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(These minutes have been seen by the Administration and cleared by the Chairman)

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Subcommittee on
Securities and Futures Bill

Minutes of meeting
held on Monday, 3 April 2000, at 10:45 am
in the Chamber of the Legislative Council Building

Members present	**:**	Hon Ronald ARCULLI, JP (Chairman) Hon Albert HO Chun-yan (Deputy Chairman) Hon Eric LI Ka-cheung, JP Hon James TO Kun-sun Hon Jasper TSANG Yok-sing, JP Hon Ambrose LAU Hon-chuen, JP Hon FUNG Chi-kin
Members absent	**:**	Hon SIN Chung-kai Dr Hon Philip WONG Yu-hong
Non-Subcommittee Member attending	**:**	Hon NG Leung-sing
Public officers attending	**:**	Mr Rafael S Y HUI, GBS, JP Secretary for Financial Services Miss AU King-chi, JP Deputy Secretary for Financial Services
Attendance by invitation	**:**	Mr Andrew SHENG Len Tao, SBS, JP Chairman, Securities and Futures Commission

Mr Mark DICKENS
Executive Director of Supervision of Markets, Securities and Futures Commission

Mr Andrew PROCTER
Executive Director of Intermediaries and Investment Products, Securities and Futures Commission

Mrs Alexa LAM
Chief Counsel, Securities and Futures Commission

Clerk in attendance : Ms LEUNG Siu-kum
Chief Assistant Secretary (1)4

Staff in attendance : Mr KAU Kin-wah, Assistant Legal Adviser 6
Ms Rosalind MA, Senior Assistant Secretary (1)6

I Briefing by the Administration

The Secretary for Financial Services (SFS) said that the Securities and Futures Bill (the composite Bill) aimed at consolidating and modernizing the existing ten Ordinances relating to the securities and futures industry so as to meet challenges in the competitive international financial market. Taking into consideration the views of Legislative Council members and market participants during the consultation in July 1999, the composite Bill was drafted with the following guiding principles:

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

(ii) it should strike a reasonable balance between certainty and flexibility;

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

(iv) investors should be empowered to help themselves;

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

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

2. SFS drew members' attention to Part II of the Securities and Futures White Bill (the White Bill). It stipulated the objectives and functions of SFC, the former of which were not provided for in the current legislation. He briefed members on the timetable for implementing the new reform under the composite Bill. The consultation period of the White Bill would end by 30 June 2000 and the Administration planned to introduce the composite Bill to the Legislative Council in October or November 2000, anticipating the enactment of the composite Bill in April 2001. In this regard, he solicited members' support for the early enactment of the composite Bill, which would be beneficial to enhancing the competitiveness of Hong Kong in the international financial market.

3. The Deputy Secretary for Financial Services (DS/FS) highlighted the key proposals in the White Bill. There were six major new elements under the reform -

(i) To combat market misconduct, enhanced powers would be provided to the Securities and Futures Commission (SFC) to inquire into a listed corporation and its contractual counter-parties, as well as to gain access to auditors' working papers. A Market Misconduct Tribunal (MMT) would be established to deal with market misconduct through civil proceedings, thus providing an alternative civil route to the existing criminal route in dealing with market misconduct activities. For greater deterrence and better protection of investors' interest, the White Bill preserved and expanded the criminal route to address specified misconduct. There was also statutory provision of immunity to auditors who voluntarily reported to SFC fraud or irregularity of listed corporations.

(ii) To improve regulation of intermediaries, existing licensing requirements would be streamlined and a single licence system would be introduced. The securities business of the authorized financial institutions (AI) would be exempted from the licensing requirements and the Hong Kong Monetary Authority (HKMA) would be responsible for the frontline supervision of the securities business of AI to avoid regulatory overlap. More proportionate disciplinary sanctions against misconduct of intermediaries such as civil fines and partial suspension or revocation of licences would be introduced. There would also be measures to protect the clients of intermediaries such as empowering SFC to transfer the custody of assets from an intermediary to an appropriate custodian to avoid dissipation.

(iii) To enhance market transparency, the disclosure regime would be modernized to upgrade the existing requirements for disclosure of interest in securities. There would be reporting requirements on large-volume transactions which were important for cross-market surveillance and management of systemic risks.

