiled by the Financial Secretary in his Budget Speech on 8 March 2000, the Government has already invited the Standing Committee on Company Law Reform to spearhead this review. This will be a separate exercise independent of the composite Bill. In any event, there is no logical reason for the immunity proposal for auditors to be made dependent on other immunity proposals. An auditor of a listed corporation, being an outside service provider, carries out an independent check on the company's accounts. He plays a unique and independent role, as compared with the management (including directors) of a company who, being employees and officers, have a different legal relationship with the company. The proposal for auditors has been well debated and considered in detail by concerned parties since 1996. We therefore believe that it is ripe for implementation.

POWER OF THE SFC TO INTERVENE IN CIVIL PROCEEDINGS

14.12 As financial markets and their infrastructure become increasingly complex, what appear to be disputes between private parties are more and more likely to have an impact on the rest of the market system. Private litigation may involve points of law that bear on the wider public interest. Clause 362 will give the SFC standing to intervene in proceedings between third parties (other than criminal proceedings) in appropriate cases to provide its regulatory perspective and expert opinion. During the July 1999 consultation, the Legislative Council Sub-committee on the Securities and Futures Bill considered that the power might be acceptable if it was in the public interest. The Bar Association took the

view that it should be for the Court to decide whether the SFC should intervene in those proceedings. We have taken these views into account in drafting the provisions, in particular to ensure that the provisions will strike a right balance in protecting the rights of the parties involved and the public interest. As safeguards, Clause 362 will require that the SFC must satisfy the Court that its intervention is in the public interest; parties to the litigation will have the right to challenge the intervention; and the intervention will be subject to such terms as the Court considers just. These are based on the current procedure for the joinder of third parties in litigation.

DEFENCE AVAILABLE TO RESPONSIBLE OFFICERS

14.13 As mentioned in Chapter 5, a "management liability" concept has been introduced for the new licensing regime under the composite Bill. Under this concept, designated controlling minds of intermediaries ("the responsible officers") would be presumed to be liable, together with the corporate entity itself, for breaches of certain fundamental regulatory requirements. To strike an appropriate balance between investor protection and the imposition of liability upon the responsible officers, care has been taken to restrict the application of this concept to only those offences which are essential for the protection of the interest of the investing public. In addition, a statutory defence has been introduced for responsible officers. Under Clause 367, a responsible officer of the intermediary will be cleared of liability if he establishes that he honestly and reasonably believed that the failure by the corporation to comply with the relevant requirements would not occur. If his state of belief was based upon reliance on information provided by another person, then such reliance would have to be reasonable.

FINANCIAL SECRETARY TO PRESCRIBE WHAT CONSTITUTES SECURITIES AND FUTURES CONTRACTS

14.14 The need for flexibility in the regulatory framework to accommodate rapid market developments and the emergence of new financial products has been explained in Chapter 2. In pursuance of this principle, Clause 369 enables the Financial Secretary to prescribe that any financial products are or are not to be regarded as "securities" or "futures contracts", for the purpose of adjusting the regulatory net to reflect new market developments.

RULES MADE BY THE SFC

14.15 In the course of developing specific regulatory requirements in individual Parts of the composite Bill, we have proposed, where necessary, to provide the SFC with the enabling power to make specific rules for the proper discharge of its relevant functions. To enable the regulator to respond in a timely manner to market developments and any foreseeable or unforeseeable changes, it is proposed that the SFC be given a general power to make rules that are necessary for the furtherance of its regulatory objectives and performance of its functions. To ensure that the SFC will exercise the power judiciously, Clause 373 stipulates as an additional safeguard that the SFC may make such rules only after consultation with the market and the Financial Secretary. Moreover, rules made by the SFC are subsidiary legislation and are to be tabled before the Legislative Council.

CHAPTER 15

PART XVII OF THE SECURITIES AND FUTURES BILL AND SCHEDULE 10

REPEALS AND RELATED PROVISIONS

INTRODUCTION

15.1 Part XVII of and Schedule 10 to the composite Bill deal with repeals and related provisions. Consequential amendments will also be included in Schedule 10 upon finalisation of the composite Bill. The transitional provisions are crucial for ensuring continuity and a smooth migration of concerned parties from the existing regulatory framework to the new regime and are equally significant for both the SFC and persons regulated by it. The following paragraphs highlight some of the more important transitional arrangements.

PART II – SECURITIES AND FUTURES COMMISSION (CHAPTER 2)

15.2 Part II of the composite Bill deals with the existence and constitutional framework of the SFC. Accordingly, the transitional provisions in this respect provide for –

(a) the continued recognition of all actions taken or in the process of being taken by the SFC under the existing legislation;

(b) the continued recognition of all committees created by or formed pursuant to the existing legislation; and

(c) the continued appointment or employment of all existing office holders, committee members and employees of the SFC and of committees created by or formed pursuant to the existing legislation.

These provisions will ensure the continued operation of the SFC and all committees formed under the existing legislation.

PART III – EXCHANGE COMPANIES, CLEARING HOUSES AND INVESTOR COMPENSATION COMPANIES (CHAPTER 3)

15.3 All the existing market operators will for the purpose of the composite Bill be deemed recognized for continuation of their existing operation.

PART IV – OFFERS OF INVESTMENTS (CHAPTER 4)

15.4 The transitional provisions for Part IV essentially ensure -

(a) the continued recognition of approvals granted by the SFC in respect of unit trusts, mutual fund corporations and the issue of advertisements and invitations relating to investment arrangements;

(b) the continued recognition and effect of any conditions imposed in relation to such approvals; and

(c) smooth continuation in the processing of applications for any such approvals.

PARTS V TO VII – THE NEW LICENSING REGIME (CHAPTER 5)

15.5 As mentioned in Chapter 5, we intend to allow for a two-year transitional period after the commencement of the Securities and Futures Ordinance. During the two-year period, existing SFC registrants, exempt authorized financial institutions, and other exempt persons can continue their business as under the present regime, while applying to the SFC for granting of license or declaration of exempt status for continuing to engage in any of the regulated activities under the new regime. This is to provide ample time for the intermediaries to prepare themselves for migration to the new regime. Firms wishing to continue their business will have to satisfy the SFC; or in the case of exempt authorized financial institutions, the HKMA under the same criteria used by the SFC, that they are fit and proper to do so. In determining the fitness and properness of the applicants under the new regime, the SFC shall have regard to the experience and expertise of the registrant under the existing regime.

PART VIII – SUPERVISION AND INVESTIGATIONS (CHAPTER 6)

15.6 Any investigation or inspection that has been carried out prior to the commencement of the Securities and Futures Ordinance, if not concluded by then, will be continued in accordance with the old provisions under the SFC Ordinance and the Leveraged Foreign Exchange Trading Ordinance. However, the power of the SFC to obtain records will not be restricted to post-commencement records in an inquiry initiated after the commencement of the new Ordinance.

PART IX – DISCIPLINE (CHAPTER 7)

15.7 In respect of misconduct of a licensed person which occurred prior to the commencement of the Securities and Futures Ordinance, the SFC may only impose the existing sanctions of reprimand, suspension and revocation of a registration in accordance with the Securities Ordinance, the Commodities Trading Ordinance and the Leveraged Foreign Exchange Trading Ordinance. The new sanction of civil fines and partial suspension or revocation of licence provided under the new Ordinance will not apply in such cases.

PART XI – SECURITIES AND FUTURES APPEALS TRIBUNAL (CHAPTER 9)

15.8 The existing Securities and Futures Appeals Panel will continue to hear those appeals against SFC's decisions which are lodged prior to the commencement of the Securities and Futures Ordinance. Those appeals lodged after the commencement of the new Ordinance, disregarding whether the respective SFC decisions are made prior to or after the commencement date, will be dealt with by the new Securities and Futures Appeals Tribunal.

PART XII – INVESTOR COMPENSATION (CHAPTER 10)

15.9 Claims arising from defaults occurring prior to the establishment of the new investor compensation fund(s) would be made to the existing compensation funds as are governed by Part X of the Securities Ordinance (the Unified Exchange Compensation Fund) and Part VIII of the Commodities Trading Ordinance (the Commodity Exchange

Compensation Fund). Surplus of the existing funds over the amount required to settle the aforesaid defaults as well as any outstanding claims will become the seed money of the new compensation fund.

PART XIII – MARKET MISCONDUCT TRIBUNAL (CHAPTER 11)

15.10 The Securities (Insider Dealing) Ordinance will continue to have effect with regard to all insider dealing cases alleged to have occurred prior to the commencement of the Securities and Futures Ordinance. These will be dealt with by the Insider Dealing Tribunal. Insider dealing and other market misconduct which occur after the commencement of the new Ordinance will be dealt with by the new Market Misconduct Tribunal.

PART XV – DISCLOSURE OF INTERESTS (CHAPTER 13)

15.11 A listed corporation which immediately before the commencement of the Securities and Futures Ordinance has been exempted by the SFC under section 2A of the Securities (Disclosure of Interests) Ordinance, is taken to have been exempted under clause 299 of the composite Bill. The provisions in section 2A of the Securities (Disclosure of Interests) Ordinance enabling the SFC to exempt listed corporations are preserved in the composite Bill, and extended to cover interests in shares held through equity derivatives to reflect changes introduced to the new disclosure regime.

