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Legislative Council

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Legislative Council
Panel on Financial Affairs

Minutes of meeting held on
Monday, 5 July 1999, at 9:00 am
in the Chamber of the Legislative Council Building

Members present	**:**	Hon Ambrose LAU Hon-chuen, JP (Chairman) Hon Eric LI Ka-cheung, JP (Deputy Chairman) Hon Kenneth TING Woo-shou, JP Hon James TIEN Pei-chun, JP Hon David CHU Yu-lin Hon Albert HO Chun-yan Hon Martin LEE Chu-ming, SC, JP Dr Hon David LI Kwok-po, JP Hon NG Leung-sing Hon Ronald ARCULLI, JP Hon James TO Kun-sun Hon CHEUNG Man-kwong Hon Ambrose CHEUNG Wing-sum, JP Hon HUI Cheung-ching Hon Bernard CHAN Hon SIN Chung-kai Dr Hon Philip WONG Yu-hong Hon Jasper TSANG Yok-sing, JP Hon Timothy FOK Tsun-ting, SBS, JP Hon FUNG Chi-kin
Members attending :		Hon CHAN Yuen-han Hon CHAN Kam-lam
Members absent :		Hon Cyd HO Sau-lan Hon Margaret NG

Public officers attending	:	**Item III** Mr Edmond LAU Acting Executive Director (Banking Policy) Hong Kong Monetary Authority Miss Clara TANG Principal Assistant Secretary for Financial Services **Item IV** Mr Bryan CHAN Principal Assistant Secretary for Financial Services **Item V** Mr CHAN Yum-min, James Principal Assistant Secretary for Financial Services **Items V and VI** Miss AU King-chi Deputy Secretary for Financial Services **Item VI** Ms Julina CHAN Principal Assistant Secretary for Financial Services
Attendance by invitation	:	**Item IV** Mr Alec TSUI Chief Executive of The Hong Kong Stock Exchange Limited **Items V and VI** Mrs Laura CHA, JP Acting Chairman of Securities and Futures Commission

Item V

Mr Mark DICKENS
Executive Director of Securities and Futures Commission

Mr Andrew Procter
Executive Director of Securities and Futures Commission

Item VI

Mr KAM Pok-man
President of Hong Kong Society of Accountants

Mr Roger BEST
Vice-President of Hong Kong Society of Accountants

Mr Andy LEE
Vice-President of Hong Kong Society of Accountants

Mr Louis WONG
Registrar of Hong Kong Society of Accountants

Mr James FAWLS
Director of Professional Standards
Hong Kong Society of Accountants

Mr Raphael DING
Director of Professional Conduct
Hong Kong Society of Accountants

Item VII

Mrs Marian LI CHAN Sien-mun
Chief Executive Officer
Exchange Fund Investment Limited

Ms Karen Deborah KEMP
Deputy Chief Executive Officer
Exchange Fund Investment Limited

Clerk in attendance : Ms Estella CHAN
Chief Assistant Secretary (1)4

Staff in attendance : Ms Connie SZETO
Senior Assistant Secretary (1)1

Item V

Mr KAU Kin-wah
Assistant Legal Adviser 6

I Confirmation of minutes and matters arising
(LC Paper Nos. CB(1)1591, 1592 and 1622/98-99)

The minutes of the meetings held on 7 January, 1 February and 1 March 1999 were confirmed.

II Information paper issued since last meeting

2. Members noted that no information paper had been issued since last meeting.

III Banking Sector Consultancy Study
(LC Paper No. CB(1)1569/98-99(01))

3. The Acting Executive Director (Banking Policy), Hong Kong Monetary Authority (ED/BP(Atg)(HKMA)) briefed members on the information paper which summarized the comments received during the three-month consultation exercise on the recommendations of the Hong Kong Banking Sector Consultancy Study (the Study). He said that there was a large measure of support from both the banking industry and other sectors of the community for both the general direction and most of the specific recommendations of the Study, although there were different views on the timing and manner of implementation of certain proposals, such as the phased deregulation of the Interest Rate Rules (IRRs) and the study to enhance explicit depositor protection. Detailed consideration of the various operational and legal issues related to the recommendations was underway. It was expected that a coherent package of policy responses including the implementation plan of the appropriate recommendations would be drawn up before August 1999.

