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Legislative Council

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(These minutes have been seen
by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 3 June 2013 at 9:30 am
in Conference Room 1 of the Legislative Council Complex

Members present :	Hon Starry LEE Wai-king, JP (Chairman) Hon CHAN Kin-por, BBS, JP (Deputy Chairman) Hon Albert HO Chun-yan Hon James TO Kun-sun Hon CHAN Kam-lam, SBS, JP Hon Abraham SHEK Lai-him, SBS, JP Hon Jeffrey LAM Kin-fung, GBS, JP Hon Andrew LEUNG Kwan-yuen, GBS, JP Hon WONG Ting-kwong, SBS, JP Hon Ronny TONG Ka-wah, SC Hon Mrs Regina IP LAU Suk-yee, GBS, JP Hon James TIEN Pei-chun, GBS, JP Hon NG Leung-sing, SBS, JP Hon Kenneth LEUNG Hon Dennis KWOK Hon Christopher CHEUNG Wah-fung, JP
Members attending :	Hon WONG Kwok-hing, MH Dr Hon LAM Tai-fai, SBS, JP Dr Hon Kenneth CHAN Ka-lok Hon CHAN Yuen-han, SBS, JP Hon TANG Ka-piu
Member absent :	Hon SIN Chung-kai, SBS, JP

Public officers attending	**:**	Agenda Item IV Mr John TSANG, GBM, JP Financial Secretary Mrs Helen CHAN, JP Government Economist Mr Arthur AU Administrative Assistant to Financial Secretary Agenda Item V Miss Salina YAN, JP Deputy Secretary for Financial Services and the Treasury (Financial Services) 1 Miss Sara TSE Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 1 Agenda Item VI Miss Ada CHAN Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 2
Attendance by invitation	:	Agenda Items V & VI Mr Ashley ALDER Chief Executive Officer Securities and Futures Commission Agenda Item V Mr Brian HO Executive Director, Corporate Finance Division Securities and Futures Commission Ms Cecilia LIEW Director, Corporate Finance Division Securities and Futures Commission

Ms Alexandra YEONG
Director, Corporate Finance Division
Securities and Futures Commission

Agenda item VI

Mr Keith LUI
Executive Director, Supervision of Markets Division
Securities and Futures Commission

Mr Rico LEUNG
Senior Director, Supervision of Markets Division
Securities and Futures Commission

Clerk in attendance: Ms Connie SZETO
Chief Council Secretary (1)4

Staff in attendance : Miss Winnie LO (Agenda items V and VI)
Assistant Legal Adviser 7

Ms Angel SHEK
Senior Council Secretary (1)4

Ms Sharon CHAN
Legislative Assistant (1)4

I Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)1131/12-13 — Minutes of the meeting on 4 March 2013)

The minutes of the meeting held on 4 March 2013 were confirmed.

II Information papers issued since the last meeting

(LC Paper No. CB(1)1137/12-13(01) — Administration's letter dated 24 May 2013 on public consultation conducted by the Securities and Futures Commission on proposed

		amendments to the professional investor regime and the client agreement requirements
LC Paper No. CB(1)1154/12-13(01)	—	Letter dated 22 April 2013 from Hon TANG Ka-piu on the impact of the Foreign Account Tax Compliance Act of the United States on Mandatory Provident Fund schemes in Hong Kong (Chinese version only)
LC Paper No. CB(1)1154/12-13(02)	—	Administration's written response dated 24 May 2013 to issues raised in Hon TANG Ka-piu's letter on the impact of Foreign Account Tax Compliance Act of the United States on Mandatory Provident Fund schemes in Hong Kong
LC Paper No. CB(1)1168/12-13(01)	—	Letter dated 13 May 2013 from Hon Dennis KWOK on issues arising from the cancellation of sale contracts of hotel room units at The Apex Horizon (Chinese version only)
LC Paper No. CB(1)1168/12-13(02)	—	Letter dated 20 May 2013 from Hon Albert HO on issues arising from the cancellation of sale contracts of hotel room units at The Apex Horizon (Chinese version only)

LC Paper No. CB(1)1168/12-13(03)	—	Securities and Futures Commission's written response dated 24 May 2013 to issues raised in the letters of Hon Dennis KWOK and Hon Albert HO arising from the cancellation of sale contracts of hotel room units at The Apex Horizon
LC Paper No. CB(1)1175/12-13(01)	—	Letter dated 29 May 2013 from Hon Christopher CHEUNG proposing discussion on the Securities and Futures Commission's proposed amendments to the professional investor regime and the client agreement requirements (Chinese version only)
LC Paper No. CB(1)1175/12-13(02)	—	Letter dated 24 May 2013 from Hon KWOK Wai-keung proposing discussion on regulatory issues relating to travel insurance arising from the incident of hot air balloon crash in Egypt (Chinese version only)
LC Paper No. CB(1)962/12-13(01)	—	Administration's written response dated 29 April 2013 to issues raised by Hon KWOK Wai-keung on regulatory issues relating to travel insurance arising from the incident of hot air balloon crash in Egypt)

2. Members noted the information papers issued since the last regular meeting held on 3 May 2013.

III Date of next meeting and items for discussion

(LC Paper No. CB(1)1128/12-13(01) — List of outstanding items for discussion

LC Paper No. CB(1)1128/12-13(02) — List of follow-up actions)

Items proposed by the Administration for discussion at the regular meeting in July 2013

3. Members agreed to discuss the following items proposed by the Administration at the next regular meeting scheduled for 5 July 2013 –

(a) Proposed establishment of an independent Insurance Authority – consultation conclusions on key legislative proposals; and

(b) Construction of West Kowloon Government Offices.

(*Post-meeting note*: At the request of the Administration and with the concurrence of the Chairman, the item on "Construction of West Kowloon Government Offices" originally scheduled for discussion at the regular meeting in July 2013 was deferred to a future Panel meeting. Members were informed of the matter vide LC Paper No. CB(1)1401/12-13 issued on 27 June 2013.)

Regulation of collective investment schemes

4. Referring to his letter dated 20 May 2013 to the Chairman, Mr Albert HO suggested that the Panel should discuss as soon as possible issues arising from the cancellation of sale contracts of hotel room units at The Apex Horizon as the matter had attracted wide public concern. He noted that the Securities and Futures Commission ("SFC") seemed to have taken enforcement action on the case only after Mr Dennis KWOK had written to SFC to express concern about the investment scheme offered in joint hotel ownership should fall within the definition of collective investment scheme ("CIS") subject to SFC's regulation. Mr HO was concerned that hotel investment schemes of a similar nature might have been offered in the past without regulation. He suggested that the Panel should discuss the matter at the coming regular meeting or a special meeting, and SFC should be invited to clarify its regulation over CIS and explain the progress of its investigation on the case of The Apex Horizon.

5. Mr Dennis KWOK said that, according to the written response provided by SFC, issues relating to The Apex Horizon did not involve policy matters but related directly to an individual case that should not be discussed by the Panel. He suggested that the Panel should discuss with SFC policy issues on the regulation of CIS, and requested SFC to provide more information in this regard to facilitate the discussion. Mr Abraham SHEK agreed that the Panel might discuss policy issues concerned but not The Apex Horizon case.

6. Members agreed to discuss "Regulation of collective investment schemes" at the upcoming regular meeting to be held on 5 July 2013, in addition to the two items proposed by the Administration in paragraph 3 above.

