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LEGISLATIVE COUNCIL BRIEF

REGULATORY REFORM
FOR THE SECURITIES AND FUTURES MARKET

Consultation on the Securities and Futures Bill

INTRODUCTION

At the meeting of the Executive Council on 28 March 2000, the Council ADVISED and the Chief Executive ORDERED that the Securities and Futures Bill should be published in the Gazette as a White Bill; and the associated Consultation Document, at Annex, be issued for public consultation.

BACKGROUND AND ARGUMENT

Challenges for an International Financial Centre

2. The securities and futures industry is one of the key sectors of Hong Kong's economy. It is a high value-added service industry and is a central pillar of our status as an international financial centre. It provides jobs and helps to promote other related service sectors, such as accounting, law, media, trade, communications, and commerce.

3. "New York/London of Asia". The economic success of New York and London demonstrates the valuable contribution that a vibrant securities and futures market can make to a city's economy. As an established service centre in Asia, Hong Kong has potential to become the premier international city of this "Third Time Zone". However, competition is fierce. Others in and outside the region are working hard at attracting the same business.

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

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

6. Need for a Modern and User-Friendly Regulatory Framework. Continuous changes mean that the regulatory framework must be flexible and change with time. The current securities legislation has served Hong Kong well, but should be updated in response to developments brought about by globalization, computer usage, and new products and services. A modern and user-friendly legal regime must be in place to ensure fair, orderly, and transparent markets that are competitive internationally as well as attractive to investors, issuers, and intermediaries.

Beginning A New Journey

7. In the wake of the stock market crash in October 1987, the Administration considered there was an urgent need for reform to the regulation of the securities and futures market. Following the recommendations made by the Securities Review Committee ("SRC") in May 1988, we implemented a series of regulatory reform. The enactment of the Securities and Futures Commission Ordinance ("SFCO") in 1989 provided for the establishment of an independent regulator, the Securities and Futures Commission ("SFC"). This represented Phase I of a comprehensive overhaul

of the securities and futures legislation in Hong Kong, to be continued after SFC was established. At the inception of SFC in May 1989, one of the major commitments undertaken by SFC and the Administration was to review all relevant ordinances governing the securities and futures market, with a view to consolidating them into an omnibus ordinance.

8. Over the years, we had amended the existing statutes and introduced new statutes[1] to implement other SRC recommendations and patch over urgent problems, but the results were not very satisfactory. The paradigm shifts that are taking place in the economies and financial markets around the globe have increasingly highlighted gaps in this patchwork of legislation. The different statutes have operated largely by reference to an increasing number of other statutes, resulting in a complex labyrinth of legislation.

9. In 1996, SFC published a draft bill which consolidated all relevant ordinances for public consultation. This marked the beginning of a major legislative reform after the establishment of SFC. At that time there was however a general lack of enthusiasm in the market for reform. After the Asian financial crisis, consensus became apparent in the market and the legislature for urgent reform to close regulatory gaps. Seizing this opportunity, the Financial Secretary announced in his Budget Speech in March 1999 that the Administration would embark on a comprehensive reform of the regulatory framework of our securities and futures market. The proposed Securities and Futures Bill builds on the 1996 draft bill by taking into account the local and overseas experience in the intervening years. It represents our final response to the SRC recommendations and the commencement of a new journey in meeting market challenges.

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[1] These include legislation for introducing a new disclosure regime (1988), establishing central clearing and settlement systems for securities and futures (1992), conducting preliminary inquiry into alleged misconduct of a listed company (1994), regulating leveraged foreign exchange trading (1994), and more recently, the merger of the exchanges, regulating margin financing and short selling in securities trading, as well as false reporting to regulators. They were made to enhance investor protection and facilitate market development.

Modernizing the Existing Laws

10. Our current set of statutory provisions, scattered over ten different Ordinances[2], is not user-friendly. The core piece of legislation, the Securities Ordinance, is a quarter of a century old. Many of the concepts and definitions in use have become antiquated. The Securities and Futures Bill ("the Bill") will consolidate the ten Ordinances and modernize the legal and regulatory framework. Drafting of the Bill has been guided by the following considerations -

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

(b) it should strike a reasonable balance between certainty and flexibility (which is critical for encouraging innovation as well as for responding to new market development);

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

(d) investors should be empowered to help themselves;

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

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[2] The ten Ordinances are –
(a) Securities and Futures Commission Ordinance (SFCO) (Cap. 24) (enacted 1989)
(b) Commodities Trading Ordinance (CTO) (Cap. 250) (enacted 1976)
(c) Securities Ordinance (SO) (Cap. 333) (enacted 1974)
(d) Protection of Investors Ordinance (PIO) (Cap. 335) (enacted 1974)
(e) Stock Exchanges Unification Ordinance (SEUO) (Cap. 361) (enacted 1980)
(f) Securities (Insider Dealing) Ordinance (S(ID)O) (Cap. 395) (enacted 1990)
(g) Securities (Disclosure of Interests) Ordinance (S(DI)O) (Cap. 396) (enacted 1988)
(h) Securities and Futures (Clearing Houses) Ordinance (SF(CH)O) (Cap. 420) (enacted 1992)
(i) Leveraged Foreign Exchange Trading Ordinance (LFETO) (Cap. 451) (enacted 1994)
(j) Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000)

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

In drafting relevant provisions in the Bill, we have drawn reference from comparable regulatory régimes in common law jurisdictions, specifically those in the UK, Australia and the US.