4. Mr Martin LEE said that the Democratic Party shared the Consumer Council (CC)'s view that full deregulation of IRRs should be implemented as soon as possible. He considered the banking sector's general view of deferring the deregulation programme to beyond year 2000 too conservative. On the other hand, Mr FUNG Chi-kin expressed concern about possible costs of IRR deregulation to consumers, such as increases in lending rates and service charges. He asked about CC's view in this respect.

5. ED/BP(Atg)(HKMA) responded that the banking sector generally supported gradual liberalization of IRRs. Whilst the Hong Kong Association of Banks opined that the time was not ripe for further deregulation of IRRs in view of the current recessionary economic climate and the uncertainty due to the Year 2000 issue, the Deposit Taking Companies Association suggested postponing the deregulation programme until all indicators as recommended in the Study became favourable and the Hong Kong economy recovered to positive Gross Domestic Product growth trend for three years. On the other hand, CC questioned whether there was in fact a justifiable concern that full deregulation would have serious impact on the profitability of banks and hence the stability of the banking system. On the concern about possible costs of IRR deregulation, ED/BP(Atg)(HKMA) remarked that while CC had not commented on this aspect, HKMA envisaged that competition among banks was likely to increase with deregulation and would bring about both benefits and costs to bank customers. He stressed that HKMA had been proceeding with a phased approach on deregulation of IRRs since 1994 and so far had achieved in removing interest rate cap on more than 99% of all fixed time deposits. In taking forward the consultants' recommendation on IRR deregulation, HKMA would carefully consider the views of various parties and pay due regard to the need of maintaining the stability of the banking system, and the benefits and costs of the deregulation programme to the community at large. In particular, HKMA noted CC's recommendations of providing a clear definition of the indicators for triggering the deregulation programme, and making known relevant assessment results to the public so as to enhance the transparency and certainty of the deregulation process.

6. On the recommendation for HKMA to clarify its role as the lender of last resort (LOLR) in Hong Kong to support troubled institutions, Mr CHEUNG Man-kwong expressed concern about HKMA's discretionary power in using the Exchange Fund (EF) in invoking its role as LOLR. He pointed out that the situations under which EF could be used for defending the value of the Hong Kong dollar were not clearly stipulated in the Exchange Fund Ordinance (EFO) (Cap. 66).

7. In reply, ED/BP(Atg)(HKMA) said that HKMA considered its role as LOLR an important element of the safety net for the banking system and recognized the need to make such support more predictable in order to provide certainty to banking institutions. Besides the speech given by the Chief Executive of HKMA recently clarifying and elaborating on HKMA's policy and practice in this respect, a policy statement setting out the details including, inter alia, criteria for LOLR support and the resources available for HKMA to take on the role, had been issued to all institutions.

8. ED/BP(Atg)(HKMA) further explained that there were provisions under EFO specifying that the Financial Secretary, with a view to maintaining Hong Kong as an international financial centre, might use EF to maintain the stability and integrity of the monetary and financial system of Hong Kong; and that HKMA was delegated with the authority to make day-to-day decisions on the use of EF having regard to the primary purpose of EF. As such, EFO had made it clear that the use of EF, including for the purposes of providing LOLR support, had to be for systemic purposes.

9. As regards the concern about compatibility of the LOLR function with HKMA's other role as a defender of the currency, ED/BP(Atg)(HKMA) remarked that the policy statement had also addressed the issue and identified ways in which the exercise of the function could be accommodated under the principles of a currency board system.

10. On the issue of improving the transparency of HKMA in exercising its discretionary power with regard to the LOLR function, ED/BP(Atg)(HKMA) stressed that a certain degree of constructive ambiguity in specifying its LOLR role was necessary in order to reduce the risk of moral hazard. The flexibility retained by HKMA in this respect was also seen in overseas regulatory counterparts. The policy statement aimed to strike a balance between transparency on the one hand and flexibility on the other.

11. Upon members' request, ED/BP(Atg)(HKMA) undertook to provide the Panel and CC with a copy of the policy statement for their reference.