Regulation of automated trading services

7. Referring to his letters dated 20 and 24 May 2013, Mr Albert HO said that the Panel should discuss issues arising from the voluntary surrender by the Hong Kong Mercantile Exchange ("HKMEx") of its authorization to provide automated trading services ("ATS") in view of the wide public concern. The Chairman advised that the item on "Regulation of automated trading services" had been incorporated in the agenda of the meeting under agenda item VI.

IV Briefing by the Financial Secretary on Hong Kong's latest overall economic situation

(LC Paper No. CB(1)1028/12-13(01) — First Quarter Economic Report 2013 and the press release

LC Paper No. CB(1)1128/12-13(03) — Administration's paper on "Hong Kong's Recent Economic Situation and Near-term Outlook")

Briefing by the Administration

8. At the invitation of the Chairman, the Financial Secretary ("FS") briefed members on the latest economic situation by highlighting the following salient points –

(a) The external environment had turned more unsteady in the first quarter of 2013 amid the inconclusive Italian election, the Cypriot bailout and the monetary easing in Japan. While the

United States ("US") had averted the fiscal cliff, its economic recovery was hampered by the automatic spending cuts and payroll tax hike. The eurozone economy, saddled by the debt overhang, was still mired in recession. The weak fundamentals of the advanced economies would continue to affect production and export activities in Asia, including those in Hong Kong.

(b) While the external sector still faced an unsteady global economic environment, the domestic sector remained relatively resilient. The Hong Kong economy continued to grow moderately in the first quarter of 2013, by 2.8% in real terms over a year earlier, same as the growth pace in the preceding quarter. On a seasonally adjusted quarter-to-quarter comparison, the economy expanded only by 0.2% in the first quarter, after a 1.4% growth in the preceding quarter.

(c) Hong Kong's total exports of goods posted a faster growth in the first quarter of 2013. However, excluding the surge in exports of non-monetary gold in the quarter, merchandise export performance was actually rather modest. While the Mainland and some other Asian markets saw solid growth, exports to advanced markets such as the US, the European Union ("EU") and Japan all remained subdued.

(d) Given impetus by the vibrant inbound tourism and increased financial market activity, exports of services picked up to show a faster growth in real terms in the first quarter of 2013. Domestically, private consumption grew briskly with consumer sentiment underpinned by broadly supportive job conditions as well as improved incomes over the past year. Overall investment spending fell back modestly in the first quarter from the high base in 2012, mainly dragged by contraction in machinery and equipment investment.

(e) The labour market held largely stable in the first quarter, with total employment rising steadily. Lured by the generally favourable employment and income conditions, the labour force grew at a pace faster than job creation. As such, the seasonally adjusted unemployment rate edged up from 3.3% in the fourth quarter of 2012 to 3.5% in February-April 2013.

(f) The overall earnings situation continued to register improvement. In the first quarter of 2013, median household income and average employment earnings in the lowest income decile group rose by 2% and 3.4% respectively in real terms over a year earlier (after discounting inflation). The recent uprating of the Statutory Minimum Wage rate would render further support to the lower-income people.

(g) The GDP growth forecast of 1.5-3.5% for 2013 as announced in the 2013-2014 Budget was maintained in the current round of review, having regard to the continued uncertainties in the external environment and the local economic growth in the first quarter that accorded with expectations.

(h) Inflation held stable in the first quarter, having eased successively over the course of 2012. Price pressures on the external front remained tame, along with the softening in global food and commodity prices and the easing inflation from import suppliers. Local cost pressures had eased somewhat as a result of the slow economic growth. However, the pick-up in fresh-letting rentals during the past year had yet to fully feed through to inflation. Headline consumer price inflation was 3.8% in the first four months of 2013, same as in the fourth quarter last year. Netting off the effects of the Government's relief measures, underlying consumer price inflation also held stable at 3.8% in the first four months of 2013.

(i) With the lagged effects of the surge in private housing rentals over the past year progressively feeding through, inflation was likely to rise slightly in the coming months. Yet imported inflation should remain tame which would help contain the upward pressure on inflation in the latter part of 2013. The forecast rates of headline and underlying consumer price inflation for 2013 at 4.5% and 4.2% respectively were maintained.

(j) The housing market had turned much quieter after the latest round of demand management measures introduced in February 2013 and increase in mortgage rates in mid March by some major local banks. The number of sale and purchase agreements for residential property received by the Land Registry plunged by 24% to 3 430 in April 2013 from an average of about 6 800 per month in 2012. Although flat prices edged down by 0.1% in March, and fell further by 0.7% in April, and flat rentals eased concurrently, the prices had already hiked by 127% since 2008. The repayment-income ratio, which reflected the home purchase affordability, had worsened to 56%, exceeding the long-term average of 48% in 1993-2012. Moreover, the situation of low interest rate and liquidity glut remained in place. The US Federal Reserve signalled in early May that the pace of asset purchases would be changed depending on economic performance. The demand-supply balance of flats was still tight in the near term. All these suggested that the housing market bubble risks should not be taken lightly.

(k) Raising flat supply through increasing land supply remained the Government's top policy priority in ensuring healthy and stable development of the property market. Reflecting the Government's continued efforts, the total supply of flats in the coming few years would increase to 67 000 units as estimated at end March 2013, the highest since September 2007. The Government will monitor closely the developments in the property market.

(l) The global environment was still overcast by a considerable number of uncertainties. Nonetheless, with sound economic fundamentals, the Hong Kong economy would be able to withstand adverse external shocks. The Government would, as always, remain vigilant and implement timely measures to respond to the global economic challenges where necessary.

(*Post-meeting note*: The press release containing the speaking note of FS (Chinese version only) was issued to members vide LC Paper No. CB(1)1221/12-13(01) on 4 June 2013.)

9. The Government Economist ("GE") gave a powerpoint presentation on the details of the latest development of the Hong Kong economy, the updated economic forecasts for 2013, and the latest situation of low-income households.

(*Post-meeting note*: The notes of the powerpoint presentation (LC Paper No. CB(1)1217/12-13(01)) were issued to members vide Lotus Notes e-mail on 3 June 2013.)

Discussion

Improvement to the business environment and support for the small and medium enterprises

10. Given Hong Kong's small and outward economy, Mr James TIEN opined that Hong Kong was more susceptible to volatilities in the external environment. In order to maintain a business-friendly environment and provide support to enterprises, in particular the small and medium enterprises ("SMEs"), he considered that the Government should adopt a more forward-looking approach in working out support measures in this area. Mr Jeffrey LAM expressed concern about the difficult operating environment faced by SMEs due to rising costs in labour and materials. He urged the Government to step up efforts to assist SMEs and avoid implementing new measures that would suffocate the business environment.

11. Mr Andrew LEUNG pointed out that the measure of doubling the ad valorem stamp duty ("AVD") for property transactions (including commercial property transactions) would increase the business cost of SMEs which were already facing numerous problems including the sluggish export demand in the advanced economies, inflationary pressure and labour shortage, etc. Furthermore, the business environment remained uncertain as US was expected to end the quantitative easing measures gradually while Japan had just launched its qualitative and quantitative monetary easing ("QQE"). Mr LEUNG enquired about the Government's measures to support SMEs in facing a new market order.