15.12 The repeal of the Securities (Disclosure of Interests) Ordinance will not affect any duty of disclosure that arose under that Ordinance; or any investigation commenced, or restrictions imposed, or orders made under it. These matters will continue to be dealt with under relevant provisions of the Securities (Disclosure of Interests) Ordinance.

Annex A

Public Consultation on Major Proposals to be included in the Securities and Futures Bill conducted in July 1999
Comments Received from the Market
(List of respondents at the end of this annex)

Serial No.	Summary of Comments	Response
Objectives, Functions, and General Duties (Part II of the Bill)		
1	A few submissions argued that the main objective should be to maintain an open, fair, and transparent market and that SFC should stay clear of fiscal, political, or other objectives of the Government.	Markets are becoming integrated. Investors, especially sophisticated institutional investors, transact across securities, futures, interest rate, forex, and other markets. SFC's expertise is in securities and futures markets. Other regulators have other focuses. They all have to work together to maintain the health of the whole system.
Automated Trading Services (ATS) (Part III of the Bill)		
2	Several submissions stated that there should be minimum standards on system capacity, contingency planning, and security.	The suggestion is taken. ATS will be regulated according to the services they provide.
3	Some submissions expressed concerns about the consistency in identification and regulation of ATS on a case by case basis.	The field is relatively new but developing at accelerating speed. A flexible and pragmatic approach is necessary because of great diversity among ATS operations. Regulators of other leading international markets are wrestling with what the appropriate rules are. SFC actively participates in international discussion and will issue guidelines in consultation with the market.
Offers of Investment (Part IV of the Bill)		
4	A submission suggested that for withdrawal of authorizations, objections should be heard by an independent body and should be appealable to the Securities and Futures Appeals Tribunal (SFAT).	The suggestion relating to appeals is taken. Such decisions will be appealable to SFAT for full merits review.

Serial No.	Summary of Comments	Response
5	A few respondents called for revision of certain concepts and definitions (e.g. "offer to the public") as well as for redraft of certain rules and procedures (e.g. one-stop shopping for authorization of scheme and prospectus).	We understand practitioners' concerns and have made attempts to redraft the definitions in the past. However, other formulations just lead to other problems. There is no blanket fix. As for one-stop shopping, functions to authorize a mutual fund scheme and approve the prospectus are already unified and done by a single department within SFC.
6	A few respondents called for exemption with respect to offer to "professional investors".	The concept is supported in principle. SFC has formed a working group with a view to recommending the way forward on this.
7	A submission stated that "investment arrangements" should not cover conventional banking transactions.	The suggestion is taken.
Licensing Review (Part V of the Bill)		
8	Several submissions stated that the range of activities covered by the proposed single license should be clarified, as should grandfathering arrangements.	The suggestion is taken. An intermediary will have two years to work out its scope of business for migration to the new regime.
9	A respondent suggested that responsible officers should be able to roll over their licence when changing employment.	Rollover should be subject to SFC approval. Circumstances leading to the move might reflect negatively on the person's fitness and properness.
10	Several submissions argued that authorized institutions (AIs) under the Banking Ordinance should not have exempt status.	AIs' securities businesses are to be regulated by HKMA using criteria equivalent to those applied by SFC to its licensees. This will be underpinned by a revised Memorandum of Understanding between HKMA and SFC, as well as corresponding amendments to the Banking Ordinance. Under exemption arrangements, HKMA will remain the frontline regulator, hence minimising regulatory overlap (see Chapter 5) .

Serial No.	Summary of Comments	Response
11	Some submissions were against extension of inquiry power to cover AIs; others thought it insufficient; still others supported the proposal.	AIs do an increasing amount of securities business. SFC, as the securities regulator, ought to have ultimate jurisdiction. To avoid double-regulation, current practice will continue. HKMA has frontline role.
12	A group of respondents were against the proposal to register professional investors.	Systemic disruption or manipulative conduct in professional market can seriously impact retail market and prejudice interest of investing public. Information gap also increases systemic risks. We must address these problems. International discussion is in same direction. Proposal will not mandate registration of professional investors but seek to address issues posing systemic concerns e.g. reporting requirements. We are monitoring developing practices in the US and the UK, as well as evolving international consensus.
13	A few submissions considered it too onerous for all Executive Directors to be licensed.	Executive Directors are decision-makers on behalf of an intermediary. They are the controlling minds. Licence requirement is commensurate with responsibility and authority. SFC will consider granting exemption on a case-by-case basis.
14	Several submissions pointed out that rescission could affect third parties who should be protected.	The suggestion is taken.
Inquiry into Listed Corporations (Part VIII of the Bill)		
15	One respondent argued for allowing inspection only when there is cogent evidence of fraud. Another respondent suggested allowing inspection only when SFC has reasonable grounds to suspect fraud or misconduct.	Section 29A of the SFC Ordinance is for preliminary inquiries to determine whether suspicions are well founded to warrant inspection under section 143 of the Companies Ordinance or police investigation. "Cogent evidence" will not be available at Section 29A stage. Proposed amendments will raise thresholds for activating the power.

Serial No.	Summary of Comments	Response
16	Some submissions argued that Section 29A of SFC Ordinance inspection should be on cooperative basis or with prior Court approval.	This is not practical because (a) cooperation rarely is extended; (b) Court order would hamper timely and effective inquiry; (c) such review generates damaging publicity for company. Request for records or explanation under Section 29A is already not self-executing.
17	A few respondents stated that banks should be released from their confidentiality duties when required to supply documents.	It is already established law that legal compulsion excuses breach of confidentiality.
18	A few respondents suggested that SFC should ask for written responses instead of working papers from an auditor.	It is difficult to set out specific questions in a preliminary inquiry; and written answers from auditors would amount to getting testimonies from them.
Supervision of Intermediary (Part VIII of the Bill)		
19	Several submissions expressed reservation about proposal to dispense with inquiry before disciplinary action as unfair.	The proposal is not to dispense with due process, but only with a separate inquiry, which is unnecessary because information is usually already gathered in other investigations. Natural justice and procedural fairness still require notice, opportunity to be heard, presentation of case etc.
Civil Fines (Part IX of the Bill)		
20	One submission asked for explanation of why proposal of HK$10 million is higher than US SEC power of US$500,000.	US levels were set years ago. Maximum of US$500,000 is clearly not appropriate for market of that size. In practice, SEC uses its other penalty powers to get much larger lump sums.
21	Another submission suggested HK$10 million limit, above which the 3-times formula should not apply and fines would be capped at actual profit made/loss avoided.	If fines are capped at actual profit made/loss avoided, then there is no reason not to engage in misconduct.

Serial No.	Summary of Comments	Response
22	A few respondents wanted to see different levels for different improper conducts. Others wanted codified criteria for determining and calibrating fines.	The SFC will issue guidelines on criteria and factors to take into account. However, disciplinary sanction is often on the basis of "fitness and properness", encompassing complex matrix of conduct and activities. Dividing it into "types" would be arbitrary. Also, constant development in trading practices would quickly outdate categorization.
23	One respondent suggested that fining power should be exercised sparingly in cases initiated by self-reporting.	Self-reporting and cooperation will be important factors when determining form and level of discipline.
24	One submission called for abolishing private reprimands.	A case (e.g. self-reported and corrected small mistake) could warrant recording of the incident. But there might be no reason for public announcement if it does not affect investor protection.
25	A few respondents highlighted the need to publicize and publish decisions (including negotiated settlements) to ensure consistency.	This is already the case.
26	One submission noted that decision should not be publicized until appeal period is over.	This is already the case.
27	Some submissions argued that disciplinary sanction should hit only people involved in misconduct and should not cover failure to supervise.	Proper supervision is a critical element in modern finance business and protection of clients. Every recent failure of large financial house involves lax supervision.
28	Some submissions stated that SFC should have power to revoke "licence" of supervisors, directors etc. as well as to blacklist them, and should also be able to fine those who resign or cancel their licences.	This suggestion is taken. Also, past record is important if a person reapplies for licence.
29	One respondent pointed out that disciplinary action should not cover those not being regulated in the first place (e.g. exempt professionals).	This suggestion is taken, except for persons involved in the management of the licensees.

Serial No.	Summary of Comments	Response
Partial Suspensions (Part IX of the Bill)		
30	One respondent asked how feasible it would be to define "part" of a business.	It is feasible. Sanctions can be tailored through discussion with intermediary.
31	Several submissions stated that partial suspension of an intermediary should not affect third parties.	This suggestion is taken. There will be provisions for protection of third parties.
Civil Liability for Misstatements (Part X of the Bill)		
32	There were a number of comments, some noting the need for materiality test, others specifying categories of statements covered, still others suggesting defence provisions.	The current proposal of civil liability for false disclosure to the market is to recognize that a person responsible for making any public communication relating to securities or futures contracts owes a duty of care to all those who may reasonably rely on it to ensure that communication is not false or misleading. If it is, the person responsible for the communication will be liable for all loss or damage as a result of the reliance. The industry and public are invited to review and comment on the draft provisions.
33	One respondent wanted SFC to act as coordinator for civil law suits.	Intention is to facilitate shareholders helping themselves. SFC might be seen as encouraging litigation, perhaps even favouring a certain outcome, in a particular case if it is involved in putting together claims.
Statutory Backing for Listing Rules		
34	A number of submissions urged that the Listing Rules should remain market oriented and flexible, and that SFC should seek Court order only as last resort. Some respondents were concerned that statutory backing might make interpretation more formalistic and less "spirit" driven.	The suggestion is taken. We have decided not to pursue the original proposal to provide statutory backing to the Listing Rules. Instead we shall pursue the proposal for civil liability for misstatements above.