(*Post-meeting note*: The policy statement was circulated to members vide LC Paper No. CB(1)1673/98-99.)

12. On Mr Kenneth TING's suggestion of providing guidelines requiring banking institutions to put more emphasis on the track record and business prospects of the borrowing enterprises instead of following the general practice of taking property as the main form of collateral in granting loans, ED/BP(Atg)(HKMA) remarked that it might be inappropriate to draw up such guidelines. HKMA, as the regulator of banks was concerned with whether institutions had adopted prudent lending policy and managed their risks appropriately to avoid over-exposure to volatile assets. Nonetheless, HKMA recognized the need for the banking industry to diversify its business to include more commercial lending rather than concentrate on property-related loans. It was believed that with the consultants' recommendations to improve the safety and soundness of the banking system, there would be further impetus for banks to enhance their risk management systems.

IV Progress of development of Growth Enterprise Market
(LC Paper No. CB(1)1637/98-99(01))

13. Mr James TIEN declared interest as a member of the Advisory Committee for overseeing the work of the Working Group on New Markets which was established in 1997 to study issues related to the establishment of a Venture Board (now renamed as the Growth Enterprises Market (GEM)).

14. Members were briefed on the progress of development of GEM. They noted that preparation of GEM Listing Rules was at an advanced stage and would be submitted to the Stock Exchange of Hong Kong (SEHK) Council and the Securities

and Futures Commission (SFC) for approval in July 1999. About 40 companies had expressed interest in applying for listing on GEM. It was expected that the first listing would take place after October 1999. SFC had been actively discussing with the China Securities Regulatory Commission (CSRC) on cooperation matters relating to the regulation of GEM.

15. Responding to enquiries about details of listing on GEM, Mr Alec TSUI, Chief Executive of SEHK said that there would be no profit requirement on enterprises. Issuers had to produce accountant's reports of the company for two financial years prior to listing and appoint sponsors (who were on SEHK's approved sponsors' list) to assist in the Initial Public Offer (IPO) and advise the company for two financial years after listing. Sponsors could be existing shareholders of the issuers and there would be no limit on shareholding of the company by sponsors. Underwriting was not compulsory at the time of IPO. Due to the higher risk involved in GEM since the majority of the enterprises were expected to be of small to medium sizes involving young and emerging businesses, there would be risk warning requirements where all listing documents and circulars to shareholders had to contain risk warnings emphasizing the higher risk profile of GEM. Clients would be asked to sign a client agreement and risk acknowledgement statement designed for trading on GEM. Mrs Laura CHA, Acting Chairman of SFC, supplemented that professional fees involved in listing would be mutually agreed between the issuers and the sponsors and professional advisers involved. GEM sponsors were expected to include licensed financial advisers, commercial banks, securities dealer firms, etc. To enhance investors' understanding of GEM and their awareness of the higher risks involved, SFC and SEHK would conduct a series of publicity and investor education programmes with the launch of GEM.

16. Pointing out that the Asian financial turmoil had resulted in a significant drop in share prices of over half of the listed companies on the Main Board, hence causing losses to a lot of small investors, Mr FUNG Chi-kin opined that it would be more necessary for SEHK and SFC to step up with regulation of the Main Board. Noting the apparent lax listing requirements for GEM as compared with those for the Main Board, he also queried the inconsistency in regulation of the two markets.

17. Mrs Laura CHA commented on the regulation of the Main Board that apart from ensuring compliance with the listing requirements when companies applied for initial listing on the market, SFC and SEHK also continued to monitor the listed companies' compliance with relevant regulatory requirements and the Listing Rules subsequently. However, under the current regime, regulators did not make judgement on the commercial viability of companies and their businesses. They required that proper disclosures be made so that investors could make their own investment decisions. Because of the greater risks involved in investing in GEM, the quality of disclosure was all the more important. Whilst GEM would be subject to a stricter and more onerous disclosure regime, other regulatory measures would be the same as those for the Main Board. SFC and SEHK would cooperate closely in supervising the new market to ensure compliance with the rules and taking enforcement actions against any

breaches of rules and market misconduct. Apart from the proposal to impose criminal sanction against misconduct by persons and companies providing false information, affected investors would also have access to statutory private right of action to seek remedies for market misconduct under the future Securities and Futures Bill.