Highlight of Major Proposals

11. The Bill will create a modern regulatory framework capable of effective enforcement by the Securities and Futures Commission (SFC) and efficient compliance by market users and intermediaries. Apart from consolidating existing Ordinances, it will introduce new regulatory elements. The major new provisions are highlighted in the ensuing paragraphs.

Reduced Burden on Intermediaries, More Effective Regulation

(a) Streamlining the present regime for licensing intermediaries (Parts V-VII of the Bill)

12. A single licence. At present an intermediary needs to apply to SFC for separate registrations for undertaking different activities in different products. Such a multiple-registration regime brings considerable cost and administrative burden to both the registered persons and SFC. In recent years, financial innovation and growing investor sophistication have blurred the lines between traditionally separate categories of products. Market intermediaries increasingly have to simultaneously deal in and advise on securities, futures, foreign exchange, as well as other investment products. Such development renders the requirement for multiple registrations unnecessary. Under the Bill, an intermediary will only need one single licence to engage in activities regulated by SFC (the "regulated activities"). Existing registered persons will have two years to migrate to the new licensing regime after enactment of the new legislation.

13. Responsibility and liability of senior management. Given that the activities of an intermediary are ultimately in the hands of its controlling minds, we have introduced in the Bill a "management responsibility" concept to

enhance investor protection. This is in keeping with international regulatory practice. By this proposal, each intermediary has to nominate at least two "responsible officers" for approval by SFC. The "responsible officers" will be responsible and accountable for directly supervising the conduct of the regulated activities of an intermediary. It will be inadequate for SFC to rely solely on its day-to-day supervision of intermediaries to promote compliance at all times. As in other jurisdictions, the regulator must also rely upon the senior personnel of the intermediaries to ensure compliance. To this end, the Bill also adopts a "management liability" concept whereby "responsible officers" of an intermediary as well as the corporation itself are liable for breaches by the corporation of certain fundamental regulatory requirements. A "responsible officer" will not be liable if he can prove that he honestly and reasonably believed that the corporation was in compliance, and he acted promptly in notifying SFC of the relevant breach once it became known to him.

14. Exempt authorized financial institutions. At present SFC grants exempt status to authorized financial institutions conducting "regulated activities", in recognition of the fact that they are already subject to regulation by the Hong Kong Monetary Authority (HKMA) under the Banking Ordinance (BO). With the introduction of a single licence regime for SFC licensees, corresponding changes are to be introduced to upgrade the existing regulation of exempt authorized financial institutions. Our guiding principles in developing this new regulatory framework are to, as far as practicable, provide adequate protection to investors; minimize regulatory overlap and thus reduce unnecessary regulatory costs; and level the playing field between exempt authorized financial institutions and SFC licensees. The proposed regulatory framework for exempt authorized financial institutions will build on the existing arrangements, whereby HKMA shall remain the front-line regulator for all authorized financial institutions regulating their conduct of not only banking but also "regulated activities". Exempt authorized financial institutions therefore will only need to be accountable to a single regulator. HKMA will perform the regulatory functions, in a manner and according to standards that are consistent with those applied by SFC to its licensees. In order to fulfil this commitment, the Bill will give HKMA inspection powers for the day-to-day supervision of the "regulated activities" conducted by exempt authorized financial institution. Where necessary, we will also propose amendments to the BO to ensure that HKMA is able to perform the regulatory functions.

HKMA has also undertaken to enhance its supervisory resources for regulating exempt authorized financial institutions. The new framework will be underpinned by a revised Memorandum of Understanding to be drawn up between SFC and HKMA.

(b) Providing for proportionate disciplinary sanctions against improper conduct by intermediaries (Part IX of the Bill)

15. Civil fines. When a licensed person breaches any regulatory requirement, the disciplinary sanctions presently available to SFC are public or private reprimands or suspension or revocation of the intermediary's registration. In many cases reprimands could be insufficient, yet suspending or revoking an intermediary's registration might be too draconian, and could cause disproportionate harm to innocent third parties. In line with well-accepted practice in the US and proposed legislation in the UK[3], the Bill will empower SFC to impose civil fines as an additional sanction. The maximum will be the higher of HK$10 million or three times the amount gained or loss avoided.

16. Partial suspension/revocation. The Bill will also enable SFC to suspend or revoke an intermediary's licence in respect of part of its business under the new licensing regime. This is a more focused sanction particularly applicable to large intermediaries and a less drastic measure than a suspension or revocation of all of an intermediary's business.