12. FS stressed that SMEs were a major driving force of economic development and employed about half of the local workforce in the private sector. The Government had always attached great importance to strengthening support for SMEs. He concurred that the current economic outlook was uncertain amidst concerns about US's exit from quantitative easing and depreciation of the yen under Japan's QQE. To help SMEs raise capital and tap new markets, the Government had proposed a number of support measures in the 2013-2014 Budget including, extending the application period for the special concessionary measures under the SME Financing Guarantee Scheme, and introducing a "Small Business Policy" scheme by the Hong Kong Export Credit Insurance Corporation for Hong Kong enterprises with an annual business turnover of less than $50 million to provide exporters with more flexibility in taking out insurance cover.

Labour market

13. Mr WONG Kwok-hing expressed concerns about calls from the business sector for importing labour in some sectors such as the construction sector with relatively higher unemployment at 5.8%, and sought FS's views on the matter. FS said that the Government would continue to consider applications for importation of workers from employers who faced genuine difficulties in recruiting local qualified workers under the established mechanism.

14. Ms CHAN Yuen-han considered that the problem of working poverty was becoming more serious. The Chairman suggested that the Government should implement measures that could release the potential manpower resources, such as by promoting family-friendly policies for employment.

15. Mr TANG Ka-piu noted from Table 5.4 of the First Quarter Economic Report 2013 that the unemployment rates for various skill segments of the labour market had increased. In particular, the unemployment rate of "craft and related workers" in the lower-skilled segment stood at a high level of 5.5% in the first quarter of 2013. He queried why there was a higher unemployment rate in this segment despite the construction, vessel and lift repair and maintenance sectors were facing shortage of labour.

16. FS said that the Administration recognized the long standing labour shortage situation in the construction and related sectors because jobs in these sectors failed to attract young people vis-à-vis white collar jobs. To support the manpower development needs of specific industries, the Government had been collaborating with institutions like the Vocational Training Council to provide quality and diversified vocational and skills training programmes for the construction sector with a view to enhancing job prospects and promoting the attractiveness of jobs to the younger generation. As regards the 5.5% unemployment rate for craft and related workers, it was likely that the relatively higher rate was partly attributable to job mismatch.

Property market and land supply

17. Dr LAM Tai-fai queried the effectiveness of the demand management measures (i.e. doubling the AVD, enhancing the Special Stamp Duty ("SSD") and introducing the new Buyer's Stamp Duty, etc.) in addressing the overheated property market and achieving the target of helping Hong Kong Permanent Residents ("HKPRs") to purchase flats at affordable prices. Instead, these measures had caused stagnancy in the property market, violated the principles of a free trade economy and deterred foreign investment in Hong Kong. In his view, the demand management measures were means employed by the

Administration to cover up its inability in increasing land and flat supply in the short term to meet the surge in housing demand.

18. Mr James TIEN and Mr Abraham SHEK concurred with the concern about adverse impact of the demand management measures on the investment sentiment, in particular investment from foreign companies to acquire properties in Hong Kong as accommodation for their staff deployed to work in Hong Kong. Mr Jeffrey LAM pointed out that some chambers of commerce had already raised concerns about the adverse impact of the increased AVD rates and enhanced SSD on the investment environment. He said that the Government should strike a proper balance between the interests of various stakeholders by flexibly adjusting or withdrawing the demand management measures when necessary and appropriate.

19. Mr Abraham SHEK remarked that the Government had not conducted comprehensive assessment on the impacts of the demand management measures on the property market. He pointed out that while the number of property transactions had dropped since the introduction of SSD in 2010, the impact was largely on the secondary property market rather than the first-hand flats. Moreover, the measures had not achieved the designed purpose of bringing down property prices at all. As observed, flat prices had surged by about 35% from 2010. Even the sale prices of newly completed home ownership scheme flats in the New Territories had risen to historic high level exceeding $9,000 per square feet. Mr SHEK took the view that the Government had benefited the most from the demand management measures and when the property market rallied which had led to increase in income from land premium and sale proceeds from subsidized housing flats.

20. FS said that the crux of the housing problem at present lied with shortage of land supply in the short and medium term. The Government would continue with its efforts to increase land and flat supply to tackle the problem through a multi-pronged approach. The initiatives included releasing suitable industrial land, "Government, Institution or Community" ("GIC") sites, and deserted or formed sites in green belt areas for housing development. Where possible and having regard to town planning requirements and standards, the development density of unleased or unallocated residential sites would be increased for expediting housing development. As a result of the Government's sustained efforts, the total supply of flats in the coming few years was forecast to increase to 67 000 units estimated as at end of March 2013. As it would take time to increase flat supply, implementation of the demand management measures would be necessary in the short term to address the exceptional circumstances of an exuberant property market and accord housing priority to HKPRs. FS added that the demand management measures were effective in curbing speculative activities in the property market as illustrated by the

reduction in number of short-term resale. He assured members that the measures would not be implemented on a permanent basis. The Administration would closely monitor market situations in reviewing the measures.

21. Dr LAM Tai-fai pointed out that the demand management measures had affected not only the livelihood of estate agents but also the viability of property-related sectors, viz. decoration, repair and maintenance for buildings, cleaning services, and retailing of furniture and fixtures. Mr Abraham SHEK shared Dr LAM's observation. At the request of Dr LAM, FS undertook to provide information on assessment of the recent employment and business performance of the above sectors.

(*Post-meeting note*: The Administration's response was circulated to members vide LC Paper No. CB(1)1457/12-13(01) on 5 July 2013.)

22. Referring to paragraphs 3.9 to 3.11 of the First Quarter Economic Report 2013, Mr Ronny TONG noted that the sale prices of retail shop space, office space and flatted factory space had surged by 2%, 5% and 10% respectively between December 2012 and March 2013 while the rentals in these segments increased by 1%, 3% and 2% respectively in the same period. The number of transactions for retail shop space, office space and flatted factory space also grew. He enquired whether the Government had studied the impact of the high sale and rental prices of commercial properties on the competitiveness of Hong Kong, and considered measures to help bring down the prices.

23. Mr James TIEN and Mr Kenneth LEUNG relayed the concerns from SMEs about the shortage and high rentals of Grade B office space. Referring to the termination of the tenancy of the hundred-odd operators in the King Wah Centre in Shandong Street by the landlord for leasing to a single store, Ms CHAN Yuen-han expressed concern about the hegemony of large property developers and increasing difficulty for operators of small businesses to find affordable shop space and for start-up designers to promote their creative products.

24. FS said that the marked increases in commercial property prices and rentals were largely supported by the vibrant retail business and other favourable economic developments. Specifically, shop rentals had cumulatively risen by 37% along with the surge in retail sales by 76% since the third quarter of 2008. Notwithstanding the rise in shop rentals, the number of SMEs had not reduced but increased by a few thousands over the period. Businesses other than large-scale chain stores were able to rent shop spaces in the market. FS added that, as part of the initiative to increase commercial land supply, nine commercial/business sites providing for a total floor area of

330 000 square metres were included under the 2013-2014 Land Sale Programme. The Government would also address the shortage by converting existing government buildings and GIC sites in Central and Wanchai to commercial use, and accelerating the development of new commercial districts.

25. Referring to pages 40 and 41 of the powerpoint, Mr Kenneth LEUNG pointed out that the trends of residential, office and shop rentals were presented with reference only to the year-on-year rate of change which had failed to reflect the rental movements by absolute value. Mr Ronny TONG also considered that the relevant charts did not realistically reflect the persistently high office and shop rental situation. FS said that he would consider how the presentation could be improved in light of members' suggestions.

