

Corporate Governance and Social Responsibility

As the statutory regulator of the securities and futures markets in Hong Kong, the SFC places great importance on corporate governance. We always strive to enhance our accountability to the public and the transparency of our work. We adopt and implement corporate governance practices commensurate with the best standards applicable to public bodies.

In this chapter, we will discuss:

- Composition and operation of the Board
- Commission committees
- Conduct standards
- Internal controls
- Independent checks and balances
- Corporate social responsibility
- Performance pledges

Composition and operation of the Board

✓ Composition of the board

The constitution and proceedings of the Board are defined by the SFO. All the Members of the Board are appointed by the HKSAR Chief Executive for a fixed term and the SFO requires that the majority of the Members must be independent Non-Executive Directors (NEDs). The composition of the Board ensures independent supervision of the SFC's executive functions.

The remuneration package of individual Executive Directors (EDs) is determined by the HKSAR Chief Executive (or Financial Secretary under the authority

delegated by the Chief Executive) upon the recommendations of Remuneration Committee of the Commission, which is chaired by an NED and comprises only NEDs. Our NEDs receive a fixed sum of honorarium every year.

At the end of the year under review, the Board comprised 11 Members: four full-time EDs including the Chairman and seven NEDs. During the year, the HKSAR Chief Executive appointed Mr Martin Wheatley as SFC Chairman for a term of three years from 1 October 2005. Mr Wheatley succeeded Mr Andrew Sheng, who has led the Commission as its Chairman for seven years until 30 September 2005. Dr York Liao was re-appointed as an NED for a term of two years from 26 May 2005, while Mr Christopher Cheng and the Hon Jasper Tsang were re-appointed as NEDs for a term of two years from 15 November 2005.

A full-time executive Chairman currently leads the Commission. On 6 April 2005, the Government introduced the Securities and Futures (Amendment) Bill 2005 into the Legislative Council (LegCo) to provide for the separation of the role of the SFC Chairman from that of the executive arm. Under the proposed structure, the Commission will be headed by a Chairman who will focus on leading the Board in setting the Commission's directions and policies, while the executive arm will be headed by a chief executive officer who will be responsible for the day-to-day running of the Commission.

At the time of this report, the Amendment Bill is being scrutinised by the Bills Committee of the LegCo.

✓ How the Commission operates

The Board is fully accountable to the public on the extent to which it fulfils its statutory objectives and functions. The Board meets each month and holds additional meetings as necessary. All important policies and decisions are discussed and approved by the Board. Commission staff attend Board meetings to explain policy proposals, report on important policy proposals, operational matters and regulatory issues. Members also consider the financial position of the Commission and are provided with monthly financial statements. The Chief Counsel attends the Board meetings to advise Members on legal issues.

To play an effective oversight role, the Board has delegated many of the regulatory powers and functions to individual EDs, staff or Committees, reserving the critical functions at the Board level. The Commission maintains a detailed delegation list.

All newly appointed Members receive briefings on the work of the Commission and are provided with relevant SFC documents including a copy of the Code of Conduct, which sets out the legal obligations and the Commission's requirements on them. All Members are required to disclose their investment portfolio upon appointment and report any subsequent changes to the Commission.

Members have independent access to the senior management and staff for additional information they may require about any policy proposal. They have access to the Commission Secretary, who is responsible for ensuring the procedures of the Commission are complied with. Members and the Commission Committees can seek independent professional advice at the expense of the Commission as and when necessary.

We published in March 2006 a document setting out the regulatory challenges that the SFC faces over the next three years. Please see Chairman's Statement for more information. The statement of Regulatory Challenges and Responses is available on the SFC website.