18. The Principal Assistant Secretary for Financial Services said that the Administration supported the establishment of GEM which would help growth enterprises both locally and in the region to raise capital. These enterprises although with good business ideas and growth potential, might not fulfil the two-year profit record requirements of the Main Board. The successful experience of second boards in major overseas markets had proven that it was viable for exchanges to provide an alternative avenue for capital raising for growing enterprises.

19. Mr Philip WONG urged SEHK to explore the possibility of introducing a "market maker" system with a view to improving the overall liquidity of the local stock market, in particular, for those third or fourth line stocks with extremely inactive trading. Such system would provide a means for investors to exit from the market.

20. In response, Mr Alec TSUI pointed out that despite some similar form of "market marker" system was adopted in Nasdaq in the U.S., the system had not been successful in improving the liquidity of third and fourth line stocks in the market. Investors' investment in particular shares, ultimately, depended on their assessment of the performance and potential of the companies concerned. SEHK was actively pursuing the feasibility of introducing the system currently adopted by some European exchanges into Hong Kong for improving market liquidity. Mrs Laura CHA added that besides the problem of the huge capital base required for a market maker, the unique situations in the local market also cast doubt on the appropriateness of adopting such a system in Hong Kong, not to mention the complicated legal and technical issues involved. Nonetheless, SFC and SEHK would continue to study means to enhance liquidity of the local market.

V The Composite Securities and Futures Bill

(LC Paper No. CB(1)1637/98-99(02), the presentation material issued subsequently vide CB(1)1669/98-99)

21. Mr Ronald ARCULLI declared interest as a non-executive director of SFC.

22. The Deputy Secretary for Financial Services (DS/FS), with the aid of audio-visual facilities, presented the major proposals to be enshrined in the composite Securities and Futures Bill (the Bill) planned to be introduced into the Legislative Council (LegCo) by the end of 1999.

23. Members generally supported the board direction of the Bill which aimed at modernizing the securities and futures regulatory framework of the Hong Kong market

to keep it on par with the best of international standards, hence enabling it to compete effectively in the international arena. However, in view of the complexity of the Bill, the voluminous and contentious nature of the proposals as well as their significant impact on the market and its players, some Members stressed the necessity of providing sufficient time for LegCo to scrutinize the Bill and conducting consultation with market bodies and the public. On the other hand, noting the rapid developments in the global financial services industry, some Members shared that the current securities legislation in Hong Kong had to be updated as soon as possible so that the regulatory regime would not lag behind rapid changes and developments. In this connection, Mr Martin LEE enquired about the possibility of proceeding with the straightforward legislative proposals first and deferring those complex and contentious proposals to until after consultation with parties concerned.

24. In response, DS/FS reiterated the need to implement the legislative reform in the securities and futures market as early as possible to effect a modern and flexible regulatory framework in response to rapid changes in the market, to facilitate development of new financial products and trading methods, as well as to plug the loopholes in the system exposed by the Asian financial turmoil. The Administration considered a major overhaul of the securities legislation necessary and more desirable than taking a phased approach in undertaking the reform since the existing legislation had been enacted for over 20 years and needed consolidation and streamlining to facilitate users and to provide investors with appropriate protection. External competition and the accelerating pace of change necessitated the industry, Administration and regulators to act quickly and decisively. DS/FS further stressed that notwithstanding the voluminous proposals in the Bill, they were built upon an earlier draft prepared by SFC and released for public consultation in 1996. Hence, apart from new elements added due to recent developments in the market, the majority of the legislative proposals were not entirely new. With a view to expediting the legislative process, the Administration had commenced drafting of the Bill, and prepared to launch a public consultation on the various proposals from 5 July 1999 onwards, presentation at the Panel being the curtain raiser. Whilst the information paper presented to the Panel had outlined the major proposals of the Bill, more details on each of the proposals would be uploaded onto the internet and available for public comments on 5 July 1999. She undertook to provide Members with the detailed proposals after the meeting.

