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The New Securities and Futures Bill - A World Class Regulatory Regime for a World Class Financial Centre

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Those of you who have been following the progress of the Securities and Futures Bill would have noted that we are at the Bills Committee stage, meeting twice and very soon as often as four times a week to go through its clause by clause stage. We are very grateful for the hard work of the Bills Committee Chairman, the Hon. Mr Sin Chungkai and his colleagues at the Legislative Council (LegCo) for contributing their valuable time, effort and experience towards getting the new Bill passed as soon as possible, hopefully by the end of this year.

The passing of the new Bill will be no small achievement. This is the last of the 1989 Ian Hay Davison Report recommendations to be implemented. Over 10 years of planning and work have gone into it with intensive efforts by all parties over the past three years. This has been a monumental task led by the Financial Services Bureau, the Department of Justice, and the Commission. I would not be too far wrong in saying that the new Bill has undergone the most extensive and thorough review of major policies and legal principles, with full consultation with the industry at each and every stage since its inception. Even up to this present time, we are still listening to feedback from the market for ways to improve various aspects of the Bill.

Major new regulatory legislation has been passed and pending in other jurisdictions such as the UK Financial Services and Markets

Act of 2000, the new US legislation that removed Glass-Steagall and the Australian Financial Services Reform Bill 2001. The time has come for us to revamp our legislation and bring in a world class regulatory regime which underpins Hong Kong's status as a world class financial centre. With global competition of today, it is imperative that we have a regulatory framework that would accommodate the profound changes wrought by technology on the structure and activities of financial markets.

Against this backdrop, I thought that rather than boring you with details of what is in the Bill, I should invite you to look at how we will implement the Bill. This brings us to the philosophical question of Why We Regulate and How We Regulate the securities markets.

It was a historical anomaly that the existing Securities and Futures Commission Ordinance sets out only the functions of the Commission, but not its regulatory objectives. The new Bill specifically spells out these objectives in order to clarify what the Commission should do to promote market integrity and investor protection. We will be held accountable to the public for the manner in which we meet these objectives.

In essence, what are we here for? The simple answer is that the Commission exists for the investor.

Why Do We Regulate?

Right from the beginning, the new Bill sets out the six principal regulatory objectives of the Commission to:

- maintain and promote a fair, transparent, efficient, competitive and orderly securities and futures industry;
- promote investor education;
- secure an appropriate degree of investor protection;
- minimise financial crime and misconduct;
- reduce systemic risks; and
- help maintain the financial stability of Hong Kong.

These six objectives can be summarised into two broad objectives or themes, which are to promote:

- market integrity; and
- investor protection.

These two broad themes guide us in everything that we do in setting operational priorities and performing our regulatory functions.

How Do We Implement the Bill?

In implementing the law, we aim to regulate firmly and fairly. This may mean we have to prosecute or take disciplinary action whenever anyone transgresses the law. However, our criteria of success is not how many we prosecute, but whether the investors are confident that our market is as transparent, as fair and as free of misconduct as other major international financial centres.

This is a big task, with competing priorities and competing interests between issuers, investors and intermediaries. We do not want to overburden the market with excessive regulation. We all have limited resources. Ultimately we must balance between these interests, our regulatory objectives and regulatory costs. Finding the right balance is therefore essential. We are confident that the way forward is to move towards transparent and accountable *risk-based regulation*.

Risk-based regulation works by firstly identifying and then focusing our attention and resources on *high risk* situations.

In his book, *The Regulatory Craft*, Harvard Professor Malcolm Sparrow states: "The essence of the [regulatory] craft lies in picking the right tools for the job, knowing when to use them in combination, and having a system for recognizing when the tools are inadequate so that new ones can be invented."

The SFC has a good range of regulatory tools to help us carry out our work. These regulatory tools include ordinances, rules, codes,

guidelines, principles, regulatory programs, policy projects and compensation schemes. Judicious application of these tools is essential to achieving the SFC's twin objectives of promoting market integrity and investor protection. For example, requiring our registrants to submit Financial Resources Rules (FRR) returns helps us *identify and assess* risks and to address these risks together with the relevant intermediaries. Carrying out market surveillance helps us *monitor and track* risks by, for example, identifying market misconduct. Issuing investor alerts on scams to the investing public helps us to *avoid* risks. Providing investor education programmes helps us educate investors to better assess their risks and protect their rights, a key ingredient for a mature and healthy market.