26. The Chairman enquired about the progress of the initiative to develop underground space, and whether any consultancy studies had been conducted on the subject. She considered that there would be less public objection to the development of underground space as compared to other alternatives for increasing land supply, such as reclamation and utilizing sites in green belt areas. FS advised that the Government was conducting a study on the long-term strategy on the development of rock caverns and underground spaces in the urban areas, which involved consideration of issues such as the relevant statutory and technical requirements/constraints. Funding approval would be sought from the Legislative Council ("LegCo") in due course for conducting the related studies.

27. Referring to page 26 of the powerpoint, Mr Albert HO queried why the mortgage payment to income ratio had worsened further in spite of stabilization in the property market and improvement in the overall earnings of the workforce. He enquired if the worsened ratio was due to an increase in the monthly mortgage payment as flat buyers or investors had taken aggressive strategy to purchase flats with decline in the property prices in recent months. Mr Abraham SHEK said that the rising mortgage payment could be attributed to the tightening of property mortgage loans and lowering of the maximum loan-to-value ("LTV") ratio under the countercyclical prudential measures implemented by the Hong Kong Monetary Authority ("HKMA").

28. GE said that, while the demand management measures introduced in late February 2013 had served to calm the property market, overall flat prices rallied by 5% in the first quarter of 2013 due to the increases in January and February. It was expected that the stabilizing effects of the demand management measures would be reflected in the upcoming data.

29. Mr Abraham SHEK commented that the mortgage payment to income ratio could not genuinely reflect the burden of mortgage loans on the middle

class as the ratio had only made reference to flats of rather small saleable area of 45 square metres. GE explained that the mortgage payment to income ratio was an economic indicator for assessing home purchase affordability and monitoring asset bubble risk by referencing the ratio of mortgage payment for a flat with saleable area of 45 square metres (assuming 70% LTV ratio and tenor of 20 years) to median income of households (excluding those living in public housing). It was different from the debt servicing ratio ("DSR"), i.e. the monthly repayment obligations of the borrower as a percentage of monthly income, adopted by banking institutions for assessing the repayment capability of mortgage applicants. After introduction of the series of countercyclical prudential measures for property mortgage lending by HKMA, the maximum DSR had already been lowered to 40% for mortgage loans assessed based on the debt servicing ability of a mortgage applicant.

Economic growth and competitiveness of Hong Kong

30. Mr WONG Kwok-hing noted with concern that, according to the world competitiveness rankings released by the International Institute for Management Development in Switzerland, Hong Kong's ranking had fallen from the first in 2011 and 2012 to only third in 2013. He was worried that Hong Kong was losing its competitiveness and enquired about measures to revive the city's competitiveness.

31. FS pointed out that the main reason for the fall in Hong Kong's ranking was the cyclical slowdown of the economy, from a growth rate of 4.9% in 2011 to only 1.5% in 2012. In fact, some other Asian economies, such as Taiwan, Singapore and India, also experienced similar slackening of economic growth in the year and, likewise, dropped in their respective world competitiveness rankings. Nevertheless, Hong Kong's economic growth picked up to 2.8% in the first quarter of 2013, and the labour market in Hong Kong remained in a state of full employment. The seasonally adjusted unemployment rate, though edging up, still remained relatively low at 3.5% in the quarter. Both wages and earnings continued to rise in early 2013, with particularly notable increases among lower income workers.

32. Dr LAM Tai-fai enquired about the comparison of the volume and its year-on-year rate of change of merchandise exports from Hong Kong, Korea, Singapore and Taiwan to markets in US, EU and Japan for the first quarter of 2013. FS said that the merchandise exports from Korea, Singapore and Taiwan were comparable to those of Hong Kong in the first quarter of 2013. GE supplemented that, in terms of total merchandise exports, the year-on-year rates of change were 4%, -6.8%, 0.4% and 2.4% respectively for Hong Kong, Singapore, Korea and Taiwan. As regards the figures for merchandise exports

to US, EU and Japan, she undertook to provide the information after the meeting.

(*Post-meeting note*: The Administration's response was circulated to members vide LC Paper No. CB(1)1457/12-13(01) on 5 July 2013.)

33. Referring to pages 39 to 42 of the powerpoint, Mr Kenneth LEUNG observed that the slackening growth of the Hong Kong economy was largely due to rising pressure in wage, office and shop rentals as well as overall inflationary pressure. Under the current forecast, the headline consumer price inflation would climb up to 4.5% for 2013. He considered that the Government should step up efforts to ease inflation. Mr WONG Ting-kwong remarked that since the return of sovereignty in 1997, the economy of Hong Kong had continued to rely heavily on the development of the four economic pillars and the fruit of the past efforts. It appeared to him that little progress had been made to enhance the development of these industries, and there was a risk that the competitiveness of Hong Kong was declining vis-à-vis other competitors in the regional or global economy. He considered that the Government should take more vigorous efforts to diversify the economy.

34. Ms CHAN Yuen-han stressed the importance to diversify the economy in order to enhance its resilience to financial adversities. She criticized that the local economy had remained reliant on a few sectors including financial services, real estate and tourism; and suggested that the Government should seize the opportunity of the development of the Mainland market to enhance Hong Kong's competitiveness and support the development of new industries to achieve diversification in the economic base. Ms CHAN cautioned that the economy and social instability would deteriorate if the Government did not actively deal with the problems.

35. FS said that the Hong Kong economy had already moved away from manufacturing towards service-oriented activities in the late 1970s and the early 1980s. The services sector now accounted for more than 90% of Hong Kong's GDP. Besides, Hong Kong's services sector was rather diversified, and there were segments complementing the manufacturing activity. At present, trading and logistics industries took up about 25% of Hong Kong's GDP while financial services accounted for 15-16%, and the shares taken up by professional/business services and tourism were some 10% and 5% respectively. The Government would make every endeavour to diversify and deepen the development of different segments of the economy, and to identify new markets. For example, under the efforts of the Government to promote Hong Kong's advantages to the BRICS countries (i.e. Brazil, Russia, India, China and South Africa), the trade with these markets had been expanding significantly. As pointed out in the 2013-2014 Budget, the Government also

reckoned the need to foster Hong Kong's economic integration with the Mainland to take advantage of the latter's market development while continuing to engage Hong Kong globally.

36. Mr Jeffrey LAM expressed concern whether Hong Kong had entered into stagflation where economic growth had slowed down but inflation remained high. He pointed out that, while the year-on-year rate of change in nominal GDP was 4.1%, the real growth rate in the first quarter of 2013 was only some 2.8% and the change in the GDP deflator was 1.2%.

37. GE said that Hong Kong was not experiencing stagflation. The GDP deflator was a broad measure of the overall change in prices in the economy. As external trade was a substantial component of GDP, it was understandable that the GDP deflator was susceptible to changes in the prices of trade. In the first quarter of 2013, the increase in prices of exports was slower than that of imports, hence leading to a slower increase in the GDP deflator. Nevertheless, it would still take time to observe whether the situation represented any long-term trend. GE further pointed out that the real growth rate of 2.8% in Hong Kong's GDP in the first quarter of 2013 was in fact higher than those of Singapore, Korea and Taiwan in the same period.

Investment spending

38. Mr NG Leung-sing noted that overall investment spending had fallen by 2.2% in real terms in the first quarter of 2013 from a year earlier, after sustaining notable growth throughout 2012 and the decline in the first quarter was mainly dragged by machinery and equipment investment which contracted by 4%, and also due to a distinctly high base of comparison in 2012. He enquired about the reasons for the "high base" of comparison in 2012, as well as the major areas of decline in investment spending in the first quarter of 2013.