(c) Protecting clients' assets from dissipation (Clauses 192 and 195 of the Bill)

17. The Bill vests in SFC the power to transfer specified property from a licensed person to an appropriate custodian. This aims to protect the assets of clients of the licensed person when there is a risk that the assets may be dissipated, misappropriated or improperly dealt with. To satisfy the requirements under the Basic Law concerning the protection of private ownership of property, we have included several safeguards. First, the

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[3] The Financial Services and Markets Bill was introduced into the UK House of Commons in June 1999. It seeks to replace, among other Acts, the Financial Services Act of 1986.

transfer of property will not affect the existing legal and equitable rights of its owner. Secondly, SFC will endeavour to identify and inform all owners. Thirdly, SFC will be required to apply to the court for orders as to how to deal with the property. Fourthly, the custodian will be obliged to take all reasonable steps to preserve the property, subject to any order of the court.

Combating Market Misconduct

(d) Establishing a dual civil and criminal route to deal with cases of specified market misconduct including insider dealing (Parts XIII and XIV of the Bill)

18. Sophisticated market practices and techniques have made it difficult to obtain sufficient evidence to prove improper activities directed at the market (rather than at particular victims) to the criminal standard. The Bill seeks to provide an alternative civil route to the existing criminal route in dealing with these activities. It will build on the strength of the Insider Dealing Tribunal, expanding it into a Market Misconduct Tribunal (MMT) to handle also specified market misconduct cases on the civil standard of proof. The MMT will be chaired by a judge[4], assisted by two members with relevant knowledge or expertise. The Tribunal will be appointed by the Chief Executive. The Financial Secretary will be able to initiate proceedings before the Tribunal, the purpose of which is to determine whether market misconduct has taken place. To facilitate proceedings, the Tribunal will be assisted by a presenting officer, to be appointed by the Secretary for Justice. He will present the case to the Tribunal and initiate such further inquiries as necessary. The Tribunal may order disgorgement of profits; issue a "cold shoulder" order[5] to restrict a person's access to the market; issue a "disqualification" order to disqualify a director from being a director of any listed corporation; and order a person to

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

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

cease and desist from committing any further acts of market misconduct[6]. A "cold shoulder" order or a disqualification order may be for a period of up to five years. We have exercised due care in calibrating these civil sanctions to ensure that they are compatible with human rights requirements.

19. A clear message should be sent to the public that market misconduct is a serious wrongdoing which will not be tolerated. Hence, Part XIV of the Bill will retain, modernize and expand the existing criminal route to deal with market misconduct cases, including insider dealing, in parallel to the MMT regime, in order to address new market developments and provide adequate deterrence. The alternative criminal route will be resorted to where there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution against the most serious instances of market misconduct.

20. Certain market misconduct activities are criminal under current legislation. However, these provisions have certain defects. The market misconduct provisions specified in Parts XIII and XIV of the Bill are modeled upon the well established Australian Corporations Law. The Australian Corporations Law carries with it a body of case law which may provide for courts in Hong Kong a convenient guide for interpreting these new provisions. Apart from insider dealing and other specified market misconduct activities, Part XIV also creates offences for "bucketing" in futures trading[7], and acts of fraud or deception targetting individual victims.

21. The Bill proposes to increase the maximum penalty for criminal offences under Part XIV to a fine of $10 million and 10 years' imprisonment. We believe the increase in the penalty level is justified for a person who perpetrated to jeopardize the integrity, stability and fairness of the markets.

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[6] The US Securities and Exchange Commission has the power to issue these "cease and desist" orders. It may impose such an order as an administrative act in proceedings before an administrative law judge. Proceedings for breach of an order are brought before a court and such breach is punishable by a civil penalty and a mandatory injunction directing compliance with the order.

[7] "Bucketing" in futures trading refers in general to brokers/dealers on the trading floor of the futures exchange in question not placing a client's orders to the floor while maintaining a pretence of doing so.

The proposed penalty is also comparable to those in other Ordinances[8] which penalize offences with elements of conspiracy to defraud.

(e) Facilitating a preliminary inquiry into a listed company (Clause 165 of the Bill)

22. Current law authorizes SFC to review the books and records of a listed company when it appears to SFC that there is fraud or other misconduct in the management of the company. In practice, however, SFC has only a limited ability to place the entries in those documents in any meaningful context or to check their veracity. The Bill will rectify this problem, allowing SFC to seek from the listed company explanations of such an entry; to make enquiries from contractual counterparties to the company; and to request for access to the working papers of the company's auditors. These enhancements will enable SFC to better perform its given regulatory role over listed companies.

23. This proposed enhancement of power has been a matter of concern for the accountancy profession. It has been suggested that SFC has to first apply to the court for an order for access to audit working papers. We have given due consideration to this suggestion. It is important to note that such a power of obtaining documents is not self-enforcing. If, for example, an auditor does not entertain SFC's request to produce the relevant records and documents, SFC would have to certify such non-compliance to the Court and seek an order from the court to compel compliance. The Court may then inquire into the case and the auditor who believes that the required document is not relevant to the inquiry by SFC could challenge the requirement to comply. Given this and the additional safeguards including those mentioned in the paragraph below to ensure SFC's proper exercise of this power, we have decided not to require a court order as a pre-requisite, but a back-up for securing compliance, to be resorted to when necessary.

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[8] Section 71 of the Crimes Ordinance imposes a maximum penalty of 14 years' imprisonment on forgery offences. Sections 17, 18, 19 and 21 of the Theft Ordinance impose a maximum term of 10 years for deception offences.