(iv) To empower the investors to seek remedies for their losses, a private statutory right of civil action would be created. This would enable investors who had suffered losses as a result of market misconduct to seek redress through civil actions against persons responsible for that misconduct. Moreover, the White Bill proposed to create civil liability for false disclosure to market. This new proposal was not included in the July 1999 consultation. The Administration had considered the suggestion of providing statutory backing for the Listing Rules of the Stock Exchange of Hong Kong (SEHK Listing Rules). However, taking the advice of administrative law experts and market participants, it had decided to preserve the non-statutory nature of the Listing Rules so as to maintain the flexibility of these commercial rules in their administration.

(v) To respond to new market needs, a number of proposals were made under the new regime. For regulation of automated trading services (ATS), a flexible regulatory framework would be designed to protect investors without stifling innovations. ATS provider would be regulated as a licensee or an exchange, depending on the characteristics of each ATS. To allow for flexibility in the legislative framework to keep pace with market changes, there were built-in arrangements for the Financial Secretary to prescribe new products in securities and futures markets and to specify new investment arrangements and new market activities for regulatory purposes. In addition, the new regime empowered SFC to intervene in civil proceedings as third parties to provide its regulatory perspective and expert opinion.

(vi) To enhance accountability and transparency of the decision-making process and operations of SFC, a Securities and Futures Appeals Tribunal (SFAT) and a Process Review Panel (PRP) would be established.

4. The Chairman of SFC (Chairman/SFC) said that the composite Bill was one of the three major reforms for the securities and futures market. The other two reforms included the merger of the two exchanges and three clearing houses with the establishment of the Hong Kong Exchanges and Clearing Limited (HKEx), and the development of eFrastructure. These reforms

helped strengthen the competitiveness of Hong Kong as an international financial centre. He said that as the regulator of the securities and futures market, SFC needed adequate powers and discretion to perform its functions effectively. To this end, the composite Bill had proposed enhancements to SFC's supervisory powers. These powers were broadly in line with the international regulatory standard. In exercising its powers and performing its functions, SFC should be both accountable and transparent. Its decisions and operations would be subject to adequate checks and balances, such as the scrutiny of the proposed SFAT and PRP.

Discussion with members

Dual civil and criminal route to deal with cases of market misconduct

5. Mr Albert HO expressed concern about the proposals to deal with cases of market misconduct. As the composite Bill contained provisions to ensure that there was no double jeopardy of MMT inquiry and criminal prosecution, the sanctions available to MMT could not be imposed on persons convicted of an offence under criminal prosecution. He enquired whether sanctions available for the MMT could also apply to cases of market misconduct handled through the criminal route so that a wider range of and more appropriate sanctions could be provided. In addition, he sought information on whether professionals convicted of market misconduct under criminal proceedings would still be subject to the disciplinary sanctions by their own professional bodies.

6. DS/FS said that in accordance with human rights and the Basic Law principles, a person who had been acquitted or convicted of an offence by criminal prosecution under Part XIV of the Bill could not be made subject of an MMT hearing in respect of the same conduct under Part XIII and vice versa. SFC would follow the "Department of Justice Prosecution Policy: Guidance for Government Counsel" together with any supplementary guidelines it issued in determining whether to recommend proceedings before MMT or criminal prosecution. Criminal prosecution would be initiated where there was sufficient evidence to meet the criminal standard and it was in the public interest to bring prosecution against the most serious instances of market misconduct. However, the same suspected market misconduct could not be put before MMT even if the defendant was not convicted under the criminal proceedings. SFS said that professionals would still be subject to disciplinary sanctions of the professional organizations concerned whether or not they had been convicted of an offence under the criminal proceedings.

7. Mr Albert HO suggested that convicted criminal cases of market misconduct might be referred to MMT for consideration of appropriate penalty so that the sanctions available under MMT could be applied to criminal cases as well. The Chairman said that in the United States (US), the regulator could handle market misconduct cases by means of negotiation arrangements under

which a wide range of sanctions like fines, suspension of licence or disqualification of director of listed companies for a certain period of time could be imposed.

8. SFS said that although sanctions under the civil proceedings were not available if the case of misconduct was dealt with by criminal proceedings, the statutory private right of action would enable persons who suffered losses as a result of market misconduct to seek remedies from those responsible for the misconduct. Moreover, there were provisions in other ordinances which would impose restrictions on persons who were convicted of a criminal offence. For instance, it was likely that the provision under the Companies Ordinance which would disqualify the convicted person from assuming the director post in a listed company. SFS undertook to discuss with the law draftsman regarding members' concerns about market misconduct.