Serial No.	Summary of Comments	Response
SFAT (Part XI of the Bill)		
35	Some respondents believed that SFAT should cover SFC's decisions on authorization of documents or grant of waivers or exemptions.	This suggestion is taken.
36	One submission suggested that SFAT should cover decisions that (a) SFC agrees to be appealable, or (b) SFAT, on preliminary application, decides to review.	Types of decisions amenable to full merits review will be clearly set out in the Bill. SFAT should not have power to arrogate jurisdiction to itself. Otherwise there will be endless applications for review. If in practice other types of decisions amenable to full merits review are found, the Chief Executive in Council can add them to the list.
37	Some respondents thought the appeal period (of 14 days) to be too short.	This suggestion is taken. The period will be extended to 21 days.
38	One respondent suggested SFAT should have power to extend appeal period for due cause.	All that the affected person has to do is to file notice of appeal within 21 days. Providing for extension would undermine finality.
Market Misconduct Tribunal (MMT) (Part XIII of the Bill)		
39	There were a number of comments on wording of the offence provisions, varying from general criticisms that they were too wide, to specific queries about whether particular activities would be caught, and to a call for administrative guidelines.	Industry is invited to review and comment on new draft provisions in the Bill, which should be clear on what constitutes market misconduct, what the criminal offences are, and what defences are available. To the extent that certain language is borrowed from overseas provisions, there will also be case law to refer to.
40	Some submissions were in favour of dual criminal/civil system, citing criminal sanctions as providing important signal and deterrence effect.	This suggestion is taken.
41	A few respondents noted that the legal provisions should cover information coming into Hong Kong "in a virtual way", i.e., without the person being here.	This suggestion is taken.

Serial No.	Summary of Comments	Response
42	A few respondents suggested that MMT should cover front running and should extend bucketing to the securities area.	Front running and pre-arranged trading have been deliberately excluded as they do not involve damage to market as a whole. These could be dealt with in disciplinary actions.
Statutory Right of Action (Parts X, XIII and XIV of the Bill)		
43	Several submissions argued that it should apply only if plaintiff has existing relationship with defendant.	This suggestion is taken.
44	There were also a number of questions about the mechanics of the proposed cause of action, including its detail elements, relationship to common law causes of action, consequent compensatory or restitutionary remedies, and identity of proper defendant.	The Bill seeks to clarify common law position regarding private right of action against market misconduct (Parts XIII and XIV), false disclosure to market (Part X) and false advertisements on offers of investments (Part IV). The industry and public are invited to review and comment on the draft provisions.
45	Two respondents called for establishing US/Canada-style derivative action mechanism.	Litigation is only the last in many links in good corporate governance. Duties of company, board, management, majority shareholder etc. must also be clear and practical. Shareholders' procedural rights are also important. A comprehensive review of corporate governance is on Government's agenda.
46	Some submissions expressed concerns that investors might become overly litigious and stated that there should have safeguards against frivolous class actions.	Proposed provision would only clarify common law position. Judicial system already has mechanism against frivolous suits and abuse.
Statutory Immunity for Auditors (Part XVI of the Bill)		
47	One submission called for imposing on auditors affirmative duty to report and for improving outside supervision of accountancy profession.	Self-regulation has long tradition and is practised in all major overseas jurisdictions. The accountancy profession already has guidelines on the reporting of fraud. At this stage, there is no intention to impose a statutory obligation on auditors to report.

Serial No.	Summary of Comments	Response
48	Several respondents argued that auditors cannot be expected to have any reporting role. Their code of ethics requires confidentiality.	The proposal will not require auditors to report. Its purpose is that, in case an auditor wants to report, he/she does not need to fear breach of code of ethics or contract.
49	The accountancy profession wanted statutory immunity to extend to company secretaries, directors, financial controllers, officers, employees, etc.	Current proposal is just one positive step forward. The issue of responsibilities of company directors and officers and their accountability to shareholders will form part of the separate initiative to review corporate governance.
Intervention into Proceedings (Part XVI of the Bill)		
50	Several submissions called for guidelines on factors to be taken into account before intervention.	This suggestion is taken. SFC will study overseas precedents and publish policy statement.
51	A number of respondents were concerned about SFC power to step into private litigation and stated that it should not be exercised to assist one claimant against another person.	SFC will have to justify to the Court its grounds for joining suit, explaining what and how issues at stake relate to SFC's objectives and functions, where the public interest is, and why it is important that SFC joins. Litigants already in the suit can voice their views. The Court will make ultimate decision and the intervention will be subject to such terms as the Court considers just.
52	One respondent suggested that the current Section 37A of SFC Ordinance should be revised to provide for Court order for disqualification up to 15 years, in line with Section 168E(3) of Companies Ordinance.	This suggestion is taken.

Serial No.	Summary of Comments	Response
Rule Making (Part XVI of the Bill)		
53	Some submissions suggested that rule making should be subject to prior public consultation and perhaps even cost-benefit analysis. A few asked about the difference in status between different SFC documents and potential sanctions against non-compliance.	The suggestion relating to public consultation is taken. Cost-benefit consideration is done as a matter of course. But it is difficult and unavoidably imprecise. A statutory requirement would only provide opportunity for delaying tactics to stymie attempt at rule making, perhaps even invite litigation. The status of each SFC code and guideline is explained at the beginning of the document itself to aid the reader.
54	A few respondents stated that SFC should have the power to give "no action" letters and to waive compliance with provisions of legislation, rules, and guidelines. Some stated a need for safe harbours, particularly for stabilization activities.	New legislation will provide more clarity to the regulatory regime. SFC from time to time issues various codes and additional guidance when need arises. Specifically on definition of market misconduct, SFC will have power to exclude legitimate activities from the definition and will perform public consultation before exercising such power. Industry is encouraged to bring any new practices to SFC's attention.

List of Respondents to the July 1999 Public Consultation on the Major Proposals to be included in the Securities and Futures Bill

1. The Actuarial Society of Hong Kong
2. The Association of Chartered Certified Accountants Hong Kong (ACCA)
3. The Bar Association
4. The Chinese Chamber of Commerce
5. Hong Kong Consumer Council
6. Democratic Alliance for the Betterment of Hong Kong
7. Democratic Party
8. The DTC Association
9. Hong Kong Association of Banks
10. Hong Kong Confederation of Insurance Brokers
11. Hong Kong Futures Exchange
12. Hong Kong General Chamber of Commerce
13. Hong Kong Institute of Company Secretaries
14. Hong Kong Institute of Directors
15. Hong Kong Securities Clearing Company
16. Hong Kong Securities Professionals Association
17. Hong Kong Society of Accountants
18. Hong Kong Stockbrokers Association
19. Hong Kong Trustees Association
20. The Law Society
21. SEHK Options Clearing House
22. Stock Exchange of Hong Kong

and a number of other individual market participants.

Annex B

Comments from Members of the Legislative Council Subcommittee on the Securities and Futures Bill (discussed at meetings held in September 1999)

Serial No.	Comments	Response
Review of Licensing Regime for Market Intermediaries (Parts V-VII of the Bill)		
1	SFC would become super regulatory body with too much power.	Adequate checks and balances such as Securities and Futures Appeals Tribunal (SFAT) and Process Review Panel (PRP) will be established to review SFC decisions and decision making process.
2	Licensed banks actively participate in securities business should also be regulated by SFC.	Banks carrying out securities and futures business are subject to regulatory requirement under the Bill, with HKMA as the frontline regulator. Close coordination between SFC and HKMA would ensure that regulatory objectives could be achieved.
3	Definition of incidental advice by solicitors and accountants, as well as reporting requirements on professionals carrying on business of dealing in securities as principal should be clarified.	SFC will clarify "incidental" concept by way of practice note, which will itself be subject to public consultation. Details concerning the so-called "professional exemption" will also be set out in guidelines after public consultation.
4	A balance should be struck between setting criteria to ensure competence of intermediaries and leaving room for small-scale intermediaries to carry on business in the market.	SFC will take pragmatic and flexible approach in considering each license application. Nature of applicant's business is relevant.
5	Whether it would be possible to establish single regulatory body for financial markets to avoid confusion.	No such plan at this stage. Close coordination between different regulatory bodies can achieve effective regulation.