39. GE said that the setback by 2.2% in overall investment spending was not unusual because fluctuations of similar magnitude were seen in other quarters. In particular, machinery and equipment investment could fluctuate substantially between quarters given that such capital investment was incurred only on a need basis. For instance, the increase in machinery and equipment investment spending was exceptionally high in the first quarter of 2012, i.e. 21.1%, which was mainly spurred by a robust growth in private sector investment spending in that quarter.

40. Mr NG Leung-sing enquired why the expenditure on building and construction had virtually remained unchanged in real terms even though the

overall investment spending had cut back. As both overall investment spending and private sector building activity had fallen back in the first quarter, Mr NG expressed concern whether these would affect the targeted number of flats on supply in the coming few years.

41. GE pointed out that there was a relatively high base of comparison in 2012 for expenditure on building and construction, in particular in the first quarter of 2012 which saw a double-digit growth of 14.6%, partly due to acceleration in public sector building activity. GE further said that the completion of residential units could vary significantly from quarter to quarter. This could be demonstrated by the fact that, among the some 10 000 units of completed flats in 2012, only some 600 units came under the first quarter of the year.

V Sponsor regulation and other investor protection initiatives

(LC Paper No. CB(1)1128/12-13(04) — Administration's paper on "Sponsor Regulation and Other Investor Protection Initiatives"

LC Paper No. CB(1)1128/12-13(05) — Background brief on sponsor regulation and other investor protection initiatives prepared by the Legislative Council Secretariat)

Briefing by the Administration

42. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Financial Services) 1 ("DS(FS)1") said that the Government conducted review on the regulatory regime and market situation regularly with a view to enhancing the health and quality of the securities market as well as strengthening investor protection. In line with these objectives, SFC had proposed a number of initiatives to enhance sponsors' role as gatekeeper in ensuring market quality in the initial public offering ("IPO") process; extend the provisions of the Securities and Futures Ordinance (Cap. 571) ("SFO") on market misconduct, disclosure of price sensitive information, etc. to listed non-corporate entities; and enable SFC to exercise supervisory cooperation with overseas regulators.

43. The Chief Executive Officer, SFC ("CEO/SFC") briefed members on the major regulatory initiatives and legislative amendments under the proposals

set out in the Administration's paper. He said that SFC would consolidate key standards and requirements for sponsors' conduct, which would become the subject of a new paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with SFC ("Code of Conduct"). The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") would also be revised to implement the said requirements.

Declaration of interests

44. Mrs Regina IP declared that one of her relatives was a sponsor and a member of the Listing Committee of the Hong Kong Exchange and Clearing Limited ("HKEx"). She said that some sponsors and lawyers had approached her to discuss SFC's proposals on enhancing sponsor regulation. Mr CHAN Kam-lam declared that he was a non-executive director of SFC.

Discussion

Publication of the first draft of prospectus

45. Mr Dennis KWOK noted that one of the proposed initiatives was to amend the Listing Rules to require the publication on HKEx's website of the first draft of a prospectus submitted by an applicant when making the listing application. As the draft prospectus would contain sensitive information on the structure and operation of the relevant company, including information on its clients and suppliers, he expressed concern whether the publication before approval of the listing application was fair to the company, in particular if the application was ultimately not approved. Mr KWOK also enquired whether the proposed requirement had made reference to similar overseas practices, and the measures to protect the interests of the listing applicants.

46. CEO/SFC responded that, when a company applied for listing, it should be prepared that its company information would, as listed company, be subject to a higher expectation of transparency than private companies. While HKEx could reject a sub-standard listing document under the existing mechanism, publication of the first draft of a prospectus would further encourage the submission of a quality prospectus that was substantially complete and carefully drafted. Applicants should do sufficient work to be reasonably confident that, from a regulatory perspective, their applications would be approved. CEO/SFC said that references had been made to the practices in US, Australia and Singapore with regard to the regulatory commenting process for listing documents and publication of the first draft of prospectus.

47. Mr Christopher CHEUNG suggested that the disclosure regime should be improved such that the relevant investment risks and critical information

disclosed in listing prospectuses would be presented in a manner easily understood and identified by investors. CEO/SFC took note of the suggestion.

Criminal liability of sponsors

48. Mr Dennis KWOK queried the need to amend the Companies Ordinance (Cap. 32) ("CO") as proposed in order to subject sponsors to civil and criminal liability, as various provisions in SFO (e.g. sections 107, 108, 277, 281 and 384) had apparently provided for sponsors' liabilities involving market misconduct, disclosure of false/misleading information, etc. Besides, SFO also conferred SFC with disciplinary powers on sponsors' non-compliance or misconduct.

49. Mr Abraham SHEK took the view that the existing provisions in CO were applicable to sponsors and the proposed legislative amendments seemed to extend rather than clarify sponsors' statutory liability as explained by SFC. He cautioned about over-regulation and indiscriminate criminalization of malpractices which could have adverse impact on the business environment and the competitiveness of Hong Kong as an international financial centre.

50. Mrs Regina IP supported the Administration's direction to maintain the quality and integrity of the IPO market and prevent dishonest parties from inducing others to invest in their companies. Mr Christopher CHEUNG observed that the performance of some companies after listing had seriously fallen short of the description in the listing prospectuses and had undermined investors' confidence in the reliability of the prospectuses and the quality of the local securities market. As such, he supported the legislative proposals to enhance sponsor regulation with a view to ensuring the integrity of the listing documents.

51. Mr CHAN Kam-lam considered that the proposals to enhance sponsor regulation would strengthen investor protection. He observed that the Administration and SFC had been working on a number of initiatives to improve investor protection in the past few years since occurrence of the Lehman Brothers incident. The Chairman also agreed that the proposals would be conducive to ensuring the quality of the securities market and affording greater protection to investors.

52. DS(FS)1 said that the health of a securities market would hinge on investors' confidence in the reliability of information provided by listing applicants, and market quality and integrity were crucial to maintaining the competitiveness of Hong Kong's securities market. At present, the position as to whether sponsors were subject to statutory civil and criminal liability under CO for untrue statements in prospectuses was unclear. There was also no Hong

Kong case law on whether sponsors were subject to the relevant provisions. SFC therefore considered it necessary to remove the ambiguity by clearly identifying sponsors as being liable for untrue statements in prospectuses. CEO/SFC said that the proposals to clarify the civil and criminal prospectus liability provisions towards sponsors would help ensure the accuracy and quality of prospectus under the legislative framework and the Code of Conduct.

53. Mr Christopher CHEUNG relayed concerns from some sponsors about the heavy penalty for giving untrue statements in prospectuses, i.e. a maximum fine of $700,000 and imprisonment of three years for criminal offences. He stressed the importance to provide clear provisions on the criminal liability of sponsors so as to help sponsors avoid inadvertent breach of the law.

54. DS(FS)1 said that the Department of Justice and SFC had always exercised caution when considering criminal offences, the liability of the relevant parties and the requirements on evidence of proof. The current proposal of requiring the prosecution to prove that a sponsor had committed an offence, and that a sponsor would commit an offence only when the sponsor had "knowingly or recklessly" made an untrue statement, would put in place a high threshold for conviction and would not be over onerous on sponsors.

