

Guide to

Legislative Proposals on

Supervision and Investigation of

Listed Companies and Intermediaries

(to be included in the Securities and Futures Bill)

5th July 1999

Introduction

1. The powers of the Securities and Futures Commission (the “Commission”) in connection with its supervision of intermediaries and its ability to investigate a variety of misconduct, including misconduct in the management of listed companies, are presently stated in Sections 29A, 30, 31, 33, and 36 of the Securities and Futures Commission Ordinance (the “SFCO”) as well as in corresponding sections in the Leveraged Foreign Exchange Trading Ordinance (the “LFETO”).
2. Section 29A gives the Commission the ability to seek the production of (and make some inquiries about) books and records when there are reasons to suspect fraud, misfeasance, or other misconduct in the management of a listed company, or that shareholders have not received information to which they are entitled. It is important to note that this power may be invoked only after misconduct is believed to have occurred, and is not a general power of corporate regulation.
3. Under Section 30, a person authorised by the Commission may enter the premises of an intermediary to inspect any record or document (and make copies) for purposes of ensuring compliance with legal requirements and licensing conditions. This allows the Commission to conduct periodic as well as special examinations of the intermediaries it has licensed, and is an essential component in monitoring ongoing compliance with regulatory provisions.
4. Section 31 provides the Commission with the power to obtain information about transactions in securities and futures from licensed persons as well as persons with an interest in such transactions. This is a necessary power for

the collection of evidence for prosecutions or other action against violations of securities law, as well as for the gathering of information useful in market surveillance.

5. Under Section 33, if there are reasons to believe that an offence, a defalcation or other breach of trust, fraud or misfeasance, insider dealing or other forms of market misconduct, or an act contrary to public interest has been committed, the Commission may initiate an investigation. Furthermore, if it is necessary to appoint (with the consent of the Financial Secretary) a person outside the Commission to carry out the investigation, special funding can be sought from the Legislative Council.
6. Section 36 provides that the Commission may apply to a Magistrate for a search warrant necessary for searching a premise and seizing evidence.
7. The powers provided under Sections 31, 33 and 36 have proven to be effective and adequate, and would be reenacted by the proposed Securities and Futures Bill (the “Composite Bill”). There is, however, an amendment required to Section 33 to empower the Commission to investigate whether or not a licensed person, or a person involved in the management of a licensed person, has committed misconduct or is a fit and proper person to remain licensed or involved. The need for such an amendment is discussed in detail in paragraphs 30 to 36 below.
8. The Commission has encountered certain difficulties when seeking to exercise its powers under Sections 29A and 30. The Composite Bill will therefore include several minor amendments that would rationalize these powers and enable the Commission to perform its functions properly. The difficulties the

Commission has encountered to date as well as the proposed amendments are discussed in detail in paragraphs 9 to 29 below.

Section 29A

9. As mentioned earlier, Section 29A empowers the Commission (or a person authorised by the Commission) to seek the production of books and records when there are reasons to suspect fraud, misfeasance, or other misconduct in the management of a listed company, or that shareholders of a listed company have not received information to which they are entitled. The section also states that the Commission may ask for explanation of entries on the books and records.
10. In practice, however, the power to ask for explanation has been interpreted as only requiring a description of what an entry relates to, and not an explanation of the circumstances in which that entry was made. The Composite Bill will rectify this deficiency in Section 29A by expressly empowering the Commission to ask for explanation as to the circumstances, reasons, and instructions for the making of an entry in the books and records.

Transaction Counterparties, Auditors, and Banks

11. In addition, the Commission currently has no ability to verify the information obtained from a listed company with its auditors, suppliers, customers, and transaction counterparties. This leaves the Commission unable to ascertain the real nature of the company's transactions – or purported transactions.
12. Transaction Counterparties. The Commission has conducted seven Section 29A inspections to date. These investigations were impeded on each

occasion by the inability to make enquiries with counterparties in questionable transactions. Examples of instances where the Commission was unable to seek explanations from counterparties include:

- a listed company repeatedly entered into substantial financial transactions at the end of accounting periods. Subsequent to each such transaction, a second transaction of an identical nature took place with the same counterparty but in the reverse;
- a listed company's books and records show it has purchased assets at what appear to be inflated prices from counterparties apparently connected with the company's management; and
- a listed company's books and records show substantial sales to counterparties in sizes disproportionate to the counterparties' ability to enter into such purchases.

Had the Commission been able to seek explanations from those counterparties, a more accurate assessment of the propriety of the transactions in question would have been possible.