Access to auditors' working papers

9. Mr Eric LI had reservations about the new power of SFC to gain access to auditors' working papers in its inquiry into a listed company. He had expressed similar concern on behalf of the Hong Kong Society of Accountants (HKSA) about the propriety of the power at the Subcommittee meetings held in September 1999. However, the concern of HKSA was not fully addressed by the proposals in the Consultation Document. When compared with the power of regulators in overseas jurisdictions to obtain papers in relation to their investigation of a corporation, the power of SFC proposed in the White Bill appeared to be more extensive. From the findings of a research conducted by HKSA, the Australian regulator would only obtain the auditors' papers for assessment of the quality of their work and the regulator had to establish the need for acquiring the papers as well as to specify the type of papers required. He said that the power of SFC was also greater when compared with local authorities like the Inland Revenue Department (IRD) and the Independent Commission Against Corruption (ICAC). These two authorities both had to apply to the court with adequate proof that there were sufficient grounds for getting access to the papers concerned. He felt that the power given to SFC would be excessive and not subject to adequate checks and balances.

10. SFS said that the Administration had meetings with HKSA to discuss their concern regarding the power of SFC to gain access to auditors' working papers. He informed members that in response to this concern, the Administration had included provisions in the White Bill that SFC had to certify in writing that it had reasonable cause to believe that the record or document sought related to the affairs of the corporation under inquiry; that the auditor possessed the record or document relating to the affairs of the corporation; and that the record or document sought was relevant to the grounds for the inquiry.

11. DS/FS explained that apart from the above requirements mentioned by SFS, other safeguards would also be in place. For instance, if auditors refused to provide the working papers as requested, SFC had to apply for a court order and in this case it had to satisfy the court that it had reasonable grounds for gaining access to the papers. She explained that such power of SFC without recourse to a court order at the start was similar to that of the IRD and ICAC. ICAC only required a warrant to obtain documents from suspects. In response to the Chairman's question on the changes made to the proposal of gaining access to auditors' working papers after the consultation with HKSA, she said that in addition to the changes mentioned by SFS above, the threshold for seeking documents from auditors had been increased from "it appears to the Commission that there are circumstances of fraud or misconduct" to "the Commission has reasonable cause to believe….". Also the White Bill had included a defined term for "audit working papers" in response to HKSA's comments to delineate the nature of documents that SFC might ask for sight.

12. The Executive Director of Supervision of Markets/SFC (ED/SM) clarified that the Australian regulator was empowered to request for documents relevant to its investigation of a corporation from any party in possession of the document, except the legal professionals. While in the US, the regulator had similar power as its counterpart in Australia but the power would only apply to investigation of cases in relation to the securities market and not the futures market. The Executive Director of Intermediaries and Investment Products/SFC (ED/I&IP) added that the US regulator's access to the relevant documents was by means of a subpoena served on the party concerned. The US regulator would have to apply for a court order only if the latter refused to comply with the requirements in the subpoena. In the case of the Australian regulator, it had power to obtain papers in two aspects. The first one was a general power as explained by ED/SM above while the second one was a separate power for obtaining auditors' papers to prepare for preliminary materials for the disciplinary board of company auditors. These were two distinct powers for different purposes and should not be confused.

13. Mr Eric LI commented that the findings of the research by HKSA on practices of overseas jurisdictions appeared to be different from the situation described by the Administration above. Nevertheless, HKSA would study the proposals in the Consultation Documents in fuller detail and submit its comments to the Administration and the Subcommittee in due course. The Chairman opined that practices in overseas jurisdictions were all clearly stipulated in their legislation. It would be helpful if a comparison of relevant provisions in overseas legislation and that of the White Bill could be made to members so that a full picture of the international practice of the regulator's power in seeking documents from third parties in inquiry into listed companies could be provided. DS/FS said that the Administration had studied the practices in overseas jurisdictions and the information gathered was forwarded to HKSA for reference. However, as the regulatory framework in Hong Kong

was different from that in overseas jurisdictions, it would not be possible to make a direct comparison between them.

(*Post-meeting note*: The information note provided by the Administration on the comparison of the power of overseas regulators to obtain the working papers of the auditors was circulated to members vide LC Paper No. CB(1) 1474/99-00.)