55. Mrs Regina IP said that during the scrutiny of the Companies Bill ("CB"), some LegCo Members had expressed grave concern about the threshold of "recklessly" for an offence relating to the contents of an auditor's report (i.e. clause 399 of CB) as the scope might include omission or error due to negligence. She cautioned that LegCo Members might not support a similar criterion for imposing criminal sanction against sponsors for an untrue statement in the prospectus under the current proposal.

56. Referring to paragraph 28 of the Administration's paper, Mrs Regina IP noted that SFC had examined sponsor's criminal liability for Singapore, Australia, United Kingdom ("UK") and US, and considered that the concept of holding sponsors liable was largely in line with the regulatory philosophy in many major markets (i.e. a person who was involved in formulating disclosures in a prospectus was to be held liable for errors and omissions). She enquired whether the concept of "sponsors" was unique to Hong Kong. The Chairman also enquired about the sponsor's criminal liability, if any, in overseas jurisdictions.

57. CEO/SFC said that the IPO markets in various jurisdictions varied with their unique features. While the concept of sponsors was unique to Hong Kong, it was analogous to the responsibility and liability of underwriters in US and some other jurisdictions. In Hong Kong, sponsors were charged with a specific role in relation to diligence and disclosure. The Executive Director,

Corporate Finance Division, SFC ("ED(CFD)/SFC") said that Singapore and UK both had the concept of sponsors. Hong Kong's existing regulatory regime for sponsors was similar to that of UK in the sense that sponsors were persons who had authorized the issue of the prospectus. Whereas the current proposal to impose criminal liability on sponsors was similar to the Singapore model. As for US and Australia, underwriters were liable to criminal liability for the contents of a prospectus and underwriters captured a wider scope of persons. In reply to Mrs Regina IP, ED(CFD)/SFC advised that there were currently over 60 intermediaries licensed to undertake Type 6 regulated activity (i.e. advising on corporate finance), including sponsor work.

58. At the request of Mr Abraham SHEK, CEO/SFC undertook to provide information on the situation of case law in major common law jurisdictions in relation to the civil and criminal liability of sponsors for the contents of prospectus issued by a listing applicant.

(*Post-meeting note*: The Administration's response was circulated to members vide LC Paper No. CB(1)1429/12-13(02) on 3 July 2013.)

Performing due diligence on companies

59. Mrs Regina IP observed that there appeared to be insufficient guidelines for sponsors with regard to the conduct of due diligence on companies, and that some sponsors were working on their own industry guidelines. She enquired whether SFC would set clear standards and requirements for sponsors in this regard or help them formulate the guidelines, so as to ensure sponsors would comply with the law and prevent inadvertent breaches. ED(CFD)/SFC said that the new paragraph 17 of the Code of Conduct would consolidate the key standards and requirements for sponsors' conduct, including due diligence, to ensure that sponsors would discharge their roles satisfactorily. DS(FS)1 agreed with the need to continue communication with the relevant stakeholders to ensure a smooth implementation of the initiatives. The Administration would encourage SFC to work along this direction.

60. Mr Albert HO enquired about the conduct of due diligence on companies incorporated outside Hong Kong. He was worried that sponsors in such case might indiscriminately rely on the company's auditors and professionals outside Hong Kong to guard against the integrity of the listing document. The Chairman said that in performing an audit, it was a requirement on auditors to verify financial statements and other information provided by the company's accountants, including those outside Hong Kong.

61. ED(CFD)/SFC said that there were no territorial constraints on the role and obligations of sponsors. If a company operated outside Hong Kong applied for listing in Hong Kong, the sponsor firm was required to perform due diligence on the company at its places of incorporation and business. Besides, sponsors should act proactively and independently when assessing expert reports. They should not place uncritical reliance on experts' work but should critically review the expert's opinion with the information disclosed in the report against the totality of all other information known to the sponsor about the listing applicant. ED(CFD)/SFC added that the roles of sponsors and experts would be clearly defined in the Code of Conduct.

Regulatory powers of SFC

62. Mrs Regina IP expressed concern that the proposals would further enhance the powers of SFC as it had already been vested with substantial powers including licensing, setting the Code of Conduct, taking investigatory and disciplinary actions, and instituting prosecutions, etc. She also urged SFC to strengthen its communication with the industry in exercising its role and functions.

63. Mr Albert HO said that, while he considered it reasonable to clarify sponsors' civil and criminal liability, he had reservation about providing SFC with additional powers to enhance regulation on sponsors. In his observation, SFC's investigatory work lacked transparency as it needed to observe the secrecy obligations under SFO. While there were provisions in SFO enabling the disclosure of information under specified circumstances (such as in response to a requirement made under a law), such powers were seldom invoked. Very often, it was unclear as to whether a suspected case was being pursued or under investigation by SFC, even if the case attracted wide public concern and this was unfair to investors and minority shareholders concerned. Mr HO urged SFC to make reference to the practices of Independent Commission Against Corruption ("ICAC") to achieve greater transparency in handling investigations and disclosure of information to the public and the relevant complainants. For instance, all ICAC investigations were overseen by its Operations Review Committee ("ORC") which consisted of independent members and professionals. The ORC received reports from the ICAC on all corruption complaints lodged with ICAC, handling of the complaints and progress of investigation on cases. Mr HO said that he might not support the legislative proposals if SFC did not improve the transparency of its investigation and related regulatory structure. Mr James TIEN shared Mr HO's view about the need to enhance the transparency of SFC's work. He said that Members belonging to the Liberal Party hoped that the Administration/SFC would take heed of the suggestions in making improvements.

64. Sharing Mr Albert HO's views, Mr Abraham SHEK remarked that SFC carried out investigations in an overly secretive manner. He considered that SFC should be subject to more effective monitoring and public scrutiny in the discharge of its duties and exercise of its powers. Mr Christopher CHEUNG opined that SFC should improve the transparency of its investigations by more proactively taking into account the views of the financial services industry.

65. Mr CHAN Kam-lam said that financial regulation was essential to ensuring investor protection and market quality, and maintaining the status of Hong Kong as an international financial centre. He considered that the financial regulators, including SFC, should be provided with sufficient powers to exercise their market supervisory roles in an effective manner, otherwise it would lead to regulatory failure. As regards the criticism about the secrecy provisions under SFO, Mr CHAN remarked that there would be serious implications if SFC was required to disclose the details of all suspected cases under its investigation, having regard to the great number of cases involved. Besides, disclosure before any misconduct or non-compliance was identified would be unfair to the parties under investigation.

66. DS(FS)1 advised that the legislative proposals had given due regard to the need to put in place appropriate checks and balances on SFC's powers. This was reflected by, for instance, the proposal to amend the criminal liability provisions in CO for untrue statements in prospectuses so that the burden of proof would be borne by the prosecution, which would in effect raise the onus on the part of SFC and other enforcement authorities concerned. She also pointed out that there was separation of powers of prosecution. While investigations on cases were undertaken by SFC, the power to prosecute was vested with the Secretary for Justice. CEO/SFC reiterated the importance of prospectus accuracy and sufficient disclosure for listing of companies, and hence the need to amend CO to make it clear that sponsors were subject to the civil and criminal liability provisions contained therein for making untrue statements in prospectuses.

67. The Chairman said that issues relating to the regulatory powers of SFC were not directly related to the subject under discussion and members might pursue related matters on other occasions.

