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Legislative Council

LC Paper No. CB(1)16/11-12

Ref: CB1/BC/11/10

Bills Committee on
Securities and Futures (Amendment) Bill 2011

Background Brief

Purpose

This paper provides background information on the Securities and Futures (Amendment) Bill 2011 (the Bill), and summarizes the concerns and views expressed by members during the relevant discussions at the Panel on Financial Affairs (the Panel).

Background

Statutory obligation for listed corporations to disclose price-sensitive information

2. At present, the requirement for listed corporations to disclose price-sensitive information (PSI) is set out in the Listing Rules of the Stock Exchange of Hong Kong Limited, not in the law.[1] The lack of regulatory teeth in the Listing Rules has been a cause for concern. The Government considers that a statutory PSI disclosure regime is necessary to enhance market transparency and quality, to bring the regulatory regime for listed corporations more in line with those of overseas jurisdictions, and to sustain Hong Kong's position as a premier capital formation centre.

3. On 29 March 2010, the Administration launched a three-month public consultation on the proposed statutory codification of certain requirements to disclose PSI by listed corporations (including the proposal to enable the Securities and Futures Commission (SFC) to institute proceedings before the Market Misconduct Tribunal (MMT)). The Administration published the consultation conclusions in February 2011. According to the Administration,

[1] The Listing Rules are made and administered by the Stock Exchange of Hong Kong Limited (SEHK). The Rules are non-statutory and compliance with which by issuers is based on the contractual listing agreements between the SEHK and the issuers.

the respondents[2] generally supported the objective of the legislative proposal of cultivating a continuous disclosure culture among listed corporations. Certain professional bodies in the legal, accounting and financial fields, as well as consumer groups indicated general support to the proposed statutory regime. Noting that the lack of regulatory "teeth" in the Listing Rules has been an issue of public concern, supporters commented that reliance on non-statutory regulation raised doubt about enforcement effectiveness. A statutory regime could encourage compliance, enhance market transparency and provide better protection to investors. However, around 20% of the written submissions (mostly listed corporations, with a few trade bodies) did not support establishing a statutory regime. They opined that a statutory regime would lead to indiscriminatory disclosure of "half-baked" information and increase compliance cost.

Direct institution of Market Misconduct Tribunal proceedings by the Securities and Futures Commission

4. Currently under the Securities and Futures Ordinance (Cap. 571) (SFO), MMT proceedings can only be instituted by the Financial Secretary (FS). Upon receipt of reports from the SFC, FS would seek legal advice from the Department of Justice to assist him in deciding whether proceedings should be instituted. In order to streamline the process for enforcement of the statutory PSI disclosure requirement and to deal with the existing six types of market misconduct stipulated in the SFO[3], the Administration proposed in the abovementioned public consultation to empower SFC to institute proceedings before the MMT direct, without having to first refer the case to FS for his decision to do so.

5. According to the Administration, the majority of the respondents who did not agree with the proposal were from listed corporations, believing that this would lead to a loss of checks and balances. Some were concerned that the SFC should not be both the investigator and prosecutor. Two respondents from the legal and banking sectors sought further elaboration on the reasons for granting the SFC direct access. A few respondents raised concerns about the resource implications to the MMT as a result of direct access. At the same time, a major professional body in the legal sector agreed with the proposal. It pointed out that the SFC has direct and expert knowledge of the securities market and law, and it would suffice to rely on the SFC's judgment as to whether a case should be referred to the MMT. Involving FS or the Department of Justice to institute proceedings before the MMT would amount

[2] The Administration had received 110 written submissions, about half of which were from listed corporations, while the others were mainly from trade bodies of the financial services, accounting and legal sectors as well as investor/consumer groups.

[3] These are insider trading, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, and stock market manipulation.

to duplication of efforts with the SFC. The professional body also pointed out that the MMT itself provides the best checks and balances in the enforcement regime.

Establishment of Investor Education Council

6. Currently, among the financial regulators in Hong Kong, only the SFC has an explicit statutory remit to pursue investor education[4], although other financial regulators and operators, as well as industry bodies, do make information available through various means to promote public understanding of various financial matters. The events of the global financial crisis in 2008 have shown that some investors would need more support and protection as they engage in financial services. SFC in its report of December 2008 on "Issues raised by the Lehmans Minibonds crisis" recommended that an IEC be established as a separate body corporate funded by SFC to co-ordinate and deliver an expanded investor education programme across the whole financial services sector.

7. The Administration launched a three-month public consultation on the proposed establishment of an Investor Education Council (IEC) and a Financial Dispute Resolution Centre on 9 February 2010. The Administration published the consultation conclusions in December 2010. According to the Administration, there was a general consensus that provision of financial education was the most effective means to enhance financial literacy of the public, hence help them make informed financial decisions and detect problems such as market scams and malpractices at an early stage. The proposed setting up of an IEC to holistically oversee the needs of investor education and delivery of related initiatives had the support of the vast majority of respondents.