Serial No.	Comments	Response
Disciplinary Powers of the SFC (Part IX)		
6	On criteria for determining and calibrating civil fines, given that size and financial resources of firm would be factor, dishonest market participants might make use of this and carry out large-scale manipulation activities through small firms to minimize the possible fine that might be imposed as a result of misconduct.	This will only be one of the factors to be considered but not the only determining factor. There would be guidelines setting out a number of criteria and circumstances to consider so as to ensure justice as well as consistency. We shall seek to address members' concern on potential attempts by some to circumvent sanctions.
7	Private reprimands might be unfair to other market participants as they then cannot learn of relevant facts.	Private reprimands used only in cases (e.g., self-reported and corrected small mistake) that warrant recording incident but do not affect investor protection and there are no reasons for public announcement.
8	How disciplinary sanctions could be enforced outside the territory when necessary.	Hong Kong has entered into MOUs and other arrangements with major overseas jurisdictions to enable extraterritorial investigation and information sharing.
9	Whether it would be possible to recover investigation cost from fines collected.	Fines will be put under Government's general revenue. SFC has no financial interest and is impartial in investigation.
Establishment of SFAT (Part XI)		
10	Under the proposal, Tribunal's decision would be made by the Chairman. Lay members on the Tribunal should also participate in decision making.	Members' suggestion has been incorporated in the Bill.
11	Interlocutory hearing by the Tribunal should be available so that a firm subject to immediate suspension has means of deferring the suspension pending appeal.	Members' suggestion has been incorporated in the Bill.

Serial No.	Comments	Response
12	Whether representative of the Hong Kong Society of Accountants could be appointed to the Tribunal.	Tribunal members are appointed on basis on market knowledge and expertise, and that they do not have conflict of interest. Persons will be appointed as distinguished members of public on their own merits, not as representatives of particular professional groups.
13	Members supported proposal for SFAT, and suggested similar approach could be used in other sectors.	This should be subject to special needs of different sectors upon consideration by Government, relevant regulatory body, and participants in that sector.
Enhancing Inquiry Powers into Listed Companies (Part VIII) Statutory Immunity for Auditors (Part XVI)		
14	Power for SFC to seek access to auditor's working papers should be subject to detailed procedures, setting out circumstances for exercise of power, what documents are considered to be working papers, and type of information to be aimed for etc.	Public enforcement agency's ability to seek auditors' working papers without court order is accepted practice in Hong Kong as well as overseas. Statutory thresholds have to be met before SFC begins investigation. Auditor can dispute SFC's request for papers and have court review. In addition, SFC's decision making process will be subject to scrutiny by new Process Review Panel. As for what documents constitute audit working papers, the Bill has clear definition which is familiar to the accountancy profession.
15	Controversial views on whether auditors and other professionals should have obligation to report fraud. On protection for whistle blower, statutory immunity should extend to other professionals.	Auditors will not have duty to report under the proposal of statutory immunity. As for types of professionals covered, current proposal just one positive step forward. The issue of responsibilities of members of corporate community will form part of the separate initiative to review corporate governance.
16	The circumstances under which auditors can report to SFC, as well as definitions of fraud and misconduct, should be clarified.	Clarified in the Bill.

Serial No.	Comments	Response
Disclosure of Interests in Securities (Part XV)		
17	Definition of "settlor" should be clarified.	Revised definition of "settlor" included in the Bill. Market views are welcome.
18	Should require dissemination of information on Internet to enhance market transparency.	Information is published on the SEHK website and in SEHK publications.
Statutory Backing for Listing Rules; Liability for Misstatements (Part X)		
19	Listing Rules should be subject to the scrutiny of the Legislative Council.	The market view is that the Listing Rules should be market-oriented and flexible. We have decided not to pursue the original proposal to provide statutory backing to the Listing Rules. Instead we shall pursue the proposal for civil liability for misstatements.
Regulation of Automated Trading Services (ATS) (Part III)		
20	Whether SEHK monopoly in respect of trading in securities would be preserved if ATS are authorized.	Global trend is to facilitate ATS and take advantage of their benefits. Market demands ATS, and operators will supply. The Bill will not change existing SEHK monopoly, but will incorporate ATS activities into regulatory regime.
21	Difficult to regulate transactions carried out offshore.	MOUs and other arrangements are in place with major overseas jurisdictions. SFC can have investigation over misconduct conducted in offshore markets but target Hong Kong market.
22	Definition of business of ATS in Hong Kong stocks should be clarified.	ATS are an extremely diverse group of service providers. As US experience has shown, there cannot be a single set of rules and definitions. ATS should be assessed individually according to type of services provided and scale of business.

Serial No.	Comments	Response
Statutory Private Right of Action (Parts XIII & XIV)		
23	Proposal would only benefit big companies or individuals with adequate financial resources to pay costs of legal proceedings, and would not help majority of small investors. A special fund similar to Consumer Legal Action Fund could be set up. The Government should balance practicability against effect on non-executive directors.	Existing legal assistance is adequate. There is no need for a separate legal aid regime for investors. The Bill also includes defences for innocent parties.
Powers of Intervention and Proceedings (Part XVI)		
24	SFC power to intervene in third party proceedings might be acceptable if limited to circumstances when it would be in the public interest. Other reasons, including in the interest of just and equitable resolution of the proceedings, are not justifiable.	The Bill will require that SFC must satisfy the court that its intervention is in the public interest; parties to the litigation will have the right to challenge the intervention; and the intervention will be subject to such terms as the court considers just.

Proposed Securities and Futures Bill

Derivation Table

This table includes some provisions in the right-hand column that merely indicate where, in current legislation, the subject matter of the relevant clause of the Bill is dealt with. The clause may in fact be quite different from current provisions.

Legend

CLA	=	Corporations Law of Australia
CTO	=	Commodities Trading Ordinance (Cap. 250)
CO	=	Companies Ordinance (Cap. 32)
ECH(M)O	=	Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555)
FSA	=	Financial Services Act of the U.K.
FSMB	=	Financial Services and Markets Bill of the U.K.
LFETO	=	Leveraged Foreign Exchange Trading Ordinance (Cap. 451)
PIO	=	Protection of Investors Ordinance (Cap. 335)
PWIO	=	Protection of Wages on Insolvency Ordinance (Cap. 380)
S(DI)O	=	Securities (Disclosure of Interests) Ordinance (Cap. 396)
SEUO	=	Stock Exchanges Unification Ordinance (Cap. 361)
SF(CH)O	=	Securities and Futures (Clearing Houses) Ordinance (Cap. 420)
SFCO	=	Securities and Futures Commission Ordinance (Cap. 24)
S(ID)O	=	Securities (Insider Dealing) Ordinance (Cap. 395)
SO	=	Securities Ordinance (Cap. 333)

Proposed Securities and Futures Bill

Derivation Table

Clause	Part	Derivation
	PART I – PRELIMINARY	
1	Short title and commencement	SFCO s. 1
2	Interpretation	SFCO s.2, LFETO s.2(3)
	PART II - SECURITIES AND FUTURES COMMISSION	
	Division 1 – The Commission	
3	Securities and Futures Commission	SFCO ss.3 & 5
4	Regulatory objectives of Commission	New:FSMB Part 1
5	Functions and powers of Commission	SFCO s.4
6	General duties of Commission	SFCO s.8
7	Advisory Committee	SFCO s.10
8	Commission may establish committees	SFCO s.6
9	Staff of Commission	SFCO s.7
10	Delegation and sub-delegation of Commission's functions	SFCO s.9
11	Directions to Commission	SFCO s.11
12	Commission to furnish information	SFCO s.13
	Division 2 – Accounting and financial arrangements	
13	Financial year and estimates	SFCO s.14
14	Appropriation	SFCO s.53
15	Accounts and annual report	SFCO ss.12 & 15
16	Auditors and audit	SFCO s.16
17	Investment of funds	SFCO s.17
	PART III – EXCHANGE COMPANIES, CLEARING HOUSES, EXCHANGE CONTROLLERS, INVESTOR COMPENSATION COMPANIES AND AUTOMATED TRADING SERVICES	
18	Interpretation	New

Clause	Part	Derivation
	Division 1 – Exchange Companies	
19	Recognition of exchange company	SEUO s.3; CTO s.13
20	Persons authorized to operate stock market	SEUO s.27
21	Transactions that may be conducted on an exchange	CTO s.16
22	Duties of recognized exchange company	SEUO ss.15, 27A & 29; CTO ss.13 & 100
23	Immunity, etc.	SEUO s.27A; SF(CH)O s.17
24	Rules of recognized exchange company	SEUO s.34; CTO s.13
25	Approval of amendments to rules of recognized exchange company	SEUO s.35; CTO s.14
26	Transfer and resumption of functions of recognized exchange company	SFCO s.47
27	Appointment of chief executive to be approved by Commission	SEUO s.10A; CTO s.15
28	Withdrawal of recognition of exchange company and direction to cease to provide facilities or services	SEUO s.36; CTO ss.18 & 19; SO s.26
29	Direction to cease to provide facilities or services in emergencies	SO s.27; CTO s.21
30	Contravention of notice constitutes an offence	SO s. 27(4) & (6)
31	Prevention of entry into closed trading markets	SO s.27(5) & (6); CTO s.24
32	Publication of directions	SO s.28; CTO s.22
33	Appeals	SO s.29; SEUO s.37; CTO s.25
34	Restriction on use of titles relating to exchanges, markets, etc.	SO s.21; CTO s.106
35	Trading and position limits and reportable open position	SO s.146(1); CTO ss.59 & 60
36	Rule-making powers of the Commission	SO s.14
37	Amendment of Schedule 3	SF(CH)O s.19
	Division 2 – Clearing Houses	
38	Recognition of clearing houses	SF(CH)O s.3
39	Duties of recognized clearing house	New
40	Immunity, etc.	SF(CH)O s.17
41	Rules of recognized clearing houses	SF(CH)O s.4
42	Approval of amendments to rules of recognized clearing house	SF(CH)O s.4
43	Withdrawal of recognition of clearing house and direction to cease to provide facilities	New
44	Appeals	New