(*Post-meeting note*: The detailed proposals and the "Overview Guide on the Proposed Securities and Futures Bill" were circulated to Members vide LC Paper Nos. CB(1)1687 and 1695/98-99 respectively.)

25. Mr Eric LI conveyed Hong Kong Society of Accountants (HKSA)'s reservation over the proposals to allow SFC access to the working papers of auditors in connection with SFC's investigation into the management of listed companies, and to provide statutory immunity to auditors of listed companies who reported suspected fraud and practices to relevant regulatory authorities. HKSA was concerned about the apparent lack of adequate check on SFC's investigative power and was of the view that the

"whistle blowing" obligation imposed on the accounting professionals might adversely affect the confidential relationship with their clients.

26. On the concern about the legislative proposal of providing immunity to auditors in reporting suspected misconduct of a listed company, DS/FS clarified that the proposal was previously introduced into LegCo in 1996. The Bill would resurrect this proposal. Under the proposal, auditors might still choose to report the misconduct to the board of directors, and/or the audit committee (if there was one) of a listed company in the first instance. By doing so, auditors should not be deprived of the proposed immunity if they chose to report to the regulatory authorities afterwards.

27. As regards the concern about granting SFC the power to seek access to auditors' working papers, DS/FS stressed that the proposal was to enhance the effectiveness of SFC's inquiry into suspected market misconduct of listed companies. Such power was also available to regulatory counterparts of overseas jurisdictions. The Administration recognized the need to provide proper checks and balances on the exercise of SFC's power in this respect. The proposal for a Securities and Futures Appeals Tribunal (SFAT) under the Bill and the establishment of a Process Review Panel (PRP) through administrative procedures, aimed to provide adequate checks and balances commensurate with the increase in SFC's regulatory powers. Mrs Laura CHA supplemented that SFC was committed to enhancing its accountability to the public and transparency in exercising its various powers. Besides setting up the new independent PRP to review the internal operations of SFC including its investigatory process and procedures, the existing Securities and Futures Appeals Panel would be upgraded and expanded to SFAT, to be vested with a broader remit and operated on a full-time basis. Moreover, SFC being a public body was subject to provisions of the Prevention of Bribery Ordinance (Cap. 201) and the Ombudsman Ordinance (Cap. 397). Mr Mark DICKENS, the Executive Director of SFC clarified that under existing legal provisions SFC already had the power to require persons relevant to an investigation to produce records and documents, which might include auditors' working papers, for SFC's inspection. In practice, SFC had been successful in accessing auditors' working papers if so warranted and this had never given rise to controversial situations. The Bill proposed to provide SFC with the power to obtain auditors' papers in the course of its preliminary inquiry of misconduct in the management of a listed company. It was believed that auditors' working papers could contain helpful information that was not otherwise available or that could curtail the need of further inquiry. The power was not aimed at assessing the quality of audit work performed. To exercise this power, SFC had to certify in writing to the auditors that it had initiated an inqury into the management of the listed company and that the production of working papers were necessary to facilitate the inquiry.

28. In reply to Members' enquiries about overseas experience of securities and futures market regulatory reforms and the role of regulatory authorities, DS/FS said that the Administration, in collaboration with SFC, had studied and made suitable reference to oversea experience in formulating the current reform proposals with a view to keeping the local system on par with international standards. Mrs Laura

CHA supplemented that the reform package was based on the three core objectives of securities regulation set out by the International Organization of Securities Commissions in 1998 which included namely, the protection of investors; ensuring fair, efficient and transparent markets; and the reduction of systemic risks. On the role of regulatory authorities in overseas reforms, Mrs CHA remarked that whilst reform proposals in the U.S. had been initiated by the concerned regulatory body in consultation with the U.S. Administration, proposals enshrined in the comprehensive Financial Services Market Bill (1998) in UK had been put forwarded by the Financial Services Authority which was independent of the UK Administration.

29. Responding to Mr Albert HO's comment on the need to update the companies legislation to complement the market regulatory reform, DS/FS concurred that a modern regulatory framework for companies was conducive to effective supervision of listed companies. To this end, the Administration had completed the consultancy on the review of the Companies Ordinance and consultation thereon in 1998. The Standing Committee on Company Law Reform was examining the consultancy report and was expected to submit recommendations by the end of 1999. The Administration would introduce relevant legislative amendments in 2000 as early as possible.