Attendance of Directors at Commission meetings in 2005-06

| Number of meetings | 14 | |
|---|------------|------|
| Attendance of individual Directors | | |
| Andrew L T Sheng | 5 | 83% |
| Martin Wheatley | 12 | 100% |
| Peter Au-Yang | 14 | 100% |
| Alexa Lam | 12 | 86% |
| Alan Linning | 11 | 85% |
| Christopher W C Cheng | 14 | 100% |
| Eddy C Fong | 13 | 93% |
| Kenneth H W Kwok | 13 | 93% |
| Raymond P L Kwok | 9 | 64% |
| York Liao | 11 | 79% |
| Liu Pak Wai | 12 | 86% |
| Jasper Tsang Yok Sing | 10 | 71% |
| Average attendance of meetings | 87% | |

The individual attendance rates are based on the respective number of meetings Members were expected to attend during their terms. For details of their terms, please see Chapter on Directors of the Commission.

Commission committees

The Commission has established the Advisory Committee, Public Shareholders Group and other consultative and regulatory committees with a largely external membership drawn from the market. These committees have their respective terms of reference and provide external input to the Commission on policy matters.

NEDs play an important role in ensuring that the Commission is accountable and transparent by chairing and participating in various Commission committees. The Commission committees circulate their minutes and report important issues to the Board regularly.

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The NEDs' role is particularly important in several internal committees:

✔ Audit Committee

The Audit Committee comprises only NEDs. Mr Eddy Fong, a Certified Public Accountant, is the Chairman. Senior staff including EDs are invited to attend meetings where necessary.

The Audit Committee convenes every quarter and additionally if necessary to review quarterly and annual financial statements before their submission to the Commission for approval. It endorses the appointment of external auditors for the Commission's approval every year and plays an important role in the design of the scope of internal and external audits. It reviews audit findings set out in the external auditors' management letters and management's responses to them, and monitors the implementation of agreed improvements.

The Audit Committee also examines management procedures to monitor the effectiveness of the systems of financial and internal control. It considers and approves our annual internal control review programme and cross-divisional audit programme.

For the provision of non-audit services by external auditors, the Audit Committee will critically consider each engagement on a merit basis. To ensure independence and objectivity of the annual audit, two different external audit firms are appointed to perform respectively the annual audit and internal control review of the Commission.

During the year, we paid KPMG, our external auditors, \$350,600 for audit-related services and \$180,000 for non-audit related activity involving an IT risk assessment training program. We paid PricewaterhouseCoopers (PwC) \$151,650 for conducting the annual internal control review.

KPMG was also engaged as the external auditors of a number of funds, such as compensation funds that are under the supervision of the Commission directly or indirectly as required by the law. In total, they paid KPMG \$280,700 for annual audits and half yearly interim reviews.

Attendance of Directors at Audit Committee meetings in 2005-06

| | | |
|---|------------|------|
| Number of meetings | 4 | |
| Attendance of individual Directors | | |
| Eddy C Fong (Chairman) | 4 | 100% |
| Raymond P L Kwok (Deputy Chairman) | 4 | 100% |
| Kenneth H W Kwok | 3 | 75% |
| Average attendance of meetings | 92% | |

✔ Remuneration Committee

The Remuneration Committee, chaired by Dr York Liao, comprises all NEDs. Senior staff are invited to attend the meetings where necessary.

The Remuneration Committee reviews policy on the level and structure of staff remuneration and makes recommendations to the Commission. It also considers and approves results of pay surveys. The Remuneration Committee is consulted on the re-appointment of EDs and decisions regarding remuneration of senior management.

The HKSAR Chief Executive (or the Financial Secretary under delegated authority) determines the remuneration packages of the SFC Chairman and EDs, taking into consideration recommendations by the Remuneration Committee. Details of the EDs' remuneration are on page 81. We have improved the disclosure by publishing, for the first time, the remuneration on an individual and named basis. The pay packages comprise an annual fixed pay and a performance-related variable pay.

The SFC Chairman consults the Remuneration Committee on the payment and amount of variable pay to individual EDs as a matter of good corporate governance practice. The recommendations are reported to the Administration for information.