Clause	Part	Derivation
45	Proceedings of recognized clearing house take precedence over law of insolvency	SF(CH)O s.5
46	Supplementary provisions as to default proceedings	SF(CH)O s.6
47	Duty to report on completion of default proceedings	SF(CH)O s.7
48	Net sum payable on completion of default proceedings	SF(CH)O s.8
49	Disclaimer of property, rescission of contracts, etc.	SF(CH)O s.9
50	Adjustment of prior transactions	SF(CH)O s.10
51	Right of relevant office-holder to recover certain amounts arising from certain transactions	SF(CH)O s.11
52	Application of market collateral not affected by certain other interests, etc.	SF(CH)O s.12
53	Enforcement of judgements over property subject to market charge, etc.	SF(CH)O s.13
54	Law of insolvency in other jurisdictions	SF(CH)O s.14
55	Clearing participant to be party to certain transactions as principal	SF(CH)O s.15
56	Securities deposited with recognized clearing house	SF(CH)O s.16
57	Preservation of rights, etc.	SF(CH)O s.18
58	Amendment of Schedule 3	SF(CH)O s.19
	Division 3 – Exchange Controllers	
59	Recognition of exchange controller	ECH(M)O s.3
60	Interest of recognized exchange controller in recognized exchange company or clearing house cannot be increased or decreased except with approval of Commission	ECH(M)O s.5
61	Person not to become minority controller of exchange controller, etc. without approval of Commission	ECH(M)O s.6
62	Exemption from section 59(1) and revocation of exemption	ECH(M)O s.7
63	Duties of recognized exchange controller	ECH(M)O s.8
64	Immunity, etc.	ECH(M)O s.8; SF(CH)O s.17
65	Establishment and functions of Risk Management Committee	ECH(M)O s.9
66	Rules of recognized exchange controllers	New
67	Approval of amendments to the rules of recognized exchange controller	ECH(M)O s.10
68	Chairman of recognized exchange controller	ECH(M)O s.11

Clause	Part	Derivation
69	Appointment of chief executive or chief operating officer of recognized exchange controller requires approval of Commission	ECH(M)O s.12
70	Withdrawal of recognition of exchange controller	ECH(M)O s.4
71	Appeals	ECH(M)O ss.3, 4, 6, 12 & 14
72	Provisions applicable where recognized exchange controller, etc. seeks to be listed company	ECH(M)O s.13
73	Commission may give directions to recognized exchange controller where it is satisfied that conflict of interest exists, etc.	ECH(M)O s.14
74	Fees to be approved by Commission	ECH(M)O s.15
75	Financial Secretary may appoint not more than 8 persons to board of directors of recognized exchange controller	ECH(M)O s.20
76	Amendment of Schedule 3	ECH(M)O s.16
	Division 4 – Investor Compensation Companies	
77	Recognition of investor compensation company	New
78	Transfer and resumption of functions of recognized investor compensation company	New
79	Duties of recognized investor compensation companies	New
80	Immunity	New; SF(CH)O s.17
81	Rules of recognized investor compensation company	New
82	Approval of amendments to rules of recognized investor compensation companies	New
83	Withdrawal of recognition of investor compensation company	New
84	Appeals	New
85	Subrogation of recognized investor compensation company to rights, etc., of claimant on payment from compensation fund	New; SO s.118
86	Financial statements of a recognized investor compensation company	New
87	Employees of and delegations by a recognized investor compensation company	New
88	Investment of moneys	New
89	Further activities of recognized investor compensation company	New

Clause	Part	Derivation
	Division 5 – General – Exchange Companies, Clearing Houses, exchange controllers and investor compensation companies	
90	Supply of information	SFCO s.48
91	Additional powers of Commission – restriction notices	SFCO s.50
92	Additional powers of Commission – suspension orders	SFCO s.51
93	Application of Companies Ordinance	SEUO s.4
	Division 6 – Automated Trading Services	
94	Authorization for providing automated trading services	New
95	Application for authorization	New
96	Conditions for authorization	New
97	Withdrawal of authorization	New
98	Rule-making powers	New
99	Breach of condition of authorization	New
	PART IV – OFFERS OF INVESTMENTS	
	Division 1 – Interpretation	
100	Interpretation of Part IV	PIO s.2
101	Investment arrangements as specified by Financial Secretary	PIO s.2A
	Division 2 – Regulation of offers of investments, etc.	
102	Offence to issue advertisements, invitations or documents relating to investments in certain cases	PIO s.4(2)(g)
103	Commission may authorize collective investment schemes	New; SO s.15
104	Commission may authorize issue of advertisements, invitations or documents	New; PIO s.4(2)(g) & (7)
105	Withdrawal of authorization	New
106	Offence to fraudulently or recklessly induce others to invest money	PIO s.3
107	Civil liability for inducing others to invest money in certain cases	PIO s.8
108	Offers by securities dealers or advisers	SO s.72
109	Offence to issue advertisements relating to advice on corporate finance, etc.	PIO s.5

Clause	Part	Derivation
	Division 3 - Miscellaneous	
110	Submission of information to Commission	PIO s.7A
111	Amendment of Schedules 4 and 5	New; PIO s.9; SO s.149
	PART V – LICENSING AND EXEMPTION	
112	Interpretation of Part V	CTO s.2; SO s.2; LFETO s.2
113	Restriction on carrying on business in regulated activities	New; CTO ss.26(5) & 27(4); SO ss.48(1) & (2), 49(1) & (2); LFETO ss.3 & 4(a)
114	Restriction on performing acts that constitute regulated activities	New; CTO ss.28(1) & (2) & 29(1) & (2); SO ss.50(2); LFETO s.6
115	Corporations to be licensed for carrying on regulated activities	New; CTO ss.30, 31, 32 & 33A; SO ss.51, 53, 53A; LFETO s.7
116	Grant of temporary licences to corporations for carrying on business in regulated activities	New
117	Licensing conditions in certain cases	New; CTO s.31; SO s. 52; SFCO s.23; LFETO s.7(5)
118	Exempt persons	SO ss.60 & 61
119	Representatives to be licensed	SO ss.2, 50 & 63(4); CTO ss.2, 28, 29 & 41(4); LFETO s.6
120	Grant of provisional licence for representatives	New
121	Grant of temporary licence for representatives	New
122	Commission to be notified if licensed representative ceases to act for principal	New
123	Requirement for executive officers	CTO s.26(2) & (3); SO ss.48(1A), 49(1A), 49C, 49D; LFETO s.5
124	Variation of types of regulated activity	New
125	Applicant to provide information	CTO s.32(1)(a)(i); SO s.53(1)(a)(i); SFCO s.24; LFETO s.8(a)
126	Determination of "fit and proper"	SFCO s.23; LFETO s.9
127	Suitability of premises for storing records and documents	SFCO s.27; LFETO s.16
128	Restriction on substantial shareholdings	SFCO s.26A; LFETO s.14A
129	Modification or waiver of requirements	SFCO ss.29 & 55A; LFETO s.69
130	Events to be reported by licensed persons & exempt persons	CTO s.41; SO s.63; LFETO s.14
131	Commission to keep register of licensed persons and exempt persons	CTO s.42; SO s.64; LFETO s.15

Clause	Part	Derivation
132	Publication of names of licensed persons and exempt persons	CTO s.43; SO s.65; LFETO s.15(4) - (6)
133	Annual fee	SFCO s.54
134	Prohibition of use of certain titles	CTO s.106; SO s.142;
135	Procedural Requirements	New; CTO s.40; SO s.53(2) & (3); SFCO s.26A(6) & (7); LFETO s.7(9)
136	Amendment of Schedule 6	New
	PART VI – CAPITAL REQUIREMENTS, CLIENT ASSETS, RECORDS AND AUDIT	
	Division 1 – Interpretation	
137	Interpretation of Part VI	CTO s.44; SO s.82
	Division 2 – Capital Requirements	
138	Financial resources	SFCO s.28; LFETO s.17
139	Failure to comply with financial resources rules	SO s.65C; LFETO s.19
140	Monitoring compliance with financial resources rules	LFETO s.20; SO s.65D
	Division 3 – Client Assets	
141	Client securities, etc. held by intermediaries	CTO s.47; SO s.81
142	Client money held by licensed corporations	CTO ss.46 & 47; SO ss.83 & 85
143	Claims and liens not affected	CTO s.48; SO s.86; LFETO s.25
	Division 4 – Records	
144	Keeping of accounts and records by intermediaries	CTO s.45; SO s.83
145	Contract notes, receipts and statements of account	CTO s.45A; SO s.75
	Division 5 – Audit	
146	Auditor to be appointed	SO s.87
147	Notification of proposed change of auditors	CTO s.49A; SO s.87B; LFETO s.28
148	Notification of end of financial year	CTO s.101; SO s.87A; LFETO s.26
149	Audited accounts to be submitted by licensed corporations and their associated entities, etc.	CTO s.50; SO s.88; LFETO s.29
150	Auditors to lodge report with Commission in certain cases	CTO s.51; SO s.89; LFETO s.31