Cost for listing application

68. Mr Abraham SHEK expressed concern that the enhanced regulation of sponsors and other related proposals would add to the operating cost of sponsors, and hence sponsors might charge higher fees when performing due diligence work, in particular for SMEs, as sponsors perceived that they had to shoulder greater liabilities for the listing of small companies. Mrs Regina IP

shared Mr SHEK's concern. Mr Christopher CHEUNG however was worried that it would become increasingly difficult for SMEs to appoint sponsors as sponsors might prefer to take up listing applications from larger companies for higher profits that would commensurate with the liabilities on sponsors. This might affect the listing of SMEs in Hong Kong.

69. CEO/SFC pointed out that the standards and requirements to ensure IPO market quality under the proposals applied to all companies intending to list, regardless of their sizes and scales. He envisaged that the streamlining of regulatory commenting process for draft prospectus under the current proposal would help save cost for listing of companies.

Conclusion

70. Concluding the discussion, the Chairman said that members did not object to the Administration introducing the legislative amendments into the LegCo in 2013-2014. She requested the Administration and SFC to take into account the views and suggestions made by members at the meeting, including the provision of due diligence guidelines for the sponsor industry, enhancing the transparency of SFC's investigatory work and communication with the industry. She said that related issues would be followed up by the relevant bills committee to study the legislative proposals in future.

VI Regulation of automated trading services

(LC Paper No. CB(1)1128/12-13(06) — Paper provided by the Securities and Futures Commission on regulation of automated trading services

LC Paper No. CB(1)1128/12-13(07) — Joint letter dated 20 May 2013 from Hon Dennis KWOK and Hon KWOK Ka-ki on issues arising from the voluntary surrender by the Hong Kong Mercantile Exchange of its authorization to provide automated trading services (Chinese version only)

LC Paper No. CB(1)1128/12-13(08) — Letter dated 20 May 2013 from Hon Albert HO on issues arising from the voluntary surrender by the Hong Kong Mercantile Exchange of its authorization to provide automated trading services (Chinese version only)

LC Paper No. CB(1)1157/12-13(01) — Letter dated 24 May 2013 from Hon Albert HO on issues arising from the voluntary surrender by the Hong Kong Mercantile Exchange of its authorization to provide automated trading services (Chinese version only))

Briefing by SFC

71. At the invitation of the Chairman, CEO/SFC clarified the major issues about regulation of ATS arising from the incident of surrender of authorization of ATS by the Hong Kong Mercantile Exchange Limited ("HKMEx") (hereafter referred to as "the HKMEx Incident"), the impact of the closure of HKMEx's futures trading platform, and process of withdrawal of HKMEx's ATS authorization.

(*Post-meeting note*: The speaking note of CEO/SFC (English version only) was circulated to members vide LC Paper No. CB(1)1221/12-13(02) on 4 June 2013.)

Declaration of interests

72. Mr CHAN Kam-lam declared that he was a non-executive director of SFC. Mr Abraham SHEK declared that he had been a friend of Mr Barry CHEUNG, the Chairman of HKMEx, for some 18 years.

Discussion

SFC's withdrawal of HKMEx's ATS authorization

73. Mr James TIEN enquired when SFC first became aware of the financial problems of HKMEx. Mr Dennis KWOK observed that, according to the records on the Companies Register, HKMEx had notified the Companies

Registry ("CR") in January 2013 of its intention to issue a share placement to raise a target capital of US$0.1 billion but HKMEx eventually did not submit the relevant form (i.e. Form SC1 "Return of allotments") to CR nor was the exercise accomplished. This was indicative that HKMEx was facing financial problems as early as January 2013. However, it was not until 18 May 2013 that SFC took action to withdraw HKMEx's ATS authorization. Mr KWOK enquired about the reasons for SFC's "belated" actions.

74. Mr Albert HO said that, while he understood that SFC could not disclose the details of the HKMEx Incident in order to preserve the independence and fairness of the ongoing investigation on the case, he considered that SFC should clarify issues relating to the incident which had aroused grave public concern, in particular, whether SFC had failed to exercise effective regulation. He noted that, according to media reports, Mr CHAN Kam-lam, a non-executive director of SFC, indicated that SFC was aware of the financial difficulties of HKMEx as early as a year before. It appeared that SFC had taken an unduly long time to observe the financial position of HKMEx and allowed a prolonged period of time for HKMEx to remedy its financial insufficiency.

75. CEO/SFC said that the financial sufficiency of a trading platform was essential to ensure investor protection. If SFC identified any financial stress of an ATS provider through its regular reporting to SFC, SFC would look at the matter closely and increase the intensity of supervision towards the provider, in particular to make sure that there would be a sufficient financial buffer for winding down and closing the positions should the operations of the trading platform cease, with a view to minimizing the impact on the market and investors concerned. CEO/SFC stressed that SFC had taken regulatory actions against HKMEx as reflected by the withdrawal of its ATS authorization, which was an irrevocable decision giving HKMEx no option but to cease its platform operations. However, as investigations by SFC and the Police were still in progress and in order not to prejudice any parties involved, he could not respond to specific issues on the HKMEx Incident. Mr James TIEN remarked that his question about when SFC was first aware of SFC's financial problems would not affect the ongoing investigations. He considered that the public was suspicious that SFC was trying to hide "something".

76. Mr Dennis KWOK noted that according to SFC, it would keep the Government informed of matters that might affect policy objectives and financial stability, or which might have public interest or policy implications. He enquired whether SFC had reported issues relating to HKMEx to relevant government officials during such regular reports or meetings after SFC had identified HKMEx's financial problems, and if so, the extent of the disclosure. CEO/SFC said that SFC had always maintained regular dialogue with the

Government to keep it informed of market issues relating to broader policy matters. Nevertheless, he could not disclose specific discussions at the meetings held between SFC and the Government in relation to the HKMEx Incident having regard to confidentiality obligations and in light of the continuing investigations. He emphasized that the role of SFC as a financial regulator was independent, and at no point of time it had received any direction or pressure from the Government as to how it should carry out its work and how issues concerning the HKMEx Incident should be handled.

77. Mr Albert HO expressed concern whether SFC had exercised extra caution in taking action against HKMEx because of the influential status of HKMEx's Chairman, as reflected by the rare arrangement of a voluntary surrender of ATS authorization by HKMEx on 18 May 2013 in lieu of withdrawal of the authorization by SFC. Mr Andrew LEUNG said that SFC should clarify whether HKMEx's ATS authorization was withdrawn by SFC or was surrendered voluntarily by HKMEx, as he was of the view that there was a significant difference in terms of severity between the two arrangements. If the ATS authorization was indeed withdrawn by SFC, Mr LEUNG asked why SFC had not made clarification in the first place when HKMEx announced its "voluntary surrender" of the authorization as the public had queried whether this had denoted SFC's favouritism to certain person.

78. CEO/SFC pointed out that SFC did decide on 16 May 2013 to withdraw irrevocably HKMEx's ATS authorization because HKMEx had failed to comply with the requirements to maintain sufficient financial resources. The SFC gave no option to HKMEx, and HKMEx did not contest SFC's decision. The withdrawal notice was served on HKMEx on 17 May 2013 (which was a public holiday). The public announcement of the withdrawal notice was made on 18 May 2013, and SFC had further explained the matter through a statement issued on 21 May 2013. CEO/SFC stressed that the withdrawal was handled in a manner which ensured an orderly winding down and closure of open positions with full cooperation by HKMEx to protect investors' interests; it was standard practice to seek an agreed outcome in preference to a potential dispute. This did not detract from the fact that the SFC made clear to HKMEx at the outset that the withdrawal decision was irrevocable. Besides, the withdrawal would not affect any subsequent enforcement action, and SFC had continued with its investigations into HKMEx.