24. In order to satisfy human rights and legal policy requirements, we have raised the thresholds[9] for triggering the SFC powers to inquire into a listed company are higher than those in existing law (Clause 165).

(f) Protecting auditors who choose to report suspected fraud (Clause 360 of the Bill)

25. The Bill will also re-introduce an earlier proposal[10] to provide auditors of listed corporations who disclose and report to SFC any suspected fraud or misconduct in the management of a listed company with statutory immunity from liability under the common law. The choice to report is entirely voluntary. The Bill intends only to remove any threat of liability against auditors who choose to sound such a warning in the course of their auditing work. The improved provisions in clause 360 have made this clear, and also have included other suggested refinements put forward by the accountancy profession.

Empowering Investors to Protect Themselves

26. Information is at the centre of an efficient market. It enables investors to make informed decisions and helps maintain a level playing field among market participants. The international trend is towards requiring better dissemination of information by the listed corporations, so that investors can take responsibility for themselves in assessing risks and returns. The proposals at (g) and (h) below seek to enhance market transparency by promoting the timely and accurate disclosure of price sensitive information.

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[9] Under s. 29A of the SFCO, SFC is required to certify in writing to a person, other than the listed company or its related companies, that it *"appears to SFC"* that the person is in possession of relevant records and documents, before SFC may ask him for production or such records and documents. Clause 165 of the Bill raises the threshold to a written certification on *"SFC has reasonable cause to believe"*. This new threshold will apply to auditors, authorized institutions and other persons.

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

(g) Improving disclosure of interests in securities (Part XV of the Bill)

27. The provision of accurate and timely data on shareholdings in listed corporations which is price-sensitive, is an important key to enhancing market transparency. To bring Hong Kong in line with international standards, the Bill will lower the initial shareholding disclosure threshold for persons other than directors and chief executives from 10% to 5%; shorten the disclosure notification period from five days to three business days; and extend certain disclosure requirements to interests in shares held through derivative products. To minimize compliance burden, the Bill will also remove certain unnecessary disclosure requirements.

(h) Creating civil liability for false disclosure to the market (Clause 200 of the Bill)

28. There is market consensus that the quality of disclosure under the various regulatory requirements, especially those relating to listings, takeovers and mergers, needs to be strengthened. Present sanctions against non-compliance, essentially public censures and "cold shoulder" orders, have become inadequate. To more effectively deter market abuse, we have recently put forward proposed legislation to criminalize false reporting to the regulators[11]. The Bill will also make a person civilly liable for disclosing to the public materially false or misleading information concerning securities or futures contracts, or that might affect the price of securities or futures contracts. Any person who has suffered loss as a result of relying on such disclosure may claim damages from the person who is responsible for the disclosure. The provisions will provide a defence for persons acting in good faith, without knowledge and with due diligence. Separate defences are available for people acting as "conduits" of such disclosure.

29. The public has called for the Stock Exchange Listing Rules to be given "teeth" to ensure accurate and adequate disclosure. At the same time, there are market calls for maintaining the non-statutory, market-oriented nature of these Rules, as they are essentially commercial rules written in business

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[11] The Securities and Futures Legislation (Provision of False Information) Bill 2000 was considered by the Executive Council on 29 February 2000 and introduced into the Legislative Council on 15 March 2000.

language and designed to be administered with commercial pragmatism and flexibility. In response we have considered creating statutory sanctions in the Bill for breach of the Stock Exchange Listing Rules and the SFC Code on Takeovers and Mergers. However, according to administrative law experts, this would mean that these Rules and Codes would become statutory. On balance we considered that these rules should remain non-statutory. It is important that they may be amended in a timely manner in response to rapid market changes. We have therefore decided not to pursue the option of creating statutory sanctions, but to focus on stating the liability in private law to pay compensation as set out in paragraph 28 above.

(i) Assisting litigants in a private right of action against market misconduct (Clauses 268 and 295 of the Bill)

30. Under the common law, a person who has suffered loss as a result of market misconduct may be able to seek redress through a civil action against the person responsible for that misconduct. In these circumstances we have been advised that it is important to have a clear relationship between common law and statutes so as to minimize uncertainty and improve transparency. The victim will generally need to fit his cause of action to an action in contract or tort such as negligence, and may not be aware of his legal position at common law. If a statute is silent as to a right of action in private law, there may be uncertainty as to the statutory effect on the common law and whether a breach of the statutes gives rise to an action for breach of statutory duty. The Bill will put Hong Kong more in line with international practice[12] by creating an express private statutory right of civil action for damages or other remedies. The relevant provision will create an express statutory cause of action for victims to sue another person for recovery of losses which result from the latter's market misconduct if the court thinks that it is fair, just and reasonable

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[12] In the United States, sections 11 and 12 of the Securities Act expressly provide for private causes of action for violations of the securities registration requirements. Section 18 gives a right of action to any person who purchases or sells a security in reliance on misleading statements in a report filed under that Act. There is also a right of action for violation of Rule 10b-5 (an anti-fraud rule made under section 10(b) of the Securities Exchange Act). Volumes of case law have interpreted this anti-fraud rule to cover an extremely wide variety of situations, thus effectively providing a catchall cause of action for private litigants. In the United Kingdom, under section 80 of the proposed Financial Services and Markets Bill, "a contravention by an authorised person is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty". Section 1324(1) of the Australian Corporations Law extends the right of action to "[any] person whose interests have been, are or would be affected by the conduct [that contravenes a legal provision]".