Clause	Part	Derivation
151	Immunity in respect of communication by auditors with Commission	SO s.89A
152	Power of Commission to appoint auditors	CTO s.52; SO s.90; LFETO s.33
153	Commission may appoint auditors on application of clients	CTO s.53; SO s.91; LFETO s.34
154	Auditors to report to Commission	CTO s.54; SO s.92; LFETO ss.35 & 38
155	Powers of auditors appointed by Commission	CTO s.55; SO s.93, 95; LFETO s.36
156	Offence to destroy, conceal, or alter accounts, records or documents, etc.	CTO s.56; SO s.96; LFETO s.37
	Division 6 – Miscellaneous	
157	Associated entities	New
	PART VII – BUSINESS CONDUCT, ETC.	
	Division 1 - Interpretation	
158	Interpretation of Part VII	New
	Division 2 – Business Conduct	
159	Business conduct	FSA s.47A; LFETO ss.76 & 77
160	Codes for business conduct	SO s.146A
	Division 3 – Other Requirements	
161	Requirements for options trading	CTO s.61; SO s.76
162	Unsolicited calls prohibited	CTO s.60A; SO s.74; LFETO s.39
163	Certain representations prohibited	SO s.78
	PART VIII - SUPERVISION AND INVESTIGATIONS	
	Division 1 – Interpretation	
164	Interpretation of Part VIII	New & SFCO s.33(2); LFETO s.44(2) [“person under investigation”]

Clause	Part	Derivation
	Division 2 – Powers to Require Information, etc.	
165	Power to require production of records and documents concerning listed corporations	SFCO s.29A
166	Supervision of intermediaries and their associated entities	SFCO s.30; LFETO s.41
167	Information relating to transactions	SFCO s.31; LFETO s.42
	Division 3 – Powers of Investigations	
168	Investigations	SFCO s.33(1), (3) & (7); SO s.56(1); CTO s.36(1); LFETO ss.12(1) & (2) & 44(1), (3) & (7)
169	Conduct of investigations	SFCO s.33(4), (8), (9), (10) & (11); LFETO ss.44(4), (8), (9), (10) & (11)
170	Incriminating answers in investigations	SFCO s.33(6); LFETO s.44(6)
171	Offences in relation to investigations	SFCO s.33(12) & (15); LFETO s.44(12), (13) & (15)
	Division 4 – Miscellaneous	
172	Certification to Court of First Instance relating to non-compliance with requirements under section 165, 166, 167 or 169	SFCO ss.32, 33(13) & (14); LFETO ss.43, 44(14) & (15)
173	Assistance to regulators outside Hong Kong	SFCO s.59A; LFETO s.63A
174	Lien claimed on records or documents	New
175	Production of computerized information	SFCO s.35; LFETO s.46
176	Inspection of records or documents seized, etc.	New
177	Magistrate's warrants	SFCO s.36; PIO s.6; LFETO s.47
178	Destruction of documents, etc.	SFCO s.37; LFETO s.48
	PART IX – DISCIPLINE, ETC.	
	Division 1 – Interpretation	
179	Interpretation of Part IX	SO s.56(5); CTO s.36(5); LFETO s.12(7)
	Division 2 – Discipline, etc.	
180	Disciplinary action in respect of licensed persons, etc.	SO s.56(1) & (2); CTO s.36(1) & (2); LFETO s.12(1)-(4)

Clause	Part	Derivation
181	Other circumstances for disciplinary actions in respect of licensed persons, etc.	SO ss.55 (1) – (3); CTO s.35 (1) – (3); LFETO s.11
182	Procedural requirements in respect of exercise of powers under section 180 or 181	SO s.56 (3) & (4); CTO s.36(3) & (4); LFETO s.12(5) & (6)
183	Disciplinary action in respect of exempt persons	New; SO ss.60(5) & 61(2)
184	Procedural requirements in respect of exercise of powers under section 183	New
	Division 3 – Miscellaneous	
185	Effect of suspension under Part IX	New
186	General provisions relating to exercise of powers under Part IX	New; SO s.57(2); CTO s.37(2); LFETO s.11(5)
187	Duty of licensed or exempt person upon revocation of licence or exemption	New
	PART X – POWERS OF INTERVENTION AND PROCEEDINGS	
	Division 1 – Interpretation	
188	Interpretation of Part X	New
	Division 2 – Powers of intervention	
189	Restriction of business	SFCO s.39; LFETO s.50
190	Restriction on dealing with property	SFCO s.40; LFETO s.51
191	Maintenance of property	SFCO s.41; LFETO s.52
192	Requirement to transfer custody of property	New; FSA s.67; SFCO s.38; LFETO s.49
193	Imposition of prohibition or requirement under section 189, 190, 191 or 192	New
194	Withdrawal, substitution or variation of prohibitions or requirements under section 189, 190, 191 or 192	SFCO s.43; LFETO s.54
195	General provisions relating to sections 189, 190, 191, 192 and 194	SFCO s.42; LFETO s.53
196	Certification to Court of First Instance relating to non-compliance with prohibitions or requirements under section 189, 190, 191, 192 or 194	New. Influenced by SFCO s.33(13)

Clause	Part	Derivation
	Division 3 – Other Powers and Proceedings	
197	Winding-up orders and bankruptcy orders	SFCO ss.45 & 46, LFETO ss.59 and 60
198	Injunctions and other orders	SFCO ss.46 & 55 (& CLA s.1324); SO s.144; LFETO s.13 & 55
199	Remedies in cases of unfair prejudice, etc. to interests of members	SFCO s.37A
200	Civil liability for public misstatements, etc. concerning securities and futures contracts	New; CO s.40
	PART XI - SECURITIES AND FUTURES APPEALS TRIBUNAL	
	Division 1 – Interpretation	
201	Interpretation of Part XI	New
	Division 2 – Securities and Futures Appeals Tribunal	
202	Securities and Futures Appeals Tribunal	New
203	Applications for review of specified decisions of the Commission	New
204	Proceedings before Tribunal	New
205	Powers of Tribunal	S(ID)O s.17
206	Contempt dealt with by Tribunal	New
207	Privileged information	S(ID)O s.21
208	Costs	New
209	Notification of Tribunal determinations	New
210	Form and proof of orders of Tribunal	S(ID)O s.28
211	Orders of Tribunal may be registered in Court of First Instance	S(ID)O s.29
212	Applications for stay of specified decisions	S(ID)O s.33
213	Referral of case stated to Court of Appeal	SFCO s.22
	Division 3 – Appeals	
214	Appeal to Court of Appeal	S(ID)O ss.31 & 32
215	No stay of execution on appeal	New
	Division 4 – Miscellaneous	
216	Time when specified decisions to take effect	SFCO s.19, 21 & 44

Clause	Part	Derivation
217	Appeals to Chief Executive in Council in respect of excluded decisions	New
218	Chief Justice may make rules	S(ID)O s.36
219	Amendment of Parts 2 and 3 of Schedule 7	New
	PART XII - INVESTOR COMPENSATION	
220	Interpretation	New
221	Establishment of compensation fund	SO s.99; CTO s.77
222	Money constituting the compensation fund	SO s.101; CTO s.79
223	Money to be kept in account	SO s.102; CTO s.80
224	Accounts of compensation fund	New
225	Investment of moneys	CTO s.83
226	Payments out of the compensation fund	SO s.108; CTO s.86
227	Subrogation of the Commission to rights, etc., of claimant on payment from compensation fund	SO s.118; CTO s.95
228	Rule-making powers	New
	PART XIII – MARKET MISCONDUCT TRIBUNAL	
	Division 1 – Interpretation	
229	Interpretation of Part XIII	S(ID)O s.2
230	Interest in securities (insider dealing)	S(ID)O s.2(5)
231	Connected with a corporation (insider dealing)	S(ID)O s.4
232	Connected with a corporation – possession of relevant information obtained in privileged capacity (insider dealing)	S(ID)O s.5
233	Dealing in securities or their derivatives (insider dealing)	S(ID)O s.6
234	Interest in securities and beneficial ownership, etc. (market misconduct other than insider dealing)	SO s.5
	Division 2 – Market Misconduct Tribunal	
235	Market Misconduct Tribunal	New; S(ID)O s.15
236	Market misconduct proceedings	S(ID)O s.16
237	Powers of Tribunal	S(ID)O ss.17 & 20
238	Further powers of Tribunal concerning evidence	S(ID)O ss.18 & 20
239	Use of evidence in other proceedings	S(ID)O s.19