13. Auditors. Corporate regulation in Hong Kong relies significantly on auditors. The auditor of a listed company is required to form an opinion on the financial affairs of that company, including its operational results for a given period. As part of the verification process, the auditor will conduct sample checks of figures appearing in the listed company's books, including verification of balances due from or to third parties.
14. Access to an auditor's working papers during a Section 29A inspection could be of great assistance in that the auditor:

- might have checked a transaction that is the subject of potential scrutiny, have obtained all relevant supporting documentation in relation to that transaction, and have sought explanations from management concerning that transaction;
 - would have calculated provisions which can provide essential information in regard to the quality of assets, the reasons why provisions are necessary, and the basis for arriving at such provisions; and
 - would have verified the profit and loss statement of the listed company, which again can provide essential information as to booking of profits and losses resulting from the company's various business activities.
15. Such information, which might include correspondence with a listed company explaining the basis of calculations, the accounting policies adopted, and internal control issues, can curtail the need for further inquiry under Section 29A. It might also provide essential information to assist a Section 29A inspection, such as identifying how and by whom accounting documents are maintained for the listed company, verification of explanations provided during an inspection, and confirmation of the existence of certain records or documents.
16. The Composite Bill will therefore authorise the Commission to obtain the working papers of the auditor of a listed company, its subsidiaries, or any other company substantially under the control of the listed company. To exercise this power, the Commission must first certify in writing to the auditor that it has already imposed a requirement on the company to produce its books and records.

17. It is stressed that the power to seek access to an auditor's papers is not aimed at assessing the quality of audit work performed. Furthermore, the proposal is in line with an international trend in ensuring that auditors not only take into account their client's interest but also the interest of the investing public, who relies heavily on the auditor to confirm that a listed company's accounting statements give a true and fair view of its financial affairs.
18. The Composite Bill will also resurrect the legislative proposal for providing immunity to auditors in reporting suspected fraud or misconduct in a listed company's accounting to relevant regulatory authorities. The proposal was initially included in the Securities and Futures Commission (Amendment) (No. 2) Bill, as gazetted on 29 November 1996. Auditors may chose to report to the board of directors, or the audit committee (if there is one), of a listed company in the first instance. To do so should not deprive the auditors of the proposed immunity, if they chose to report to the regulatory authorities afterwards.
19. Banks. Existing Section 29A contains a potential drafting defect that might leave doubt as to the Commission's ability to seek information from banks, although the intent is quite clear. The Composite Bill will rectify this point by expressly allowing the Commission access to the banking records of companies on which the Commission may otherwise exercise its inspection powers. The Commission, however, will have to first certify to the bank that it has initiated an inspection (by imposing a requirement on the listed company to produce its books) and that the banking records are relevant to the inspection.

20. The Commission has consulted the Hong Kong Monetary Authority on this clarifying amendment, and HKMA is agreeable to the proposal.

Purpose of These Amendments and Role of the Commission

21. The amendments described above would not change the purpose of the existing provision. Section 29A is intended to provide for a preliminary inquiry of suspected misconduct. If appropriate, such an inquiry could lead the Commission to apply to the courts for restraining orders or receivership under Section 37A of the SFCO, or to refer the matter to the Financial Secretary with recommendation for a full inspection under Section 143 of the Companies Ordinance. (Section 127 of the SO, which authorises the Commission to appoint an inspector, will not be reenacted as it duplicates other provisions.)
22. It is important to emphasize that neither Section 29A, nor the proposed amendments, will make the Commission a corporate regulator. In Hong Kong, responsibility for overseeing the business conduct and activities of public companies is distributed among many persons and organizations – certified public accountants, the Registrar of Companies, the Commercial Crime Bureau of the Hong Kong Police, the Independent Commission Against Corruption (“ICAC”), the Stock Exchange of Hong Kong Limited (“SEHK”), the Commission, and the Financial Secretary.
23. The Registrar of Companies ensures filing of statements by companies incorporated or registered in Hong Kong, and is concerned with the limited liability status of these entities. SEHK sets listing, disclosure and corporate governance requirements for public companies, monitors compliance and

punishes breaches. An auditor examines (usually annually) a company's documentation of transactions as well as presentation of its financial position. The Police and ICAC are involved only when fraud, deceit, or corruption is suspected, and is concerned with criminal punishment of such wrongdoing through the courts. The Financial Secretary has the authority to appoint company inspectors.

24. The Commission's role is to assist by making preliminary inquiries where appropriate, to oversee SEHK in enforcement of the listing rules, and to ensure compliance with legal requirements on disclosure of interests. Its mandate is primarily that of a securities and futures regulator, and not the supervision of corporate governance.