14. Noting that auditors would have to bear the legal cost if SFC succeeded in obtaining a court order subsequent to their refusal to comply with SFC's request for information, the Chairman expressed concern about the difficulties would be encountered by small audit firms with limited resources to meet the legal cost involved. These firms might have no alternative but to comply with SFC's request, thus making the checks and balances of SFC's power in this respect meaningless. Mr Eric LI concurred and commented that as SFC's power to gain access to working papers was not subject to adequate checks and balances, auditors had to take up excessive responsibility in assisting SFC in its inquiries. He urged the Administration to introduce further checks on SFC by increasing the threshold to be met by SFC before exercising its power.

15. The Chief Counsel/SFC (CC/SFC) responded that HKSA's views expressed during the July 1999 consultation had been taken into consideration in drafting the White Bill. To address their concern about the type of documents SFC could gain access to, the White Bill had provided for the definition of audit working papers which meant any documents or records prepared by or on behalf of or obtained and retained by, an auditor for or in connection with the performance of any of his functions relating to the conduct of any audit of the accounts of a company (clause 164). She assured members that SFC would be very careful in exercising its power. She stressed that to maintain a fair, open and transparent securities market, it would be necessary for SFC to solicit cooperation of auditors in its inquiry into the financial status of a listed corporation. Moreover, auditors of listed corporations should be responsible to individual shareholders who would rely on the auditors' work to assess the financial status of a listed corporation.

Suspension of trading of a particular stock

16. Mr FUNG Chi-kin expressed concern about the criteria for suspending the trading of a particular stock when there was great fluctuation of its share price. He commented that suspension of trading would affect market operation and investors might suffer losses if there was a sharp fall in the share price upon the resumption of trading. The Chairman, while declaring interest as the non-executive director of SFC, said that SFC was aware of the impact of suspension of trading on market operation and there were only a few cases of suspension in the past ten years.

17. Chairman/SFC explained that suspension of trading was a measure to protect investors' interest. Whenever SFC's surveillance team detected any untoward movements in the prices and/or volume of shares, it would analyze the reasons behind such movements. If such movements of a company's share price appeared to be based on rumors or speculative comments, SFC would take appropriate follow up actions. The company concerned would have to explain the movement or request suspension of trading, depending on the nature of the case. Trading of the stock would be resumed as soon as possible when the company concerned had clarified the rumors or comments through appropriate means, such as disclosing relevant information to the public. ED/SM added that market surveys had revealed that the majority of the retail investors supported SFC for suspension of trading of particular stocks in the interest of investors when there were untoward movements in their prices which the company concerned could not explain.

Checks and balances on the power of SFC

18. In response to Mr FUNG Chi-kin's enquiry on the disciplinary actions on SFC officers who were found to have abused SFC's power, Chairman/SFC said that there was an internal mechanism in SFC to avoid the over-concentration of power in a small number of officers. Decisions would be made in a collective manner and there were operational guidelines for officers to follow so as to increase transparency and accountability. Moreover, the decisions of SFC were subject to judicial review as well as the monitoring of the proposed PRP. Its work would also be overseen by the office of the Ombudsman who would handle complaints from the public.

19. Mr Albert HO shared Mr FUNG's concern about the checks and balances on the powers of SFC. He sought information on the composition and operation of the PRP, whether it would look into individual complaint cases or just review the internal process of SFC generally. Moreover, he sought information on the role of the non-executive directors of SFC in handling complaints.

20. SFS explained that the PRP was established to review the internal process of SFC instead of handling complaints. Although it might come across individual complaint cases during its course of review, it was not set up for the purpose of receiving and handling complaints. There were other channels for appeals and complaints such as the SFAT and the office of the Ombudsman. Persons aggrieved by SFC's decisions might also seek judicial review. He advised members that the Administration and SFC were working out a proposal on the composition and operation of the PRP. The Administration fully appreciated the importance of a mechanism for checks and balances on SFC's powers and thus planned to establish the PRP in September 2000, well before the anticipated enactment of the composite Bill. The initial idea on the formation of the PRP was to make reference to the Operation Review Committee (ORC) of ICAC. Except for the Chairman and non-

executive directors of SFC, the majority of the PRP members including its Chairman would be independent persons appointed to oversee the work of SFC. A representative from the Department of Justice would be appointed as well. CC/SFC added that although the PRP was not established to handle complaints, reviewing the process of handling complaints by SFC would be part of its responsibilities.