Clause	Part	Derivation
240	Privileged information	S(ID)O s.21
241	Orders, etc. of Tribunal	S(ID)O ss.23 & 27
242	Further orders in respect of officers of corporation	S(ID)O s.24
243	Interest on moneys payable under section 241 or 242	New
244	Costs	S(ID)O ss.26 & 26A
245	Contempt dealt with by Tribunal	New
246	Report of Tribunal	S(ID)O s.22
247	Form and proof of orders of Tribunal	S(ID)O s.28
248	Orders of Tribunal may be registered in Court of First Instance	S(ID)O s.29
	Division 3 – Appeals, etc.	
249	Appeal to Court of Appeal	S(ID)O s.31
250	Powers of Court of Appeal on appeal	S(ID)O s.32
251	No stay of execution on appeal	S(ID)O s.33
252	Chief Justice may make rules	S(ID)O s.36
	Division 4 – Insider Dealing	
253	Insider dealing	S(ID)O s.9
254	Insider dealing – certain persons not to be regarded as having engaged in market misconduct	S(ID)O s.10
255	Insider dealing – certain trustees and personal representatives not to be regarded as having engaged in market misconduct	S(ID)O s.11
256	Insider dealing – certain persons exercising right to subscribe for or acquire securities or derivatives not to be regarded as having engaged in market misconduct	S(ID)O s.12
	Division 5 – Other Market Misconduct	
257	False trading in securities	SO s.135(1) & (2); CLA s.998
258	Price rigging in securities markets	SO s.135(3) & (4); CLA s.998
259	Disclosure of information about prohibited transactions in securities	SO s.135(5); CLA s.1001
260	Stock market manipulation	SO s.137; CLA s.997; FSA s.47
261	Disclosure of false or misleading information inducing transactions in securities	SO s.138; CLA s.999
262	False trading in futures contracts	CTO s.62; CLA ss.1259 & 1260

Clause	Part	Derivation
263	Price rigging in futures markets	New; CLA s.1260
264	Disclosure of information about prohibited transactions in futures contracts	New; CLA s.1263
265	Disclosure of false or misleading information inducing transactions in futures contracts	CTO s.64; CLA s.1261
	Division 6 – Miscellaneous	
266	Duty of officers of corporations	S(ID)O s.13
267	Transactions constituting market misconduct not void or voidable	S(ID)O s.14
268	Civil liability for market misconduct	New; SO s.141; CO s.40; FSMB s.120
269	Transactions not to constitute market misconduct	New
270	No further proceedings after Part XIV criminal proceedings	New
271	Market misconduct regarded as contravention of provisions of this Part	New
272	No retrospectivity	New
	PART XIV – OFFENCES RELATING TO DEALINGS IN SECURITIES AND FUTURES CONTRACTS, ETC.	
	Division 1 – Interpretation	
273	Interpretation of Part XIV	S(ID)O s.2
274	Interest in securities (insider dealing offence)	S(ID)O s.2(5)
275	Connected with a corporation (insider dealing offence)	S(ID)O s.4
276	Connected with a corporation – possession of relevant information obtained in privileged capacity (insider dealing offence)	S(ID)O s.5
277	Dealing in securities or their derivatives (insider dealing offence)	S(ID)O s.6
278	Interest in securities and beneficial ownership, etc. (market misconduct offences other than insider dealing offence)	SO s.5
	Division 2 – Insider dealing offence	
279	Offence of insider dealing	S(ID)O s.9
280	Insider dealing offence – general defences	S(ID)O s.10

Clause	Part	Derivation
281	Insider dealing offence – defences for certain trustees and personal representatives	S(ID)O s.11
282	Insider dealing offence – defences for certain persons exercising right to subscribe for or acquire securities or derivatives	S(ID)O s.12
	Division 3 – Other market misconduct offences	
283	Offence of false trading in securities	SO s.135(1) & (2); CLA s.998
284	Offence of price rigging in securities markets	SO s.135(3) & (4); CLA s.998
285	Offence of disclosure of information about prohibited transactions in securities	SO s.135(5); CLA s.1001
286	Offence of stock market manipulation	SO s.137; CLA s.997; FSA s.47
287	Offence of disclosure of false or misleading information inducing transactions in securities	SO s.138; CLA s.999
288	Offence of false trading in futures contracts	CTO s.62; CLA ss.1259 & 1260
289	Offence of price rigging in futures markets	New; CLA s.1260
290	Offence of disclosure of information about prohibited transactions in futures contracts	New; CLA s.1263
291	Offence of disclosure of false or misleading information inducing transactions in futures contracts	CTO s.64; CLA s.1261
	Division 4 – Fraudulent or deceptive conduct offences	
292	Fraudulent or deceptive devices, etc. in transactions in securities, futures contracts or leveraged foreign exchange trading	SO s.136; CTO s.63; LFETO s.40
293	Falsely representing dealings in futures contracts on behalf of others, etc.	New; CLA s.1258
	Division 5 – Miscellaneous	
294	Penalties	New
295	Civil liability for contravention of this Part	New; SO s.141; CO s.40; FSMB s.120
296	Transactions not to constitute offences	New
297	No further proceedings after Part XIII market misconduct proceedings	New

Clause	Part	Derivation
	PART XV – DISCLOSURE OF INTERESTS	
	Division 1 – Preliminary	
298	Interpretation of Part XV	S(DI)O s.2
299	Exemptions	S(DI)O s.2A
	Division 2 – Disclosure of notifiable interests and short positions	
300	Duty of disclosure: cases in which it may arise and relevant time	S(DI)O s.3
301	Interests to be disclosed	S(DI)O s.4
302	Notifiable interests	S(DI)O s.4
303	Short positions to be disclosed	New
304	Circumstances in which duty of disclosure arises	S(DI)O s.4
305	Percentage level in relation to notifiable interests and short positions	S(DI)O s.5
306	Notifiable percentage level and specified percentage level	S(DI)O s.6
307	Notification to be given and particulars to be contained	S(DI)O s.7
308	Time of notification	S(DI)O s.7
309	Notification of family and corporate interests and short positions	S(DI)O s.8
310	Agreement to acquire interests in a particular listed corporation	S(DI)O s.9
311	Notification of interests of parties to agreement	S(DI)O s.10
312	Duty of parties to agreement acting together to keep each other informed	S(DI)O s.11
313	Circumstances in which persons have interests in shares or short positions by attribution	S(DI)O s.12
314	Notification by agents	S(DI)O s.15
315	Duty to publish and notify Monetary Authority of information given under section 307	S(DI)O s.20
316	Offences for non-compliance with notification requirements	S(DI)O s.16
	Division 3 – Listed corporation's powers to investigate ownership	
317	Power of listed corporation to investigate ownership of interests in its shares etc.	S(DI)O s.18

Clause	Part	Derivation
318	Duty to notify relevant exchange company, Commission and Monetary Authority of information given under section 317	S(DI)O s.20
319	Listed corporation to investigate ownership of interests in its shares etc. on requisition by members	S(DI)O s.21
320	Listed corporation to report to members	S(DI)O s.22
321	Duty to deliver report prepared under section 320 to relevant exchange company, Commission and Monetary Authority	S(DI)O s.23
322	Penalty for failure to provide information required by listed corporation and power to impose restrictions	S(DI)O s.24
323	Register of interests in shares and short positions	S(DI)O s.16
324	Registration of interests and short positions disclosed under section 317	S(DI)O s.19
325	Removal of entries from register	S(DI)O s.25
326	Otherwise, entries not to be removed	S(DI)O s.26
327	Inspection of register and reports	S(DI)O s.27
	Division 4 – Disclosure of interests and short positions of directors and chief executives	
328	Duty of disclosure by director and chief executive	S(DI)O s.28
329	Interests to be disclosed by director and chief executive	S(DI)O s.28
330	Short positions to be disclosed by director and chief executive	New
331	Notification to be given by director and chief executive and particulars to be contained	S(DI)O Schedule, Part II & III
332	Time of notification by director and chief executive	S(DI)O Schedule, Part II
333	Notification of family and corporate interests and short positions by director and chief executive	S(DI)O s.31
334	Duty to publish and notify Monetary Authority of information given under this Division	S(DI)O s.32
335	Offences for non-compliance with notification requirements by director and chief executive	S(DI)O s.28 & Schedule, Part IV
	Division 5 – Listed corporation's duties upon receiving information from directors and chief executives	
336	Register of directors' and chief executives' interests and short positions	S(DI)O s.29

Clause	Part	Derivation
337	Inspection of register on directors' and chief executives' interests and short positions	S(DI)O s.30
	Division 6 – Power to investigate listed corporation's ownership	
338	Power to investigate ownership of a listed corporation	S(DI)O s.33
339	Investigation of contraventions of sections 328 to 333	S(DI)O s.34
340	Inspector's powers during investigation	S(DI)O s.35
341	Production of records and evidence to inspectors	S(DI)O s.36
342	Delegation of powers by inspectors	S(DI)O s.37
343	Obstruction of inspectors	S(DI)O s.38
344	Inspector's reports	S(DI)O s.39
345	Expenses of investigation of the affairs of a corporation	S(DI)O s.40
346	Power to impose restrictions on shares etc. in connection with investigation	S(DI)O s.41
347	Power to obtain information as to those interested in shares, etc.	S(DI)O s.42
348	Privileged information	S(DI)O s.43
	Division 7 – Orders imposing restrictions on shares etc. under section 316, 322 or 346	
349	Consequence of order imposing restrictions	S(DI)O s.44
350	Punishment for attempted evasion of restrictions	S(DI)O s.45
351	Relaxation and removal of restrictions	S(DI)O s.46
352	Further provisions on sale by court order of restricted shares or equity derivatives	S(DI)O s.47
	Division 8 – Miscellaneous	
353	Offences by corporations	S(DI)O s.48
354	Method of giving notification	S(DI)O s.51
355	Immunity	S(DI)O s.51A
356	Form of registers and indices	S(DI)O s.52
357	Regulations	S(DI)O s.53