30. In view of the complexity of the Bill, Mr SIN Chung-kai opined that it would be desirable to advance the detailed study of the reform proposals by inviting the Administration to brief Members on each of the major proposals in separate briefing sessions. Members shared the view that the briefing sessions would allow more time for the exchange of views between Members and the Administration and that Members' input could also be incorporated into the draft Bill before it was introduced into LegCo. As other LegCo Members might also wish to take part in the detailed study of the proposals, Members agreed that the Panel should recommend formation of a subcommittee under the House Committee to commence study on the reform proposals under the Bill in September 1999 before the Bill was introduced into LegCo.

(*Post-meeting note*: The paper recommending the setting up of a subcommittee under the House Committee to study the reform proposals under the Bill was discussed at the House Committee meeting on 9 July 1999. The House Committee accepted the Panel's recommendation to form the Subcommittee on Securities and Futures Bill.)

VI Regulatory mechanism for auditors
(LC Paper No. CB(1)1637/98-99(03))

31. At the Chairman's invitation, Mr KAM Pok-man, President of Hong Kong Society of Accountants (HKSA) briefed members on the regulatory regime for the accounting and auditing profession in Hong Kong which were detailed in the Administration's information paper. Members noted that HKSA was vested with statutory powers under the Professional Accountants Ordinance (PAO) (Cap. 50) to

establish entry requirements for the profession, specify professional standards for its members, carry out regular reviews of members' practices, conduct investigations and order disciplinary actions.

32. Mr CHEUNG Man-kwong expressed the Democratic Party's grave concern about the recent incident of withdrawal of the auditor's report on a listed company's previous year's account by the appointed auditor. The company's financial hardship had surfaced recently but the auditor report had not reflected the company's financial position as of that date. Mr CHEUNG was concerned about the professional competence and conduct of auditors and the adequacy of the existing regulatory mechanism for auditors. He urged the Administration to consider enhancing protection for investors who relied heavily on auditor's reports in assessing the financial health of companies.

33. In response, DS/FS said that the Administration was equally concerned about the incident of withdrawal of the released auditor's report which was unprecedented. Whilst the Independent Commission Against Corruption was undertaking an investigation into the case to check whether any fraud or other misconduct was involved, the Administration would study existing laws to see whether such withdrawal was permissible and if so, whether remedies should be introduced; and to consider the need to enhance the disclosure requirements on listed companies about their financial positions so as to render better protection for investors. She stressed that as a result of the adverse economic climate following the Asian financial turmoil, it was not surprising that some listed companies would experience financial difficulties. The functioning of the existing regulatory regime for auditors should be assessed against this background. As to the legal responsibility of auditors, DS/FS said that apart from the self-regulatory efforts of HKSA, the work of auditors was governed by relevant laws, which were enforced by authorities, like the Police and various market regulators. Auditors might be liable to the company for any loss caused by negligence arising out of the audit and in special circumstances be liable to other persons who relied on the report and suffered financial loss. There were proposals under the future Securities and Futures Bill of creating a statutory right of action for private litigants allowing a person, who suffered from material losses as a result of another person's certain misconduct, to seek remedies.

34. Mr KAM Pok-man stressed that both HKSA and the Administration were committed to putting in continuous effort to improve the effectiveness of the regulatory system of auditors with a view to enhancing protection for users of audit services. HKSA's Auditing guidelines provide that where material information came to light after the issuance of an audit report, the auditor should follow the matter up with the board of directors and sought legal advice regarding the question of communication with the shareholders and the public. In the U.S. system, auditors, under justifiable circumstances, could be allowed to withdraw their reports and take appropriate action to warn investors at large about the unhealthy financial positions of companies concerned. HKSA was reviewing the Society's guidance on this aspect making reference to experience of other jurisdictions.