Proposals under the Bill

8. The Bill was introduced into the Legislative Council on 29 June 2011. The objects of the Bill are to amend the SFO to enhance the regulatory regime for the financial market and improve investor protection by codifying certain requirements to disclose PSI, empowering SFC to institute proceedings before the MMT and strengthening SFC's investor education role.

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[4] Section 5 of the SFO prescribes the functions of the SFC, which include inter alia –

(a) to promote understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products;

(b) to encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the SFC under any of the relevant provisions; and

(c) to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor.

9. The Bill proposes to:

(a) require listed corporations to disclose PSI (to be named "inside information" in the Bill) in a timely manner to the public and impose civil sanctions for breach of the requirement;

(b) enable SFC to institute MMT proceedings direct for market misconduct cases when it has obtained consent from the Secretary for Justice (SJ), appoint Presenting Officers in MMT in place of SJ and apply to the Court of First Instance without having first to consult FS;

(c) enable SFC to establish a wholly owned subsidiary to facilitate the performance of its wider investor education functions; and

(d) make certain technical amendments to SFO.

Discussion at the Panel of Financial Affairs

Statutory codification of certain requirements to disclose PSI by listed corporations

10. The Panel discussed the consultation proposals on the statutory PSI disclosure regime (including the proposal to enable SFC to institute proceedings before the MMT) on 3 May 2010 and the relevant consultation conclusions on 21 February 2011. The major concerns and views of members are summarized in the paragraphs below.

Obligations and liabilities of directors/officers

11. Some members expressed concern about the obligations and liabilities of individual directors and high level staff responsible for managing a listed corporation in disclosing PSI. They were particularly concerned about the obligations of independent non-executive directors, as they were normally not directly involved in the daily operation of listed corporations. The Administration advised that enforcement actions against a listed incorporation and individual director(s)/officer(s) regarding breaches of the disclosure requirements would be based on evidence as to whether such a breach was a result of intentional, reckless or negligent act of the individual director(s)/officer(s). In order to prevent directors from shirking their responsibilities on the disclosure requirements, an individual director would be held responsible if he had not taken all reasonable measures to prevent the listed corporation from breaching the disclosure requirements. The negligence of individual directors/officers would be assessed based on the "reasonable man"

principle, i.e. whether the directors/officers had acted reasonably in handling and disclosing the PSI. Under the Companies Ordinance (Cap. 32), the obligations of executive and non-executive directors were the same, and all directors would have to observe the same disclosure requirements under the current proposals.

12. A member queried the appropriateness of the expression of "ought reasonably to have come into possession of the PSI" in the indicative draft legislative relating to the obligations of company directors and high-level staff in disclosure of PSI. The Administration advised that there was general support from respondents to the public consultation for the indicative draft legislative provisions. A company director or high-level officer would only be held responsible if SFC could provide evidence to prove that the breach in relation to a listed corporation was a result of the intentional, reckless or negligent act of that director or officer, or that director/officer had not taken reasonable measures to prevent the breach in relation to the listed corporation.

Professional service providers

13. Some members expressed concern that the proposed legislation did not cover professional service providers such as lawyers and accountants, while these persons might leak or take advantage in certain ways of the PSI obtained in the course of providing services to listed corporations. The Administration advised that if a professional service provider breached the confidentiality agreement with a listed corporation and leaked PSI to other parties, the professional service provider would be in breach of the relevant professional code of conduct, and subject to disciplinary action by the relevant professional body. Persons making use of PSI leaked by the professional service providers for trading in the securities concerned might be subject to enforcement action by the SFC under the insider dealing regime of the SFO.

Civil sanctions

14. As to why only civil sanctions were proposed for the PSI disclosure regime, the Administration explained that the proposed codification arrangements, including the civil sanctions, were made having regard to the practices and procedures in the United Kingdom and other EU countries. SFC was responsible for investigation of each case. And if other misconduct on the part of the directors and related parties in dealing with “inside information” was identified during the investigation, criminal sanctions could be imposed under the existing provisions of the SFO.

15. Some members enquired about the basis for setting the maximum regulatory fine level at $8 million. A member opined that instead of setting the maximum regulatory fine level at $8 million, it would only be fair to set

different ceilings of fines based on the capital size of the listed corporations. The Administration advised that the maximum fine level of $8 million was set based on legal advice and having regard to the maximum fine level of $10 million for a criminal offence under the SFO. The proposed maximum fine level was considered suitable for a civil sanction. The legislation would require the MMT to comply with the principle of proportionality when determining the amount of regulatory fines to be imposed in a particular case, and consider a number of factors, such as the financial resources of the individual and/or the listed corporation involved, records of their past breaches, seriousness of the breach and its impact on the investing public, etc. In addition to the regulatory fine, other sanctions would also be considered.