79. Referring to the remarks of Mr CHAN Kam-lam about the financial difficulties of HKMEx and SFC's investigations in response to the media's enquiries, Mr James TO queried whether Mr CHAN, as a non-executive director of SFC, was also subject to the secrecy obligations under SFO, and if so, why Mr CHAN could make those disclosures. CEO/SFC reiterated the need to observe secrecy obligations for cases under investigation. In his view, Mr

CHAN had intended to clarify to the media issues about SFC's approach to regulation of ATS providers.

80. Mr CHAN Kam-lam clarified that the purpose of his earlier comments in response to media's enquiries was to clarify some public misconceptions about the regulation of ATS vis-à-vis services provided by securities brokers in general, and the allegation that SFC had treated HKMEx favourably. In any case, he stressed that he had not disclosed any specifics about SFC's investigation on HKMEx. Mr CHAN emphasized that SFC had been closely monitoring the financial situations of HKMEx and hence identified its financial problems in the process. He believed that SFC had duly exercised its role and duty to maintain a healthy and orderly securities market. SFC had not imposed dual standards on ATS providers and other market intermediaries.

Regulatory standards for ATS providers and brokers

81. Mr Albert HO requested SFC to clarify whether it had applied different regulatory standards to HKMEx vis-à-vis other securities brokers. Mr Christopher CHEUNG said that it appeared to him that HKMEx needed to hold client assets in the interim before the positions were cleared by the clearing house in London. Hence, he did not subscribe to SFC's view that ATS providers did not hold client assets and therefore had lower risks compared to securities brokers. Mr CHEUNG pointed out that an ATS involved operation on a global level and any failure or irregularity of the platform would critically affect the status of Hong Kong as an international financial centre. It was therefore of paramount importance that HKMEx should have sufficient financial resources. He considered that ATS, like securities brokers, should be subject to equally stringent requirements on financial sufficiency for risk management and early detection of any financial problems in operation.

82. CEO/SFC explained that the regulation of service of ATS providers was subject to a specific set of regulations different from that for securities brokers given their different nature of operation, and this did not involve any favouritism. HKMEx did not hold client assets, all of which were located in an independent third-party clearing house. There was complete segregation of client assets at all times. Therefore, in regulating ATS providers, as the service essentially involved the provision of an electronic trading platform, the focus would be more on the stability, transparency and operational integrity of the platform itself. This distinguished the approach to ATS from that adopted for brokers and others which handled client assets.

83. The Executive Director, Supervision of Markets Division, SFC ("ED(SOM)/SFC") pointed out that the business model of a securities broker was different which might include providing margin loan and other credit to

clients. As such, the requirements on the financial sufficiency of a securities broker and a trading platform were different. The business of securities brokers involved operational and market risks whereas ATS providers involved operational and clearing risks if it also provided clearing services to clients. He added that HKMEx provided facilities for trading only and did not offer clearing. For clearing of futures trades, an investor had to open an account with a local broker who was licensed by SFC to undertake Type 2 regulated activity and the trades were cleared by the local broker or by a clearing member of the clearing house through the local broker. In the case of HKMEx, all financial obligations arising from trades in HKMEx futures were handled between the broker (and not HKMEx) and the clearing house in London which was completely independent of HKMEx.

84. Mr James TO and Mr Christopher CHEUNG enquired about the criteria for considering the sufficiency of financial resources of an ATS provider, and the frequency HKMEx was required to report its financial situation to SFC. Mr Albert HO queried the standard adopted by SFC for considering the financial sufficiency of an ATS provider as, according to some sources, HKMEx had been suffering from financial problems that it was unable to even pay for its office rental. Mr CHAN Kin-por said that, if an ATS provider sustained losses persistently for an extended period, it was a sign of insufficient financial resources. The mere fact that it would raise or had raised new capital might not prove its financial soundness as the provider might have resorted to fraudulent means in demonstrating its financial position.

85. CEO/SFC said that, like any other start-up business, a newly established ATS provider might suffer losses and rely on invested capital to fund operating expenses until it became self-sufficient. If the financial viability of an ATS provider became uncertain, SFC would increase supervisory intensity towards the provider and make sure that there was a sufficient financial buffer at all times to ensure that its clients' positions could be wound down in an orderly manner, as happened in the case of HKMEx.

Regulation of HKMEx and other providers of ATS

86. Referring to paragraph 5 of SFC's paper, Mr Abraham SHEK noted that, apart from HKMEx, there were other ATS providers authorized under Part III of SFO, e.g. the Chicago Mercantile Exchange, ICE Futures Europe, ICE Futures US, LCH Clearnet, etc. which were large international ATS providers. He enquired whether SFC had applied checks on the background and financial resources of these ATS providers, and given that HKMEx was a new set-up in Hong Kong, whether stringent due diligence test had been applied to it.

87. CEO/SFC and ED(SOM)/SFC said that the principles for regulation and standards of practice set out in SFC's paper applied to all ATS operations. SFC did conduct due diligence on the other ATS providers which were large overseas exchanges and clearing houses and had a much longer history of operation than HKMEx. Unlike these ATS providers which are subject to regulation by their home countries, HKMEx was the first locally established ATS provider and was subject to intensive supervision by SFC. ED(SOM)/SFC pointed out that it was not easy to start up and operate a commodity exchange. SFC had made careful considerations in granting the ATS authorization to HKMEx and the supervision of HKMEx's services given that it was the first local commodities futures exchange.

Investor protection

88. Mr CHAN Kin-por noted that, according to SFC's statement released on 21 May 2013, the process for winding down HKMEx's trading operations and investors' open positions had been smooth and was completed. He enquired about the protection for the affected investors if they had sustained investment loss as a result of the closure of HKMEx, and how such investors could seek redress. Mr James TIEN enquired about the amount of loss, if any, incurred by investors arising from the closure of HKMEx.

89. ED(SOM)/SFC said that, if an ATS provider ceased operations, any outstanding positions of its clients would be wound down in accordance with the terms and conditions laid down in the rules of HKMEx and the clearing house in London, as duly stated in the clients' contracts entered into with HKMEx. HKMEx had encountered financial difficulties mainly because its low revenue was unable to cover its operating costs. Nevertheless, as the business volume of HKMEx was not large, the impact on the market and investors was not substantial.

90. Mr Christopher CHEUNG said that HKMEx collected a membership fee of US$20,000 from each member, and it had continued to solicit new members for the trading platform despite its financial problem surfaced and before the withdrawal of its ATS authorization. He opined that there appeared to be a violation of the Code of Conduct and urged SFC to review the matter. He considered that the situation was no different from the malpractices of some beauty service providers that continued to lure customers to purchase their services even though their business had run into trouble and was about to close down. Mr Andrew LEUNG shared the concern. The Chairman enquired whether the membership fees had been returned to the affected members after closure of HKMEx's trading platform.

91. ED(SOM)/SFC said that, as an ATS platform, HKMEx was obliged to continue its operation until its authorization to provide the service was withdrawn. As regards HKMEx's membership fees, it depended on the contractual arrangements between HKMEx and the individual members.

VII Any other business

92. There being no other business, the meeting ended at 12:50 pm.

Council Business Division 1
Legislative Council Secretariat
6 September 2013