35. On the concern about the adequacy of the self-regulatory mechanism for auditors, Mr KAM Pok-man stressed that HKSA was a statutory body governed by its Council. Among the 16 Council members, two were ex-officio members representing the Government. Besides monitoring the work of auditors on a continuous basis through reviews of the financial statements of listed companies and also regular reviews of practices of certified public accountants, HKSA also acted on complaints from the public and referrals from other regulatory bodies. Regarding the openness and independence of HKSA's disciplinary process, Mr KAM remarked that when HKSA Council decided to refer a complaint to the Disciplinary Panel (DP), the Council needed to form a five-member Disciplinary Committee (DC) for hearing the case. There were at present three lay members in DP. HKSA would be looking at the structure of the DP and at the question of making the DC proceedings more transparent.

36. Referring to recent confusing press reports about the 11 cases of material misstatements relating to audited financial statements of listed companies referred by SEHK for review of HKSA, Mr CHEUNG Man-kwong requested HKSA and the Administration to disclose the details of the cases.

37. DS/FS explained that SEHK carried out initial examinations of all the cases involving qualified or modified audit opinion in financial statements to ascertain whether sufficient disclosure of information had been made to the market. If the examinations revealed that there might be non-compliance of auditors with the relevant professional standards for accountants, SEHK might refer the cases for review by HKSA. SEHK referred eight cases to HKSA for follow-up in 1998. Another three cases were referred since the beginning of 1999. She noted that there were teething problems in the referral system in view of the increase in caseload, but was glad to note that with the coordination of SFC, both SEHK and HKSA had been working closely to iron out the problems.

38. On the position of the 11 cases referred by SEHK, Mr KAM Pok-man said that HKSA had reviewed three cases and concluded that the circumstances did not justify further investigation. Review on one case was underway. HKSA was awaiting SEHK's further information to enable a proper review of another three cases and was considering whether proper reviews should be conducted for another two cases. SEHK had suspended the enquiries into the remaining two cases and would not pursue these cases further.

39. As regards the suggestion to disclose details of the investigation, Mr KAM Pok-man explained that information obtained during the investigation was subject to the secrecy provision under PAO which prohibited the use of such information for purposes other than for HKSA's disciplinary proceedings. As SFC and SEHK did have the details of the cases, they might consider the appropriateness of releasing them.

40. Pointing out that there were only a very small number of problematic reviews of financial statements of listed companies and practice reviews of certified accountants as revealed in the information paper, Mr CHAN Kam-lam remarked that the concern about accountants' professional competence might have been overstated. He further opined that the Administration should step up co-operation with HKSA in improving the corporate regulatory framework for supervising business conduct and activities in Hong Kong.

41. DS/FS noted that the responsibility for overseeing business conduct and disclosure requirements of companies was distributed among different parties including market bodies, the Registrar of Companies, public accountants, etc. She advised that further study into the subject of corporate governance based on the overall review of the Companies Ordinance (Cap.32) would be one of the key policy programmes of the Financial Services Bureau in the year 2000.

VII Exchange Fund Investment Limited's proposal to dispose of the securities acquired during the August 1998 operation

(LC Paper No. CB(1)1637/98-99(04))

42. Members noted that the Panel had extended an invitation to the Chairman of the Exchange Fund Investment Limited (EFIL) to attend the meeting. However, the Chairman of EFIL had replied that it would be more appropriate at this stage for the Chief Executive Officer of EFIL (CEO/EFIL) to attend the meeting to brief Members on EFIL's proposal to dispose of the securities acquired by the Government using the Exchange Fund (EF) during the market operation in August 1998.

43. Upon the Chairman's invitation, CEO/EFIL briefed Members on EFIL's plan to dispose of a portion of the shares acquired during the market operation in the form a unit trust product tracking the Hang Seng Index (HSI). She said that the Financial Secretary announced in his Budget Speech in March 1999 the new investment strategy for EF, under which the present holdings of local equity amounting to 17% of EF would be reduced to 5%. Among the Hong Kong equity portfolio currently valued at about HK$210 billion, HK$46 billion worth of stocks would therefore be retained by EF as long term investment and the remaining about HK$170 billion worth of the portfolio would be disposed of. Since the proposed unit trust product would hold a portfolio of stocks reflecting the composition and weighting of all the shares in HSI, the maximum size of offer would be in the region of HK$60-$70 billion. However, the final issue size of the unit trust product would depend on investors' appetite and the prevailing market conditions. It was expected that preparatory work would take at least four to five months to complete. Whilst EFIL would focus on the product in launching the disposal programme, other disposal methods including block placements, company buybacks and exchangeable bonds, etc., might be considered for subsequent phases of the programme.