for him to recover. It will also allow the court hearing a private action to admit findings of the MMT and criminal convictions for market misconduct under Part XIV as evidence that market misconduct has been committed (see paragraphs 18 to 21 above). The victim will still need to prove that the MMT findings or criminal convictions are probative and relevant to his civil proceedings. However, the admissibility of MMT findings and criminal convictions is likely to be of considerable assistance to those who have suffered loss as a result of market misconduct and intend to recover such loss through a private civil action.

Friendly to Innovation, Meeting New Market Needs

(j) Adopting a flexible and pragmatic approach to regulation of automated trading services (Division VI in Part III of the Bill)

31. The rapid development of automated trading facilities, through which automated trading services (ATS) are provided, is conducive to the rapid growth in electronic trading in overseas markets. The activities and services of these technology driven operators should be appropriately regulated for investor protection and systemic risk management. Yet the diversity and the rapid development that marks these ATS requires us to approach the question of regulation with caution and flexibility. Imposing a set of requirements that applies universally would probably leave undesirable loopholes and impede competition, innovation and growth. Accordingly, the Bill takes a flexible and pragmatic approach by enabling SFC to examine each application for ATS authorization and, on the basis of the specifics of each individual case, to determine which rules[13] are to be applied. Through this proposed arrangement, the Bill seeks to provide an environment that will facilitate the growth of ATS operation in Hong Kong whilst at the same time ensuring adequate regulation for investor protection. It is noteworthy that the proposed approach also has

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[13] Examples of areas covered by such rules are –
(a) the standards of conduct in relation to the provision of an automated service;
(b) steps to be taken to avoid and deal with conflicts of interest;
(c) steps to ensure that there is integrity, transparency and fairness in transactions conducted through the service;
(d) procedures to discourage and identify any money laundering activities.
They are similar to rules governing an exchange for ensuring adequate market surveillance, managing systemic risk, enhancing market liquidity, monitoring system capabilities, regulating user admission standards, etc.

been adopted elsewhere, including the United States and the United Kingdom. To provide for clarity and certainty to ATS operators, SFC has undertaken to promulgate guidelines which set out in greater detail as to how it is going to perform its statutory functions in respect of ATS.

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

(k) Enhancing transparency in the professional investors markets (Clause 35 of the Bill)

33. Persons who act as principals and deal solely with professional investors (i.e., who have no retail clients) do not directly pose any investor protection concerns, and are not required to be licensed. Nevertheless, their activities can have significant impact on the market, and information about their trading is essential to ensure proper management of systemic risks. While the best approach in addressing these issues remains a subject of active international discussions following the Asian financial turmoil, the Bill will include large-position reporting requirements in the futures and options markets to bring our reporting standards more in line with those of major international financial centres. These will build on the existing provisions which allow SFC to set position limits for market participants in respect of individual futures and options contracts.

34. We shall continue to monitor the development of any international consensus on the surveillance of large capital flows, a subject being considered in ongoing discussions on international financial architecture; and consider how best it may apply in the domestic context.

(l) Allowing SFC to join in litigation between third parties (Clause 362 of the Bill)

35. As financial markets and their infrastructure become increasingly complex, what appear to be disputes between private parties are more and more

likely to have an impact on the rest of the market system. Private litigation may involve points of law that bear on the wider public interest. The Bill will give SFC standing to intervene in civil proceedings between third parties in appropriate cases to provide its regulatory perspective and expert opinion. As safeguards, the Bill will require that SFC must satisfy the court that its intervention is in the public interest; parties to the litigation will have the right to challenge the intervention; and the intervention will be subject to such terms as the Court considers just. These are based on the current procedure for the joinder of third parties in litigation.

(m) Investor Compensation (Part XII of the Bill)

36. The existing compensation funds for both the SEHK and the Hong Kong Futures Exchange rely in part on deposits paid by members of the exchanges. The compensation ceilings are respectively $8 million per stockbroker and $2 million per futures broker. The per broker ceilings give an uncertain level of investor protection, as it does not communicate to investors the amount of coverage available to them individually. We propose the establishment of a new investor compensation scheme whereby insurance leveraging on the existing compensation fund assets may be used, with a view to minimizing the cost to the industry. We also propose a per investor compensation ceiling to be prescribed by the Chief Executive in Council[14].

37. We have included in Parts III and XII of the Bill a flexible framework to enable the SFC to consult the newly established HKEx on the establishment and operation of the new compensation scheme. Part III provides for the recognition of one or more companies as Investor Compensation Companies to facilitate the management and administration of the new compensation scheme. Detailed rules for the operation of the new compensation scheme, once agreed among concerned parties, will be set out in subsidiary legislation.

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[14] These proposals were put forward for market consultation in September 1998 and generally well received.