Clause	Part	Derivation
	PART XVI – MISCELLANEOUS	
358	Preservation of secrecy, etc.	SFCO s.59; SO s.94; CTO s.57; LFETO s.63
359	Immunity	SFCO s.56; SF(CH)O s.17; LFETO s.62
360	Immunity in respect of communication by auditors of listed corporations, etc. with Commission	New
361	Obstruction	SO s.145; CTO s.108; LFETO s.64
362	Power of Commission to intervene in proceedings	New; CLA s.1330
363	Proceedings not to be stayed	New; CLA s.1331
364	Standard of proof	New; CLA s.1332
365	Prosecution of certain offences by Commission	SO s.148; CTO s.114; SFCO s.62; LFETO s.65
366	Limitation on commencement of proceedings	SO s.148A; CTO s.114A; PIO s.7B; LFETO s.67; S(ID)O s.35
367	Liability of executive officers, directors, etc.	SO s.147; CTO s.110; PIO ss.7 & 34; LFETO s.66
368	Liability of corporations for act of directors, employees, agents, etc.	CTO s.112
369	Financial Secretary to prescribe interests, etc. as securities and futures contracts	New: FSMB Part 1
370	Orders by Chief Executive in Council for levies	SFCO s.52
371	Rules by Chief Executive in Council for payment of fees	SFCO s.54; LFETO s.72
372	Reduction of levy	SFCO s.52
373	Rules by Commission	SO ss.146 & 146A; CTO s.109; LFETO ss.45 & 73
374	Codes or guidelines by Commission	New; SFCO s.4(2);
375	Service of notices	SFCO s.60; LFETO s.61
376	Evidence regarding Commission's records or documents	SFCO ss.58 & 61; LFETO s.68
377	General requirements for documents lodged with Commission	New
378	False representations in applications to Commission	CTO s.40; SO s.62; LFETO s.10
379	General provisions for approvals by Commission	ECH(M)O
380	Exclusions of provisions of Gambling Ordinance	CTO s.116; LFETO s.70
381	Inland Revenue Ordinance not affected	New

Clause	Part	Derivation
	PART XVII – REPEALS AND RELATED PROVISIONS	
382	Repeals	New
383	Savings, transitional, consequential and related provisions, etc.	New
384	Provisions of Part XVII, etc. not to derogate from section 23 of Interpretation and General Clauses Ordinance	New
385	Amendment of Schedule 10	New

Part		Derivation
	Schedule 1	
Part 1	Interpretation	
Part 2	Specified Futures Exchanges	LFETO Schedule
Part 3	Specified Stock Exchanges	LFETO Schedule
Part 4	Qualifying Credit Rating	LFETO Schedule
	Schedule 2 – Securities and Futures Commission	
Part 1	Constitution and proceedings of Commission, etc.	SFCO ss.3, 5 & 10
Part 2	Non-delegable functions of Commission	SFCO Schedule
	Schedule 3 - Exchange Companies, Clearing Houses, Exchange Controllers	
Part 1	Specification of persons who are associated persons	ECH(M)O Part 1 Schedule1
Part 2	Specification of persons who are not associated persons	ECH(M)O Part 2 Schedule 1
Part 3	Specified Commodities	CTO Part 1 Schedule 1
Part 4	Specification of persons who are not indirect controllers	ECH(M)O Part 3 Schedule 1
Part 5	Property which may be subject to a market charge or provided as market collateral	SF(CH)O Schedule 1
Part 6	Requirements for default rules of recognized clearing houses	SF(CH)O Schedule 2
Part 7	Provisions applicable where there is contravention of notice under section 59(9)(b), 70(1) or 61(10)(b) of this Ordinance	ECH(M)O Schedule 2
Part 8	Specification of persons who are not minority controllers for the purposes of this Ordinance	ECH(M)O Part 1 Schedule 3
Part 9	Exemption from section 59(1)	ECH(M)O Part 2 Schedule 3
	Schedule 4 – Offers of investments	
Part 1	Sum specified for purposes of section 102(3)(f)(i) and (g) of this Ordinance	PIO Schedule
Part 2	Instruments specified for purposes of section 102(3)(g) of this Ordinance	PIO Schedule
Part 3	Multilateral agencies	PIO Schedule
Part 4	Exempted Bodies	PIO Schedule
Part 5	Sum specified for purposes of definition of "relevant condition" in section 102(12) of this Ordinance	PIO Schedule
	Schedule 5	
Part 1	Requirements to be satisfied in relation to offers to acquire securities	SO Schedule 1
Part 2	Requirements to be satisfied in relation to offers to dispose of securities	SO Schedule 2

Schedule 6 – Regulated Activities		
Part 1		New
Part 2		New
Schedule 7 – Securities and Futures Appeals Tribunal		
Part 1	Appointments of Members and Proceedings of Tribunal, etc	New; SFCO s.21
Part 2	Specified Decisions	New; SFCO s.19; LFETO ss.56 & 57
Part 3	Excluded Decisions	New
Schedule 8 – Market Misconduct Tribunal		New; S(ID)O Schedule
Schedule 9 – Provisions Supplementing and Interpreting Part XV of this Ordinance		
Rules for interpretation of this Schedule		
Part 1	Definitions	
Rules for interpretation of Division 2 of Part XV of this Ordinance		
Part 2	Interests and short positions to be notified	S(DI)O s.13
Part 3	Interests to be disregarded for the purpose of notification	S(DI)O s.14
Part 4	Particulars to be contained in notifications required by section 307 of this Ordinance	S(DI)O s.7
Rules for interpretation of Division 4 of Part XV of this Ordinance		
Part 5	Interests and short positions to be notified by directors and chief executives	Schedule, Part I
Part 6	Interests to be disregarded for the purpose of notification by directors and chief executives	Schedule, Part I
Part 7	Particulars to be contained in notifications by directors and chief executives required by section 331 of this Ordinance	Schedule, Part III
Schedule 10 - Savings, Transitional, Consequential and Related Provisions, Etc.		
Part 1	Savings, transitional & supplemental arrangements	New
Part 2	Consequential and supplemental amendments	New

Annex D

Major elements of the Proposed Licensing Regime[1]

(1) A substantial revision of existing criteria for the granting of exempt status

(2) Exempt status to be limited to authorized institutions under the Banking Ordinance only

(3) Extension of the SFC's power of investigation to cover exempt persons in relation to their conduct of "regulated activities"

(4) Clarification of the SFC's attitude to the advisory activities performed by lawyers and professional accountants that are incidental to their ordinary business and the carrying out of which does not require a licence

(5) Continuation of exempt status for persons who deal solely with professional investors, but subject to a new requirement that they should be subject to reporting and certain Code of Conduct requirements

(6) Issuance of a single licence to investment intermediaries, specifying the scope of permitted business

(7) New legislation to re-define the activities for which a licence is required

(8) Scope for the SFC to authorize a person to perform a licensed function to a limited extent

(9) A requirement that all who are able to exercise a significant influence over the conduct of a licensed entity and those who are directly responsible for the management and supervision of the operations of a licensed corporation, including all executive directors, be licensed and designated as responsible officers who must satisfy additional licensing criteria; licensed corporations are to be supervised by at least two responsible officers, including one executive director

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[1] Extract from "Consultation Paper on Review of Licensing Regime" issued by the SFC in June 1999

(10) A requirement that licensed corporations engage only those who have proper credentials to be senior officers directly responsible for the performance of the key internal control functions of the corporations

(11) Power for the SFC to issue provisional licences to representative applicants with a view to saving time and costs

(12) Measures by the SFC and the Exchanges to harmonize their licensing process

(13) A limitation that only corporations will be licensed to carry out "regulated activities"

(14) Recognition of approved industry courses as prerequisites for obtaining a licence as a representative or responsible officer

(15) Power for the SFC to specify competence standards for responsible officers

(16) A continuous training requirement to be included as an on-going obligation for licensed persons

(17) A requirement that licensed corporations have a training policy to provide continuous training to accredited representatives

(18) A provision that investment contracts made with an unlicensed intermediary be voidable at the client's option

(19) Power of the SFC to issue orders against persons who are not fit and proper, banning them from participation in the industry

Part XV – Disclosure of interests
Comparison with overseas economies

Substantial Shareholding Disclosure Threshold

The U.K.	3%	The U.S.	5%
Australia	5%	New Zealand	5%
Japan	5%	Singapore	5%
Malaysia	5%	Thailand	5%
Indonesia	5%	The Mainland of China	5%

Hong Kong:

Present	10%
Proposed	5%

Notification Period

The U.K.	2 business days	The U.S.	10 days
Australia	2 business days	Indonesia	10 days
Singapore	2 days	Malaysia	14 days
Thailand	1 day		
The Mainland of China	3 working days		
New Zealand	As soon as one has knowledge		

Hong Kong:

Present	5 days
Proposed	3 business days