Attendance of Directors at Remuneration Committee meetings in 2005-06

| | | |
|---|----------|------|
| Number of meetings | 3 | |
| <i>Attendance of individual Directors</i> | | |
| York Liao (Chairman) | 3 | 100% |
| Christopher W C Cheng (Deputy Chairman) | 3 | 100% |
| Eddy C Fong | 2 | 67% |
| Kenneth H W Kwok | 3 | 100% |
| Raymond P L Kwok | 2 | 67% |
| Liu Pak Wai | 3 | 100% |
| Jasper Tsang Yok Sing | 2 | 67% |

Average attendance of meetings **86%**

✓ Budget Committee

The Budget Committee is chaired by NED Mr Raymond Kwok. It examines and approves the proposed parameters and basis for annual budget compilation, including the estimates of our income and expenditure for the next financial year, which will then be submitted to the full Commission for approval.

Attendance of Directors at Budget Committee meetings in 2005-06

| | | |
|---|----------|------|
| Number of meetings | 1 | |
| <i>Attendance of individual Directors</i> | | |
| Raymond P L Kwok (Chairman) | 1 | 100% |
| Christopher W C Cheng (Deputy Chairman) | 1 | 100% |
| Peter Au-Yang | 1 | 100% |
| Alexa Lam | 1 | 100% |
| Liu Pak Wai | 1 | 100% |
| Andrew L T Sheng | N/A | N/A |
| Martin Wheatley | 1 | 100% |

Average attendance of meetings **100%**

Mr Sheng was a member until 30 September 2005. There was no meeting during his term.

✓ Management Committee

The Management Committee comprises EDs, Senior Directors and the Chief Counsel. It performs administrative, financial and management functions as delegated by the Commission. At its monthly meetings, the Committee considers funding requests from departments and divisions including requests to engage outside consultants and advisers. Every month, it also reviews the Commission's financial and staffing positions, and progress of major information technology projects.

Conduct Standards

✓ Code of conduct

The Commission requires the highest standards of integrity and conduct from its staff. It sets out in the Code of Conduct its requirements and the relevant legal obligations. In particular, all Commission staff should be aware of potential conflicts of interest and ensure that their work is carried out properly, impartially and free from any suggestion of improper influence. All Commission staff are required to keep information acquired in the course of duties, confidential.

The Code sets out a clear policy for staff on personal dealings in securities and futures contracts and various statutory requirements relating to personal dealings. The Code requires staff to declare their investment in securities and futures contracts upon commencement of employment and report all subsequent transactions. A new Staff Investment Recording System was implemented during the year to enable staff to input their investment disclosures and update transactions.

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✔ Public interest grievances

The Personnel Manual comprises major human resources policies and procedures as approved by the Commission, which include the Equal Employment Opportunities policy, grievances procedures and disciplinary procedures. These procedures ensure that personnel matters are handled in a fair and impartial process with adequate checks and balances.

The Grievance Procedures – Public Interest Grievances is published on our website to assist those who believe that they have discovered improper practices or misconduct relating to the running of the Commission or work related activities of Commission employees, to report these to the Commission in a constructive manner. The procedures enable the following persons to report confidentially: any person who has an employment contract with the Commission, is on secondment to the Commission, is engaged as an independent consultant by the Commission or is a contractor or supplier of services to the Commission.

A quarterly report is made to the Audit Committee providing information on any grievances raised and any decisions taken in respect of them under the Grievances Procedures.

✔ Complaints against SFC staff

The Commission has a policy of transparency and accountability. It takes seriously any dissatisfaction regarding the way in which Commission staff have carried out or failed to carry out their duties. The Procedures for Handling Complaints against Commission Staff ensures prompt handling of any complaints from members of the public against our staff and facilitates effective follow-up action. We have published the procedures on our website to enhance transparency and provide clear guidance to the public.

A quarterly report is made to the Audit Committee providing information on any grievances raised and any decisions taken in respect of them under the Grievances Procedures.

Internal controls

The internal control procedures ensure that the Commission achieves its regulatory objectives and performs its regulatory functions in a fair and transparent manner and in accordance with the law. In addition, the Commission's operational procedures help safeguard assets against unauthorised use or disposition, maintain proper accounting records and ensure reliability and integrity of information used within the Commission or for publication.