In implementing the Bill, we will be guided by the principles of *fairness and natural justice*. This means that we stand firm by our decisions if we believe it is in the interest of the investing public or under public interest to do so. We try to ensure that our decisions or actions are generally *consistent with past regulatory decisions*, bearing in mind that each case or situation is considered in light of its own specific facts and circumstances. This also involves the process of ensuring that our decisions or actions are *proportionate* to the wrongdoing in question.

We will also be *transparent* in the way we exercise discretion. There will be a statutory requirement to publish information about waivers - who benefits, what and why (subject to a discretion to hold back information of a highly sensitive commercial nature).

Improving the Quality of our Markets

We all recognize that technology, globalization and intensifying competition have changed our business environment profoundly. Competition is all about quality. As the markets change, so must the regulator. The new Bill not only encourages intermediaries, market

participants and investors to embrace higher standards but also addresses the problem of gaps in the existing regulatory framework. It provides new tools and solutions in relation to these areas.

Let me illustrate with a couple of points from the Bill.

Licensing and Intermediaries

Under the Bill, there will be:

- A single licensing system; and
- Senior management of brokerage firms will be responsible for ensuring compliance with regulatory requirements.

Intermediaries will benefit from the new licensing and regulatory regime that will provide a level playing field between banks and brokers. They will also benefit from reduced barriers to entry and more streamlined processes. For example, under the new licensing system, it will only be necessary to complete one FRR return and one annual report instead of one for each type of licence held under the current regime. We are mindful that the cost or burden of regulation should be kept to a minimum, and that the benefit of such regulation should outweigh the cost.

Minimising Market Misconduct

The SFC takes a very serious view of market misconduct as it strikes at the very heart of market integrity and investor confidence.

Currently, market manipulation (a term that includes price rigging, stock market manipulation, dissemination of false information to induce trading, etc.) is a criminal offence. It is, however, increasingly difficult to prove such offences to the criminal standard of "beyond a reasonable doubt".

Under the new Bill, the SFC will have the option of choosing between civil and criminal routes for punishing market manipulation and insider trading. The civil route will involve a Market Misconduct Tribunal chaired by a full term judge and assisted by two members with the necessary expertise. This should improve our success rate in combating misconduct.

The SFC will also have more investigation powers or "tools" in relation to inquiries on listed companies, including obtaining additional information from its officers/employees, and information relevant to an inquiry from auditors, bankers and third parties. This will greatly assist us in gathering the necessary evidence when investigating suspected improper conduct in a listed company.

The new Bill will also create a statutory civil right of action against those found to be responsible for market misconduct and those who have made false or misleading public communications that affect share prices. This is a good step towards increasing investor remedies.

Minority Shareholder Protection

More work on improving minority shareholder protection and corporate governance is required and this has to be done outside this Bill. In particular, we need to look at improving the quality of financial information available to the public, the rights of minority shareholders, encouraging greater shareholder involvement and enhancing institutional investors' involvement in the market. The Standing Committee on Company Law Reform is currently studying these issues and will be making proposals later this year. In the meantime, the SFC has established a Shareholders Group that is aimed at increasing investor protection and improving corporate governance. The first meeting was held last month and we will be keeping you informed on their progress.

Checks and Balances on the SFC

The SFC is keenly aware that no one wishes to be regulated without clear checks and balances. On the other side of the coin is the undeniable fact that adequate powers must be given to the regulator so that it can regulate effectively. The regulator needs extensive powers and discretion not only to protect investors but also to facilitate business. Of course, sufficient checks and balances must be in place to ensure that the SFC uses its powers fairly, reasonably, proportionately, with clear respect to natural justice and due process.