44. Responding to Mr FUNG Chi-kin's enquiry, CEO/EFIL said that the three financial advisers appointed by EFIL for studying the optimal shares disposal strategy concurred that the proposed unit trust product was the most appropriate disposal method to launch the shares disposal programme. Advantages of the method included catering for the needs of both retail and institutional investors, neutrality to the market as it did not involve the selection of individual stocks, and causing least disruption to the market.

45. As to Mr FUNG's concern that the product would become an arbitrage tool of institutional investors. CEO/EFIL remarked that the presence of arbitrage trading activities in the cash and futures markets would increase the depth, liquidity, and efficiency of the market and would be beneficial to all investors. Directional market players (which should be distinguished from arbitrageurs) would be likely to find it more cost effective to concentrate their market activities in the futures market.

EFIL/ FSB

46. Pointing out that there had been much public concern about methods for disposing the shares acquired in the August 1998 market operation, Mr James TO urged the Administration to consider disclosing details of the analysis and recommendation by the three financial advisers and EFIL Board on the various proposed disposal methods for the information of the public.

47. Messrs Albert HO, CHEUNG Man-kwong and SIN Chung-kai pointed out that the market operation in August 1998 had adversely affected the liquidity of shares and had indirectly "pushed up" HSI. They raised concern about the effectiveness of the proposed unit trust product in improving the liquidity of shares and further opined that without committing to a timetable for disposing all the shares, the problem of liquidity would not be alleviated, hence making the market more susceptible to manipulation.

48. On the issue of liquidity of shares, CEO/EFIL explained that as the unit trust product would be listed on SEHK, trading of the new product would add liquidity to the market. Furthermore, consideration would be given to adopting the approach of the Standard Poor's Depository Receipts (SPDRS) in the US which allowed for redemption in kind enabling investors to redeem units for shares from the SPDRS trust. If such approach was adopted, it would return some liquidity to the market when investors redeemed units for shares. As to the comment about the adverse impact of the August 1998 market operation on the liquidity of shares, CEO/EFIL responded that a comparison of the average daily turnovers of the local stock market for the period of six to nine months prior to and after the market operation revealed that the daily turnover remained in the range of HK$6 to 8 billion indicating that liquidity of shares had not been adversely affected by the market operation. On the other hand, whilst the rise in HSI was a sign of improvement of the local economy with continuous improvement of the regional and global economic environment, East Asian and US stock markets had also recorded substantial rises in their indices recently. She further remarked that listed companies would take the opportunity to issue new shares, thereby increasing the supply of stocks to meet the increased demand at higher price

levels. Market forces would therefore ensure that sufficient liquidity was available in the stock market. This was made evident by recent activities of corporates to issue new shares.

49. Regarding the timetable for disposal of all of the acquired shares, CEO/EFIL stressed that it remained the objective of EFIL to dispose of all the shares in the Hong Kong equity portfolio (except those holdings which would be held as a long-term investment of EF) in an orderly manner without disrupting the market. Given the substantial size of the portfolio and changing circumstances in the market, it would be difficult to commit to a definite disposal timetable. Whilst the unit trust approach was considered the most appropriate method to launch the disposal programme, it required a longer lead time for necessary preparation which included undertaking market research, obtaining listing and other regulatory approvals, and conducting marketing programme to promote the new product.

50. As regard the concern about possible conflict of interest between the Government's roles as rule-maker of the market and shareholder of listed companies. CEO/EFIL said that EFIL Board recognized the importance of striking a right balance between non-interference with the day-to-day management of the companies and the need to safeguard Government's interest as a shareholder. As such, EFIL had developed proxy voting guidelines in the respect.

VIII Any other business

51. The Chairman informed members that Panel meeting would resume in the next session after the Chief Executive's Policy Address on 6 October 1999. However, meetings could be convened in the summer recess if there were matters requiring urgent attention.

52. The meeting ended at 1:10 pm.

Legislative Council Secretariat
11 January 2000