✔ Accountability and transparency

Individual divisions and departments of the Commission follow operating manuals in performing functions and exercising powers. The manuals ensure that we comply with relevant legal, regulatory and administrative requirements. They are subject to review by the independent Process Review Panel for the SFC.

The Commission is accountable for the use of its financial resources and has established detailed financial and budgetary control procedures. For the reporting and disclosure of the Commission's financial statements, we have adopted the International Financial Reporting Standards promulgated by the International Accounting Standards Board since 2000-01.

The financial statements are considered by the Audit Committee and approved by the Board before the Chairman and one NED sign them. Each year, the revised and proposed budgets are submitted to the Financial Secretary for approval and laid before the LegCo after consideration by the Commission. By law, the Director of Audit may examine any books, accounts, vouchers, records or documents kept by the Commission.

The Commission is committed to open communication with our stakeholders and the public. We publish our Quarterly Reports and Annual Report in a timely manner. We report our operations and activities to the public through periodic newsletters, press releases, publications and press conferences. Last year, we introduced new functions and content on our website to make it more accessible and informative to the public and market practitioners, and as part of our corporate governance initiatives.

✓ Internal audit

As a relatively small organisation, we do not have a full-time internal audit unit. Instead, we have appointed PwC to conduct internal control review for us annually. PwC's review forms part of the Commission's overall annual internal control review programme, which is approved by the Audit Committee and includes also reviews by our cross-divisional audit teams.

The purpose of the internal control review is to assess whether the systems of internal control as set out in the various Commission's manuals are adhered to, to evaluate the adequacy of the controls in place, to safeguard assets and ensure reliability and integrity of information, and to identify enhancements to current procedures and controls to improve operating efficiency. The internal controls are designed to provide reasonable, but not absolute, assurance that errors and irregularities will not occur, and that procedures are performed in accordance with management's intentions.

During the year, PwC reviewed the fixed assets acquisition and insurance policy, payroll procedures, staff benefits, training and sponsorship approval processes. They

confirmed that the controls over these areas were satisfactory. Their findings and recommendations were reported to the Audit Committee.

The Corporate Finance Division conducted a cross-divisional audit on the fees collection procedures of the Licensing Department during the year. The audit report will be submitted to the Audit Committee for comment and approval.

✓ Risk management and contingency plans

The operational divisions of the Commission closely monitor and assess risks in their respective regulatory areas. They regularly report their risk analysis and make recommendations in managing the risks to the Board. We have a market contingency plan, which details procedures for dealing with emergency situations that may affect Hong Kong's securities and futures markets.

We also have prepared an internal contingency plan to deal with emergency situations that may affect the Commission's operations, such as fire, flooding or other disasters that may affect the Commission's offices. The plan details the contingency measures from all operational and supporting divisions in recovering and resuming their business during and after any emergencies. We reviewed the plan in the second half of last year to ensure it remained comprehensive and effective.

During the year, we put the information regarding contingency situations in the form of frequently asked questions on our website to enhance the understanding by the public in this area.

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✔ IT security

We have established an information security framework to manage our IT environment. Under the framework, all staff members are required to attend mandatory information security awareness training. We have also developed an information security policy and established an information security unit.

As a new corporate governance initiative, during the year, we appointed Ernst & Young to perform a security audit on our computer network to identify information security gaps and system control weaknesses. The audit confirmed that our information security framework and security controls procedures have met the level of security standard of a well-controlled organisation.

Independent checks and balances

The Commission is subject to various external checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal, judicial review, and scrutiny by independent bodies such as the Process Review Panel (PRP), the Ombudsman and the Independent Commission Against Corruption (ICAC).

✔ Process Review Panel for the SFC

The Commission's internal procedures for regulating the markets, including procedures for ensuring consistency and fairness, are reviewed on an ongoing basis by the PRP. The PRP is an independent, non-statutory panel established by the HKSAR Chief Executive in November 2000. The Commission is the first securities regulator in the world to have in place such an external review system on its internal operations.