International Cooperation

38. SFC is committed to cooperating with regulatory authorities in other jurisdictions[15]. Existing law enables SFC to share information with and grant investigatory assistance to overseas regulators. In addition to preserving these provisions, the Bill will allow SFC to cooperate with overseas regulators in combating cross-border market misconduct. This is built into the new civil and criminal régimes on market misconduct set out in paragraphs 18 to 21 above.

39. In view of the increasing trend of globalization and interconnection of markets worldwide, and with the advent of telecommunications technology, cross-border trading has been cheaper and easier than ever. Global strategic alliances between exchanges are becoming an international market trend. This will render geographical boundaries less and less significant. It is important that securities and futures legislation in Hong Kong would allow us to tackle the most advanced and elaborated market offences just as well as other international financial centres. We cannot allow Hong Kong to become a haven for international market manipulators and those persons who may affect the integrity and stability of markets in Hong Kong. There is also developing international consensus that insider dealing and market manipulation should be outlawed internationally, including insider dealing and market manipulation which span geographical boundaries[16]. The proposed provisions will enable SFC to perform better its role as a responsible market regulator in the international arena.

40. Parts XIII and XIV of the Bill will therefore seek to combat activities in Hong Kong and elsewhere which were directed at manipulating the Hong Kong markets; and activities in Hong Kong which were directed at manipulating a market outside Hong Kong, if such activities are also offences under that jurisdiction.

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[15] SFC has entered into 46 MOU, cooperative arrangements and informal exchanges of information arrangements with securities regulators around the world.

[16] The Financial Services and Markets Bill (FSMB) of the UK proposes that markets accessible from the UK will in effect be treated as situated in the UK, and the FSMB would therefore prohibit abusive behaviour which takes place in a market accessible from the UK. In addition, the Securities Act and Securities Exchange Act of the US prohibits manipulative conduct in an overseas market by a person resident in the US. The US also criminally prosecutes misconduct in its jurisdiction that affects other jurisdictions.

Transparency and Accountability of the SFC

41. SFC needs adequate powers and discretion to perform its functions effectively. In exercising its powers and performing its functions, SFC should be both transparent and accountable, and subject to proper consideration of privacy and confidentiality. To this end, the Bill has created a number of checks and balances to guard against possible abuse. One notable measure of accountability is the inclusion of the regulatory objectives of SFC in clause 4, which will serve as benchmarks by which the public and the industry will be able to measure the performance of SFC.

Existing Accountability Arrangements

42. When SFC was first established in 1989, we exercised due care in prescribing adequate safeguards when vesting powers in the new regulatory watchdog. The main accountability arrangements include -

(a) the Chief Executive appoints all SFC directors, half of whom must be non-executive, and approves SFC's annual budget;

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

(c) the Chief Executive approves estimates of SFC's income and expenditure and the approved estimates are to be laid before the Legislative Council;

(d) SFC must furnish such information to the Financial Secretary as he may specify;

(e) the Director of Audit may examine records of SFC;

(f) an independent Securities and Futures Appeals Panel (SFAP) is established to hear appeals from parties aggrieved by certain decisions made by SFC;

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

(h) judicial review by the Court of First Instance of relevant SFC decisions is available; and

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

These accountability measures will be preserved in the Bill, subject to changes such as the SFAP being replaced by the Securities and Futures Appeals Tribunal.

Additional Checks and Balances

43. The Bill will vest certain new regulatory powers in SFC. At the same time the existing accountability measures will be correspondingly enhanced to ensure that there are adequate checks and balances.

(a) Securities and Futures Appeals Tribunal (Part XI of the Bill)

44. As an improvement to the mechanism of checks and balances, the Bill will replace the current SFAP with a Securities and Futures Appeals Tribunal (SFAT) which will have judicial status, operate on a full-time basis and have an enlarged remit.

45. The existing SFAP is a part-time merits review panel. Its jurisdiction is limited to certain decisions made by SFC on licensing and intermediary intervention and discipline. As it operates on a part-time basis, the SFAP does not have the resources to handle a large caseload. Any delay caused by caseload is contrary to the aim of setting up the SFAP to provide a quick and effective means of merits review.

46. The SFAT and all its members will be independent of SFC. The tribunal will be chaired by a judge[17] and is expected to include a number of market practitioners and others with appropriate knowledge and experience of the industry. It will have a wider jurisdiction than the SFAP and may review many important decisions of SFC, including all licensing and disciplinary decisions as well as certain matters relating to intermediary supervision, investment products, and registration of prospectuses, as set out at Schedule 7 of the Bill. We anticipate that with the SFAT operating on a full-time basis, the time required to get an appeal heard could be significantly shortened.

(b) Process Review Panel

47. It is important for public confidence and trust in SFC to be maintained. Part of its work is necessarily subject to privacy and confidentiality requirements and specific information cannot always be publicly disclosed. This, however, could give the public the misconceived impression that SFC is not taking appropriate action. To bridge this gap, we will establish an independent non-statutory Process Review Panel to review aspects of SFC's internal operations (including investigative procedures) that cannot be meaningfully scrutinized by the SFAT. Panel membership should be broadly-based and equipped with the necessary market expertise and professional skills. As currently envisaged, the Panel will comprise a majority of independent, prominent persons in the community, to be appointed by the Chief Executive. The Panel will submit its report to the Financial Secretary. To demonstrate SFC's openness to independent scrutiny, it is our intention to establish the Panel in the third quarter of this year, without waiting for enactment of the Bill.