Section 30

25. As mentioned earlier, under Section 30, a person authorised by the Commission may enter the premises of an intermediary to inspect any record or document (and make copies) for purposes of ensuring compliance with legal requirements and licensing conditions.
26. Experience has shown that the activities of non-intermediary companies within a group can have a significant impact on the business of an intermediary. Indeed, the recent failure of the Peregrine Group serves as an apt example of how problems in one part of a family of enterprises can cause problems for the entire group, including regulated intermediaries.
27. In light of such, the Composite Bill proposes to expressly state that the Commission may enter the premise of an intermediary and exercise its power of inspection over matters relating to the intermediary, its related companies,

as well as companies that are substantially under the same control as the intermediary. This power already exists under Section 41 of the LFETO. Furthermore, in a recent ruling by the Court of First Instance (In the Matter of Mansion House Capital Limited, M.P. 6485/98), the Court made a declaration that such is already within the present scope of the Commission's power under Section 30 of the SFCO. The amendment proposed in the Composite Bill would merely clarify and make this explicit.

28. A second deficiency with Section 30 is that there is no opportunity to ask questions about the records or documents already subject to inspection. The Composite Bill will rectify this by expressly allowing the inspector to make inquiries about the records and documents, as well as about transactions and activities that were undertaken in the course of, or that might affect, the business of the intermediary. Such a power is necessary for an inspection to be meaningful and productive.
29. The Composite Bill will also make clear that the scope of an inspection covers not only compliance with statutory requirements and provisions in subsidiary legislation, but also codes of conduct, guidelines, as well as terms and conditions of a licence or exemption.

Section 33

30. At present, Section 56 of the Securities Ordinance (the "SO") and corresponding sections in the Commodities Trading Ordinance and LEFTO require the Commission to conduct an inquiry before it can revoke, suspend, or reprimand an intermediary. The Composite Bill will first streamline the disciplinary process by eliminating the inquiry as a prerequisite, as experience

has shown that misconduct by intermediaries is often identified in other statutory investigations or inspections. Secondly, the Commission's inquiry function under Section 56 will be merged into its investigatory powers, currently stated in Section 33 of the SFCO. In doing so, the Commission's power to inquire will be brought into line with the investigatory power to obtain information. This will address the occasions where an investigation, or further investigation, will be necessary before disciplinary action is taken. The proposed revision to Section 33 is discussed in paragraph 32 below.

31. At present, an inquiry under Section 56 depends on the voluntary cooperation of registered persons and persons with information relevant to the inquiry. The Commission does not have the power to compel production of information, explanations, or answers to specific questions. The absence of express powers in conducting an inquiry should be rectified.
32. The Composite Bill will add a provision to the equivalent of Section 33 of the SFCO, authorising the Commission to conduct an investigation as to whether an intermediary or a person involved in the management of an intermediary has committed misconduct, or is fit and proper to remain so licensed or involved. The amendment will provide the Commission with the same powers to require production of information and attendance before the investigator when conducting an inquiry as when conducting other investigations.
33. Similar powers are already available to the Commission under Section 12(2) of the LFETO. The Composite Bill will only rectify the deficiency currently found in the other ordinances and thereby rationalize the Commission's authority across all areas.

34. Allowing the regulator such powers in investigating the conduct of a licensed person is accepted practice in other leading jurisdictions. In the United States, Section 21 of the Securities Exchange Act (as well as Sections 19 and 20 of the Securities Act) allows the Securities and Exchange Commission discretion to “make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate” any provision of the statutes, regulations, or rules. The section further states that, in conducting such an investigation, “any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry”.
35. For the United Kingdom, Section 97 of the proposed Financial Services and Markets Bill states that “if there are good reasons for doing so”, the Financial Services Authority (the “FSA”) may initiate an investigation into “the nature, conduct or state of the business of an authorised person or of an appointed representative”. In addition, Section 100 allows the FSA to commence an investigation “if it has reasonable grounds for suspecting that an individual is not a fit and proper person to be employed in connection with any kind of regulated activity, or a particular kind of regulated activity”. The powers of investigators are set out in Section 104, and include the power to compel a person to attend a hearing and to answer questions under oath, as well as the power to require the production of documents.
36. The powers of the regulator in Ontario, Canada in this regard are perhaps the widest. Under Sections 11 and 12 of the Ontario Securities Act, the Ontario

Securities Commission may “make such investigation [and financial examination] with respect to a matter as it considers expedient for the due administration of Ontario securities law or the regulation of the capital markets in Ontario”. In addition, an investigator or examiner “has the same power to summon and enforce the attendance of any person and to compel him or her to testify on oath or otherwise, and to summon and compel any person or company to produce documents and other things, as is vested in the Ontario Court (General Division) for the trial of civil actions”. Furthermore, this power is self-executing in that “the refusal of a person to attend or to answer questions or of a person or company to produce such documents or other things as are in his, her or its custody or possession makes the person or company liable to be committed for contempt by the Ontario Court (General Division) as if in breach of an order of that court”.