The PRP currently comprises 12 members, including nine members from the financial sector, academia and the legal and accountancy professions, and three ex-officio members including the Secretary for Justice (or his representative), the Commission's Chairman and an NED of the Commission.

Over the past year, the PRP reviewed various completed cases and advised the Commission upon the adequacy of its internal procedures. These cases covered the following aspects: licensing of intermediaries, authorisation of collective investment schemes, inspection of intermediaries, prudential visit to intermediaries, settlement of disciplinary cases, issuance of warning letters, and dual filing cases.

✔ Securities and Futures Appeals Panel/ Tribunal

A wide range of the regulatory decisions of the Commission are subject to a full review by the Securities and Futures Appeals Tribunal (SFAT), which is chaired by a High Court judge appointed by the Chief Executive and comprises two other members appointed by the Secretary for Financial Services and the Treasury. There were 17 applications for review lodged with the SFAT during the year: three were determined, three were withdrawn and eleven are in progress. In addition, six cases were carried forward from 2004-05, of which four were withdrawn and two were determined.

Before the establishment of the SFAT, there was an independent Securities and Futures Appeals Panel (SFAP) established under the repealed Securities and Futures Commission Ordinance. The SFAP heard appeals against decisions made by the SFC relating to the registration, regulation and discipline of intermediaries. The SFAP was disbanded upon the conclusion of the last case in 2005-06.

✓ ICAC

The Independent Commission Against Corruption has conducted periodic corruption prevention reviews on the procedures and practices of the Commission since 1990. There was no ICAC review during the year.

✓ Reporting to the Government

The Commission is an independent regulatory body but is subject to regular reporting and furnishing of information to the Financial Secretary, Secretary for Financial Services and the Treasury and the Financial Services and the Treasury Bureau regarding its operations and important issues. We are required to consult the Financial Secretary before exercising certain powers.

In addition, according to section 11 of the Securities and Futures Ordinance, after consultation with the Chairman of the Commission, the Chief Executive may, upon being satisfied that it is in the public interest to do so, give the Commission written directions as to the furtherance of any of its regulatory objectives or the performance of any of its functions. This reserve power of the Chief Executive has never been exercised since the establishment of the SFC in 1989.

✓ Public redress mechanism

Members of the public can complain to the Ombudsman against the Commission and its staff if they believe that we have been guilty of maladministration in the performance of our functions. During the year, there were two complaints. The Ombudsman found one of them not substantiated and is dealing with another one.

Anyone who is dissatisfied with the Commission's performance of its functions may take civil action in the Courts against the Commission, by either applying for

judicial review of the Commission's decisions or seeking remedies. There was one application for judicial review against the Commission last year. The applicant was not granted leave by the court to proceed. Details are on page 78.

Corporate social responsibility

We review in this new section of the Annual Report the initiatives or work of the SFC that we believe will make positive social and environmental impact.

✓ Care for the society

SFC staff have formed a volunteers team called the Commission Possible Volunteers Group. Last year, it organised five activities for 230 elderly, children and their family members. These included: a visit to the Hong Kong Heritage Museum with the elderly, an Ocean Park tour with families of South Asian ethnic origin, home visits to the elderly in Wanchai to celebrate the Mid-Autumn Festival, a Christmas party for children and parents in Tai Kok Tsui, and a visit to the Mr & Mrs Lawrence Wong Lutheran Home for the Elderly to celebrate the Chinese New Year. About \$40,000 cash donations were raised from staff to support the activities.



A child received a Christmas present from Santa Claus, played by an SFC staff.



An SFC investigator in the Chinese God of Fortune costume shared the joy with two elderly people.

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From time to time the SFC will upgrade the office computers to enhance efficiency and to meet changing needs. Many replaced computers are in good working condition and suitable for basic office use and Internet connection. The volunteers team is working out a scheme to donate these computers to charitable bodies that are registered with the Social Welfare Department. Further details will be published on the SFC website.