Other more urgent tasks

48. In preparing the Bill, we are mindful of the need to implement in parallel those legislative amendments which are required urgently to address important market issues and close regulatory gaps. These include recent legislative amendments to regulate margin financing in securities transactions,

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

short selling and false reporting, as well as the introduction of a new regulatory framework for HKEx[18]. They have been, or will be, incorporated into the Bill as they have been enacted.

A Modern Regulatory Framework

49. By including the proposals set out above in the Bill, we aim to create a regulatory framework that -

(a) is user- and technology-friendly;

(b) keeps pace with and facilitates market development and innovations; and

(c) is on a par with international standards and practices.

These objectives are essential for building a modern legal and regulatory framework to enable our securities and futures markets to meet the challenges of global competition, technological advances and rapid financial innovations.

THE WHITE BILL

50. The purpose of the Bill is to consolidate and amend the law relating to financial products including securities, futures contract, collective investment schemes, and leveraged foreign exchange contracts and the relevant markets and industry, as well as the law relating to the protection of investors. The Bill is divided into 17 Parts.

51. Part I provides for commencement and specifies that definitions of general application are set out in Schedule 1.

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[18] These legislative initiatives are enshrined in the Exchanges and Clearing Houses (Merger) Ordinance (enacted on 24 February 2000), Securities (Margin Financing) (Amendment) Ordinance (enacted on 15 March 2000), Securities (Amendment) Bill (introduced to the Legislative Council on 5 January 2000), and Securities and Futures Legislation (Provision of False Information) Bill 2000 (introduced to the Legislative Council on 15 March 2000).

52. Part II provides for the operations of SFC and its constitutional framework.

53. Part III provides for the regulation of exchange companies, clearing houses, exchange controllers, investor compensation companies and automated trading services. It incorporates the Exchanges and Clearing Houses (Merger) Ordinance enacted on 24 February 2000.

54. Part IV deals with the regulatory framework for the offering of investment products.

55. Part V provides for a new licensing regime for market intermediaries. Part VI imposes capital requirements and other requirements relating to client assets, records and audit applicable to intermediaries. Part VII regulates business conduct of intermediaries.

56. Part VIII deals with the supervision and investigation of intermediaries and preliminary inquiries into listed companies.

57. Part IX provides for disciplinary powers of SFC exercisable in respect of licensed corporations and exempt persons.

58. Part X provides for powers of intervention exercisable by SFC and for relevant proceedings.

59. Part XI contains provisions relating to the SFAT, which is established to deal with appeals against decisions made by SFC under specified provisions.

60. Part XII contains provisions for establishing a framework within which specific compensation arrangements for investors can be developed.

61. Part XIII contains provisions relating to the Market Misconduct Tribunal, which is established to deal with insider dealing and other specified market misconduct. Part XIV provides for market misconduct offences and by so doing establishes a dual alternative route in which market misconduct which can be the subject of proceedings in the Market Misconduct Tribunal can as an alternative be punishable in appropriate circumstances as an offence.

62. Part XV sets out the regime for the disclosure of interests in shares relating to listed corporations.

63. Part XVI contains miscellaneous provisions and Part XVII deals with repeals and transitional provisions.

IMPLEMENTATION TIMETABLE

64. The timetable for implementation is as follows –

Gazette of White Bill	7 April 2000
Public consultation	April to end June 2000
Preparing draft subsidiary legislation, codes and guidelines	April to September 2000
Refining the Bill	April to September 2000
Introduction into Legislative Council	October/ November 2000

65. Since we exposed the major proposals in the Bill to the market and the Legislative Council for comments in July 1999, we have received strong and repeated requests from the industry and professional bodies for a three-month consultation period on the draft provisions of the Bill. There is some fear, in particular among the big market players, that the Government will rush the Bill through the Legislative Council without adequate consultation. To canvass market views and public support, we have decided to publish the Bill in the form of a White Bill for public consultation. In the interim, we shall start preparing the subsidiary legislation, codes and guidelines which are appropriate for the commencement of the Securities and Futures Ordinance.

66. Subject to market comments on the White Bill, we aim to finalize the Bill for introduction into the Legislative Council as the next legislative session begins. Our target is to secure enactment of the Bill in April 2001.

BASIC LAW IMPLICATIONS

67. The Department of Justice has confirmed that the Bill does not conflict with those provisions of the Basic Law not carrying human rights implications.

BILL OF RIGHTS IMPLICATIONS

68. The Department of Justice has confirmed that the Bill does not conflict with those provisions of the Basic Law carrying human rights implications.

BINDING EFFECT

69. The Bill proposes no changes to the binding effect of those existing Ordinances which the Bill seeks to consolidate and modernize.