A Note on Checks and Balances

37. The Commission strongly believes that administrative power should be complemented with adequate checks and balances. Accordingly, even though the investigatory powers discussed above have been carefully crafted to limit their application to the necessary circumstances, and the proposed amendments are minor in nature, the Composite Bill will nevertheless contain a number of procedural safeguards and review mechanisms with respect to the investigations so authorised.

Beginning an Investigation

38. Statutory Thresholds. As mentioned above, the application of the Commission's investigatory powers is limited to specific circumstances. For an investigation of a listed company, the Commission must first have reasons to suspect fraud, misfeasance, or other misconduct in the management of the company, or that the shareholders have not received information to which they are entitled. As for investigation of improper market activities, the Composite Bill will expressly set out the reasons (such as fraud, defalcation, insider dealing, contravention of statutory prohibitions etc.) based on which the Commission may begin an investigation. These statutory thresholds will help ensure that the Commission exercises its investigatory powers reasonably and appropriately.
39. The Commencement of an investigation. As a matter of policy, the Commission has delegated its power to appoint one or more of its employees to investigate a matter only to senior staff members of the Commission's Enforcement Division (Directors and above), the Chairman, and the Executive Director of the Corporate Finance Division.
40. Authorised Financial Institutions. The Commission is required to provide written certification of relevance when directing inquiries at banks or other authorised financial institutions. This power is again only delegated to senior staff members of the Commission's Enforcement Division (Directors or above) and the Executive Director of the Corporate Finance Division.

Conduct of Investigations

41. Legal Representation. In all investigations concerning misconduct or improper market activities, a person (including the person under investigation)

will have the right to legal representation. His legal adviser may attend any examination of that person, and may reasonably ask questions of the person as well as address the investigator.

42. A Person Must be Told of His Right Against Self-Incrimination. With respect to all investigations under the provisions of the Composite Bill, before the investigator directs a question or request for explanation to the person under investigation, a witness, or any other person, the investigator must first inform that person of his right against self-incrimination. If a statement might tend to incriminate the person making it, and he so claims in advance, then the statement as well as the requirement on the person to make the statement will not be admissible in any subsequent criminal proceedings (except for offences of perjury).
43. Secrecy and Confidentiality Obligations on the Commission. The Composite Bill will expressly impose on the Commission stringent requirements as to secrecy and confidentiality, and the Commission will be obligated not to disclose information it obtains in the course of an investigation except in formal reports or under certain other limited circumstances.
44. Magistrate's Warrants. The Commission's power presumes cooperation on the part of the relevant persons. An investigator cannot forcibly enter a premise or seize a record or document. A warrant is needed in this regard, and the Commission will have to go through the necessary judicial procedures.

External Independent Review

45. Process Review Panel. Aspects of the Commission's supervisory and investigatory functions, like other areas of its work, are necessarily subject to

privacy and confidentiality requirements of law. Specific information cannot always be publicly disclosed. To bridge this gap, an independent panel to review the Commission's internal operations will be established. As currently envisaged, the panel will comprise a majority of independent, prominent public persons, to be appointed by the Chief Executive, as well as some non-executive directors of the Commission. The panel will make its report to the Financial Secretary.

46. Judicial Review. Parties may also seek complete judicial review by the Court of Appeal.
47. Office of the Ombudsman. The Commission's work is subject to the jurisdiction of the Ombudsman. Any person who is dissatisfied with the Commission's conduct may lodge a complaint with the Ombudsman, who will determine whether an inquiry or intervention might be justified.

Public Consultation

48. The above proposals are necessary in order for the Commission to perform its supervisory and investigatory functions properly. The Government and the Commission recognise that administrative authority must be placed within a system of checks and balance. As discussed above, the Composite Bill will build a number of procedural safeguards into the Commission's exercise of its powers. Furthermore, we are presently undertaking a major initiative to subject the Commission to external independent review.
49. The Government and the Commission believe the proposals detailed in this Guide will improve the regulatory framework and put it on par with the best of international standards, thereby enhancing Hong Kong's competitiveness as an

international financial centre. Comments and views are sought from the financial community and general public. Please write to the Securities and Futures Commission, 12th Floor, Edinburgh Tower, The Landmark, 15 Queen's Road Central, Hong Kong, or email to <newbill@hksfc.org.hk>. In view of the tight legislative timetable, we would be grateful if your comments and suggestions could reach the Commission before 6 August 1999.