Safe harbours

16. Regarding the proposed safe harbour for information concerning the provision of liquidity support by the Exchange Fund or a central bank, a member asked whether and when such incidents would be disclosed to the public, and what accountability arrangements the Hong Kong Monetary Authority (HKMA) would be subject to in such incidents. The Administration advised that it had discussed the proposed safe harbour with HKMA and considered that the stability of the banking sector might be adversely affected if such incidents were disclosed to the public, even in the aftermath of the liquidity incidents. Disclosure of such incidents might also incur moral hazard in that the public might be misled to believe that the Government would always provide liquidity support to a troubled financial institution. Taking into consideration the advantages and disadvantages of disclosure, the Administration considered that such incidents should be kept confidential. HKMA provided after the meeting supplementary information vide LC Paper No. CB(1)1574/10-11(02).

Market Misconduct Tribunal

17. Noting that since its inception in 2003, the MMT had only dealt with four cases, a member enquired about the reasons for the few cases handled by MMT, and expressed concern whether MMT had the capacity to deal with an increased number of cases resulting from the implementation of the proposal. The Administration explained that MMT was charged to handle market misconduct cases that happened after the commencement of SFO in 2003. Some market misconduct cases were handled by criminal proceedings, not by the MMT. Following SFC's investigation, MMT heard the first case in 2007. So far, the MMT had dealt with five cases. The Government would monitor the operation of MMT and where necessary, would allocate additional resources to MMT to meet an increased workload.

Timing for disclosure

18. A member opined that listed corporations should be required to disclose PSI outside the trading hours of the Hong Kong stock market so as to allow time for digestion of the relevant information by the market. The Administration advised that the guidelines to be promulgated by SFC on disclosure of inside information would set out in more detail the operational arrangements with respect to the timing of disclosure.

Investor Education Council

19. The Panel discussed the consultation proposal for the establishment of an IEC on 1 March 2010, and the relevant consultation conclusions on 3 January 2011. The major concerns and views of members and the Administration's responses are summarized below.

Need for an IEC

20. A member doubted the need of establishing a separate body to take charge of investor education, and considered it more appropriate to set up a separate department within SFC to continue the work. The Administration explained that under the existing SFO, investor education provided by SFC could cover securities and futures only. In the light of market development and for investor protection, the Government considered it necessary to set up an IEC to holistically oversee the work of investor education. The IEC would be staffed by 10-odd staff only.

Target groups and strategy

21. Members enquired about the target group(s) of investors for the investor education provided by the IEC and whether the IEC would render advice on the risks involved in individual financial products. The Administration and SFC advised that the IEC would target general retail investors in its work rather than institutional investors. The IEC would conduct a survey to gauge the financial literacy of the general public. Different strategies would be pursued to improve the financial literacy of different groups of investors, including regular and mass media campaigns to reach large audiences, sustainable and tailored outreach programmes for different sectors of the community, and a website for the young, more educated and independent investors to get access to comprehensive and impartial investor education information. In proposing the establishment of the IEC, the Government had made reference to the relevant arrangements in overseas countries; the IEC would also adjust its strategy where necessary after gaining more implementation experience.

22. A member expressed concern that if the IEC was established, HKMA, SFC and financial institutions might shirk their responsibility of offering advice to investors on the risks of the financial products offered in the market, and refer all enquiries to the IEC. The Administration advised that the relevant financial regulators and the financial institutions concerned would still have to shoulder their responsibility for educating or alerting investors the risks involved in financial products, even after the establishment of the IEC. The IEC would not offer investment advice regarding individual financial products. The financial institutions concerned would still be responsible for explaining to their customers regarding the risks of the financial products. Investors might also seek advice from their personal financial advisers regarding the investment in particular financial products.

The IEC Board

23. Regarding the composition of the IEC Board, the Administration advised that the SFC Board would recommend to FS an independent non-executive director of SFC as the Chairman of the IEC Board. Membership of the IEC Board would comprise representatives from the regulators. Representative(s) of the Consumer Council and independent experts in the relevant fields would serve on the advisory groups of the Board.

Relevant papers

24. The relevant papers and their hyperlinks are given at the **Apppendix**.

Council Business Division 1
Legislative Council Secretariat
11 October 2011

Appendix

Securities and Futures (Amendment) Bill 2011

Relevant papers

Committee	Date of meeting	Hyperlinks
-	-	The Bill
-	-	Legislative Council Brief
-	-	Legal Service Division Report
Panel on Financial Affairs	21 February 2011	Agenda Minutes (paragraph 3 to 32) Follow-up paper by HKMA
Panel on Financial Affairs	3 January 2011	Agenda Background brief Minutes (paragraph 40 to 62)
Panel on Financial Affairs	3 May 2010	Agenda Minutes (paragraph 6 to 28)
Panel on Financial Affairs	1 March 2010	Agenda Minutes (paragraph 7 to 31)

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