The SFC corporate website (www.sfc.hk) provides a valuable source of information also for market practitioners, investors and other users. Over 3,900 people subscribed to the Update Alert service to get emails of new information. The website drew average daily hits of 390,549 in March 2006, a record since a major revamp in November 2004.

Last August, we further improved the site and introduced a text-only version which enables visually impaired visitors to browse for key information about the SFC. New sections were created to report our upcoming events and latest market contingency arrangements, and to explain our procedures for handling the public's complaints against our staff.

Our website received a Gold Award in the Web Care Award 2005, which was run by the Hong Kong Internet Professional Association to promote no-barrier websites for all users including people with disabilities.



✔ Environment protection

Waste paper, carton boxes and newspapers are collected by building management for recycling on a daily basis. Confidential materials are sealed and collected for recycling by an approved contractor every two months.

Since 2000, the SFC has introduced facilities for internal e-filing, which may cut down the consumption of paper. All our computer printers have a power saving feature and enable double-sided printing. Dispensed laser/ink cartridges are collected by the General Post Office for proper disposal.

We have also been using e-fax for sending or receiving fax. This saves the printing out of a document for conventional transmission. Our fax volume could be substantial, particularly with divisions handling prospectuses.

We are aware of calls by environment friendly groups for shorter IPO prospectuses. The SFC's primary concern is that the public are given all material information to make investment decisions. In our reform proposals for the prospectus regime, published last August, we encourage shorter prospectuses without compromising the availability of more detailed or technical information. We proposed the introduction of a framework permitting information lodged with a central online document repository to be treated as forming part of a prospectus.

We also encourage licensees to submit their monthly financial resources returns electronically. To date, more than 70% of the firms are using e-submission.

We use energy saving light tubes and bulbs. Staff also make sure that appliances and lighting are turned off in the evening or if they will not be used for a long time.

Performance pledges

In discharging our regulatory duties, we pledge to be responsive to the general public, market participants, and intermediaries under our supervision. The following table shows how we met the pledges last year.

| Performance pledges | | | % of cases meeting the pledge in 2005-06 |
|---|------------------|--|--|
| Investor enquiries | | | |
| ■ Preliminary response to telephone enquiries | 4 business days | | 100% |
| ■ Preliminary response to written enquiries | 2 weeks | | 99.8% ¹ |
| General enquiries | | | |
| ■ Preliminary response to enquiries via enquiry@sfc.hk | 4 business days | | 99.7% ² |
| Public complaints | | | |
| ■ Preliminary response to verbal & written complaints | 2 weeks | | 99.7% ³ |
| Licensing applications | | | |
| Processing of licensing applications | | | |
| ■ Representatives (provisional licence) | 7 business days | | 92% ⁴ |
| ■ Representatives (normal licence) | 8 weeks | | 87% ⁴ |
| ■ Representatives (responsible officer) | 10 weeks | | 95% ⁴ |
| ■ Corporations | 15 weeks | | 93% ⁴ |
| ■ Change of accreditation | 7 business days | | 82% ⁴ |
| Modification/waiver and subordinated loan applications | | | |
| ■ Acknowledgement of receipt upon receiving any application | 2 business days | | 99% |
| Investment products authorisation | | | |
| ■ Take-up of applications upon receipt | 2 business days | | 100% |
| ■ Preliminary response to applicants after take-up for unit trusts, mutual funds, investment-linked assurance schemes and MPF pooled investment funds | 7 business days | | 100% |
| ■ Preliminary response to applicants after take-up for other schemes | 14 business days | | 100% |

1. One enquiry failed to meet the pledge due to the exceptionally heavy workload when the enquiry was received.
2. Three cases failed to meet the pledge due to the exceptionally heavy workload when the enquiries were received.
3. Three cases failed to meet the pledge due to their complexity. More time was needed to collect information to facilitate assessment.
4. Performance pledges only apply to cases where the applicants had supplied all the required documentation in their applications and satisfied all regulatory requirements.