FINANCIAL AND STAFFING IMPLICATIONS

70. Subject to the enactment of the Bill in its present form, we will create 14 new posts with annual staff cost of $20 million for the MMT. This will be offset by the deletion of the same number of posts with an annual staff cost of $16 million under the IDT. Therefore, the net additional staff cost to Government is $4 million. The MMT will also require an additional $4 million each year to meet its operating expenses which largely comprise witness and professional fees.

71. For SFAT, we will create three new posts with an annual staff cost of $3 million for the SFAT. We will also provide $4 million for the SFAT to cover its operating expenses, the nature of which is similar to that of the MMT.

72. Any proposed changes to the Bill may have additional financial and staffing implications for Government. The Secretary for Financial Services will reassess the overall resource requirement for the implementation of the Bill

after the public consultation exercise. Any additional requirement will be sought in the normal way.

73. There may be additional workload for SFC as a result of the strengthening of its supervisory, regulatory and investigatory powers. The same applies to HKMA in light of its plan to upgrade the regulation of exempt authorized financial institutions (see paragraph 14 above). SFC would absorb the additional resource requirement to cope with this extra workload, including the expenses for the setting up of the Process Review Panel under SFC within its existing resources. HKMA anticipates that it would be able to meet the additional workload internally. However, should there be a requirement for additional resources, it would secure them in the normal way.

ECONOMIC IMPLICATIONS

74. Measures to enhance the health, transparency and vibrancy of the securities and futures market through regulatory reforms, in the way described in this Bill, will help boost the vitality and strength of Hong Kong's financial sector as it evolves along with global financial market developments. This is crucial for the securities and futures market to meet its economic role in the mobilization of capital and also for Hong Kong to maintain its position as an international financial centre and the premier capital formation centre for the Mainland of China.

PUBLIC CONSULTATION

75. After giving an overview presentation to the Legislative Council's Financial Affairs Panel on 5 July 1999, we launched, together with SFC, a public consultation exercise on the major proposals in the Bill. We received submissions from 22 market organizations, political parties, chambers of commerce and professional bodies. The comments and our response are summarized at Annex A to the Consultation Document on the White Bill.

76. The Legislative Council also took the initiative to establish a Subcommittee on the Securities and Futures Bill to consider the major

proposals. We held four meetings with the Subcommittee in September 1999 to present the proposals in detail to members and canvass their views, which are summarized, together with our response, at Annex B to the Consultation Document on the White Bill.

77. The response has been supportive of the need for reform and the broad direction of the reform. Industry as well as public respondents supported the inclusion of SFC's statutory objectives at the beginning of the Bill, the transition to a single licence regime, the introduction of civil fines and partial suspension as intermediate disciplinary tools, the establishment of a Market Misconduct Tribunal, and the regulation of automated trading services. They were positive about the proposed safeguards, namely upgrading and expanding the Securities and Futures Appeals Panel to a Securities and Futures Appeals Tribunal, and establishing a Process Review Panel to ensure that SFC follows its internal due process procedures.

78. Certain market and legal practitioners expressed concerns about the original proposal for a general statutory private right of action for losses resulting from violation of regulatory requirements, and the proposed power for SFC to intervene in litigation between third parties. We have revised the proposals, as explained in paragraphs 30 and 35 above, to address these concerns.

79. The accountancy profession expressed concerns about the proposal for SFC to request for access to audit working papers during a preliminary inquiry into the management of a listed company (see a paragraphs 22 - 24 above), and about the proposed statutory immunity for an auditor who chooses to report suspected fraud (see paragraph 25 above). We have taken their suggestions into account in preparing clauses 165 and 360 of the Bill.

80. The banking industry also expressed concern over possible regulatory overlap with regard to exempt authorized financial institutions. The agreement reached between SFC and HKMA on the regulatory arrangement for exempt AIs, as set out in paragraph 14 above, aims to address such concern.

81. Various professional organisations and market bodies also expressed concern as to how market misconduct should be defined and suggested the

need for "safe harbours" (i.e., exemptions) to allow for the continuation of certain acceptable market practices. We have paid particular attention to these market views when drafting the relevant clauses in Parts XIII and XIV. Clauses 269 and 296 now allow SFC to make rules for safe harbours after consulting the market and the Financial Secretary.

82. A number of respondents, in particular the local and international stockbrokers, the legal and accountancy professions, and the banking industry have asked for the draft Bill to be exposed to the market for separate consultation before introduction into the Legislative Council. Our proposal to publish the Bill in the form of a White Bill for a three-month consultation is in response to this market demand.

PUBLICITY

83. Both the White Bill and the Consultation Document have been put on the websites of the Financial Services Bureau at http://www.info.gov.hk/fsb and SFC at http://www.hksfc.org.hk on 2 April 2000 for visits by members of the public. Hard copies of the Consultation Document will also be distributed to concerned market organizations and professional bodies. The White Bill will be published in the Gazette on 7 April 2000. The Administration and SFC will make media arrangements and briefings for concerned market bodies to publicize and explain the Bill. They will brief the Subcommittee of the Securities and Futures Bill of the Legislative Council on 3 April 2000.

ENQUIRIES

84. For any enquries on this brief, please contact Miss Emmy Wong, Assistant Secretary for Financial Services at 2529 2379.

Financial Services Bureau
2 April 2000
(SU B38/2000)