At present, there are various checks and balances already in place. For example:

- The presence of six Non-Executive Directors on the Board of the SFC which provides *independent supervision* of the SFC's executive functions and an important objective perspective.
- The right of an aggrieved person to seek *judicial review* of the SFC's decisions.
- The right of an intermediary who is disciplined or refused a licence to appeal to an independent *Securities and Futures Appeal Panel.*
- Under the new Bill, a full-time *Securities and Futures Appeal Tribunal* (SFAT) will be empowered to carry out a full merits review of all our licensing and disciplinary decisions, including, for the first task, reprimands. The Tribunal, which will be chaired by a full time judge, will have the power to call new evidence, stay legal proceedings, overturn or even substitute SFC decisions.
- The fact that much of our work falls within the ambit of the Ombudsman and the ICAC. Also, the SFC is subject to regular review of our operating Divisions by the ICAC. The last review was carried out this year.
- The requirement that we report suspected market misconduct to and consult with the Financial Secretary before taking certain regulatory actions, e.g. before seeking certain Court orders against listed companies, making a suspension order or making certain rules.

In addition, the Government has established a fully independent audit body, the *Process Review Panel* (PRP), to review the SFC's procedures in relation to our operational decisions and actions. Its term of reference is to ensure that our internal decision-making processes are fair, and give due regard to the requirements of natural justice and due process. In addition, the PRP has the power to audit completed or discontinued cases to check that we have followed these procedures.

I know of no other financial regulator in the world, which is subject to this degree of scrutiny.

The PRP's role is not to review cases on their merits - that would be supplementing the functions of the SFAT. Nor will it be a complaints handling body to supplement the Ombudsman. Rather, it is there to ensure that apart from having reached a fair and correct decision (a matter for SFAT), we have also reached the conclusion through a due process in a fair, reasonable and proper manner. In other words: to ensure that persons who are subject to our regulatory action have, in the process of that action, received due, proper and fair treatment.

To this end, we have thoroughly reviewed our internal processes and procedures, and fine-tuned them so that they are consistent with the transparency requirements of today's market. We are also looking at how certain processes can be further streamlined to dovetail with the spirit and letter of the Bill.

Overall, the provisions of the new Bill and the establishment of the PRP will benefit both intermediaries and the investing public as it will provide greater transparency and accountability on the part of the SFC.

Balancing Act

In conclusion, the Bill, as it now stands, strikes a good balance in providing sufficient flexibility for market innovation and delivering adequate investor protection and accountability of the regulator.

The SFC will continue to implement the law without fear or favour, fully subject to all the checks and balances that we have built into the system. As the regulator and custodian of the rule of the law in the securities and futures markets, we must set high standards of due process and accountability. Our powers come from the market because it wants firm and fair regulation. We will always listen to and work closely with the market.

Our process of market consultation and feedback is pretty thorough and will be incorporated into the law. Before any code or rule is changed, we undergo an elaborate consultation process. First, a consultation paper is drafted. This may, depending on the issues, be referred to our newly revamped Advisory Committee, comprising 16 experts from all sectors of the securities and futures community for industry advice. We have also established a good number of working groups of market participants and experts to work alongside us to examine policy and drafting of subsidiary legislation, codes and guidelines under the Bill.

Once the Advisory Committee or user group has given their advice on the consultation paper, it goes before the full Commission, which meets monthly, for approval. It is then released for full market consultation, with consultation periods of between one to three months.

Once submissions have been received, we consider market views that may result in revisions to, for example, a final code or rule change before they are put to the Commission for approval. We meet regularly with the stakeholders, press and LegCo members to brief them of our activities and purposes.

In addition, we are working on a 3-year strategic plan that will help us prioritise and focus our efforts in critical areas. We have also commissioned an independent external survey of stakeholders' views to find out how the market thinks the SFC is doing right or wrongly.

With all these measures in place, I can honestly say that we will have a world class regulatory framework for Hong Kong as a world class financial centre. As I am fond of saying, the proof of the pudding is in the eating. We are content to be judged on our impartiality, professionalism and performance. And we are ready for that judgement.

Finally, let me give my sincere thanks to everyone who has worked so hard to take the Bill to this penultimate stage. Credit must go to colleagues in the SFC, Financial Services Bureau, the Department of Justice and other professional bodies who have contributed so much.

Like our counterparts in the UK, the Financial Services Authority, who are looking forward to N2 when the Financial Services and Markets Act will come into force, we too can look forward to the day when our Bill becomes law.

Postscript

The Securities and Futures Ordinance was enacted in the Legislative Council on 13 March 2002.