21. As to Mr HO's question on the role of non-executive directors in the handling of complaints, the Chairman said that they would refer the complaints to SFC and these cases would be handled under the normal procedures as in other complaint cases. Chairman/SFC added that SFC had always tried to maintain transparency in its work. Complaints would be looked into in detail and problems detected would be rectified as soon as possible. SFC accorded great importance to the maintenance of a transparent, fair and open regulatory regime and thus supported the proposals of establishing the PRP and SFAT in the Consultation Document.

22. Mr Eric LI commented that it would not be appropriate for the PRP to follow the practices of the ORC in all aspects. From his experience in the advisory committees in ICAC, he noted that the ORC only dealt with closed cases where investigation had been completed. He said that it would be more desirable for the PRP to review cases which were still in progress rather than closed ones only. He urged the Administration to consider in detail the way of putting in place suitable mechanisms for complaints handling, process review as well as checks and balances on the powers of SFC. The Chairman opined that while putting in place these mechanisms, it would be important to note that excessive monitoring of the power of a regulator might place unnecessary obstacles to their work.

23. SFS thanked members for their views and said that the Administration would take these into consideration when formulating the composition and operation of the PRP. The Administration would keep the Financial Affairs Panel informed of the establishment of the PRP.

Other concerns

24. On the proposal of creating civil liability for disclosure of false information to the market, Mr FUNG Chi-kin expressed concern about the type of persons who would be held liable. He sought clarification of the liability of those analysing stock performance in the media.

25. DS/FS replied that the proposal was made in response to calls from the market that the quality of disclosure under the various regulatory requirements, especially those relating to listings, takeovers and mergers, needed to be strengthened. The White Bill contained provisions which would make a person civilly liable for disclosing to the public materially false or misleading information concerning securities or futures contracts that might

affect the price of securities and futures contracts. Any person who had suffered loss as a result of relying on such disclosure might claim damages from the person who was responsible for the disclosure. The provisions would provide a defence for persons acting in good faith, without knowledge and with due diligence. Therefore, those market analysts writing commentaries in the press would not be liable if they could meet the defence provisions above. Separate defences were available for people acting as "conduits" of such disclosure, such as reporters, Internet providers and publishers.

26. Mr Eric LI expressed dissatisfaction about the Administration's arrangements in releasing the Consultation Document and the White Bill. Instead of briefing the Legislative Council members before releasing the documents to the public, which was the Administration's normal practice, it held a press conference announcing the consultation exercise on 2 April 2000. He opined that without any document in hand, it had made Legislative Council Members difficult to respond to press enquiries about the White Bill. He also commented that it would be difficult for members to consider the proposals in detail without having the hard copy of the White Bill. He opined that while the White Bill was consolidating ten different ordinances, it should try to make improvement on the current legislation rather than copying the provisions from the existing statutes directly.

27. SFS explained that the White Bill was published for the purpose of consultation only. When the composite Bill was ready, probably in October or November 2000, the Administration would certainly follow the normal procedures of briefing LegCo before releasing the Bill to the public. He said that in drafting the White Bill, the Administration had been very mindful not to include provisions that were already in the common law unless otherwise on very strong grounds. The White Bill consolidated the ten existing ordinances and at the same time modernized the legal and regulatory framework. Drafting of the Bill had been guided by the considerations as elaborated at the beginning of his briefing. DS/FS added that the White Bill would be gazetted on 7 April 2000 and meanwhile, it was available at the web site of the Financial Services Bureau.

Way forward and future meetings

28. Members noted that there would be a three months' consultation which would end on 30 June 2000. The Chairman suggested and members agreed that the Subcommittee would invite submissions from the concerned organizations and a member of the public who had sent written submissions to the Administration during the July 1999 consultation. Members also agreed that the deadline for submissions to the Subcommittee would be on 15 May 2000. The Subcommittee would arrange meetings to hear the oral representations from deputations after they had submitted their views. In the meantime, members would consider the reform proposals of the White Bill at

the coming meetings. Members agreed that the next two meetings would be scheduled for Tuesday, 11 April 2000 at 2:30 pm and Friday, 14 April 2000 at 3:30 pm respectively.

(*Post-meeting note:* Invitation letters were sent to 18 organizations and a member of the public on 8 April 2000.)

29. The meeting ended at 12:50 pm.

Legislative Council Secretariat
22 September 2000