

**Guide to**

**Legislative Proposals on**

**Objectives, Powers and Functions of**

**the Securities and Futures Commission**

**(to be included in the Securities and Futures Bill)**

**5<sup>th</sup> July 1999**

## **Introduction**

1. In recent years, regulators have learnt from experience that it is helpful to the public as well as to the securities and futures industry if the objectives of regulation and the functions of the regulator are spelt out clearly. This not only helps to clarify the role of the regulator, but also increases its transparency and accountability to the public.
2. The Securities and Futures Commission Ordinance of May 1989 (the “SFCO”), which established the Securities and Futures Commission (the “Commission”), listed the functions of the Commission, but did not spell out its regulatory objectives.
3. As markets evolve and develop with technology, competition and institutional structure, so must their regulatory regime. Thus, the functions of the Commission are subject to periodic review. In 1990, a function was added for it to report insider dealing to the Financial Secretary, and in 1991 it was given the function to cooperate with other regulators in Hong Kong and elsewhere.
4. In October 1998, members of the International Organization of Securities Commissions (“IOSCO”) agreed that the core objectives of securities regulation are:
  - (a) the protection of investors;
  - (b) ensuring that markets are fair, efficient and transparent; and
  - (c) the reduction of systemic risks.

IOSCO also emphasized as a principle of securities regulation that the responsibilities of the regulator should be clear and preferably set out by law, and that the regulator’s exercise of powers and discharge of functions should be comprehensible and transparent to the public.

5. The recent Financial Services and Markets Bill in the United Kingdom (the “FSMB”) follows the same lines as IOSCO by spelling out the objectives of the new regulator, the Financial Services Authority (the “FSA”), as:
  - (a) maintaining confidence in the UK financial system;
  - (b) promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment or other financial dealings;
  - (c) securing the appropriate degree of protection of consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and
  - (d) reducing financial crime.

The FSMB also sets out in plain language the proposed regulatory approach and how the FSA would meet its statutory objectives.

6. Following international practice, the proposed Securities and Futures Bill (the “Composite Bill”) will at its outset spell out the regulatory objectives of the Commission and appropriately modernize the functions of the Commission. The objectives will collectively constitute the mission statement of the Commission, while the functions will set out its jurisdiction and serve as the source of its authority.
7. In addition, this modernized set of regulatory objectives and functions will provide a benchmark by which the public as well as the securities and futures industry can judge the performance of their regulator, and will act as a discipline on the Commission.

## **Objectives of the Commission**

8. Under the Composite Bill, the objectives of the Commission will be:
- (a) to maintain and promote fair, efficient, transparent and orderly securities, futures and related financial markets;
  - (b) to promote public confidence in and understanding of the financial system, and to secure the appropriate degree of protection for members of the investing public;
  - (c) to minimise crime and misconduct in the securities, futures and related financial markets;
  - (d) to reduce systemic risks in the securities, futures and related markets; and
  - (e) to assist the Government in maintaining the stability and integrity of the monetary and financial systems in Hong Kong.

These objectives are closely related and not mutually exclusive. They are part and parcel of the overall goal, enshrined in Article 109 of the Basic Law, to maintain Hong Kong's competitiveness as an international financial centre.

9. The strength of Hong Kong as an international financial centre lies in – indeed, its survival will depend upon – the ability to attract investors and financial firms from developed as well as emerging markets. However, modern financial business is extremely mobile. If Hong Kong lags behind other jurisdictions in the global race, investors and firms will simply bypass us in favour of other venues.
10. The Commission is committed to ensuring that Hong Kong's system of regulation is on a par with international best practice. Indeed, a key aim in introducing the new Composite Bill consolidating nine existing ordinances is

to ensure that Hong Kong remains attractive to international investors and financial firms. Comments and views are welcome, in particular on the extent to which the new legislation can improve the international community's confidence in our financial system.

### **Powers, Flexibility and Accountability**

11. Financial markets are changing rapidly, with growing globalization, innovation and competition. We need a flexible regulatory framework that can cope with these rapid changes and maintain Hong Kong in the forefront of competitiveness as an international financial centre.
12. Even the definitions of financial products have changed. The SFCO was enacted when the instruments traded in Hong Kong's financial markets were predominantly equity interests and traditional futures. It was therefore practical as well as practicable to describe the Commission's role by reference to such terms.
13. However, modern financial engineering has created a proliferation of derivative products, where many hybrid instruments do not fit within the existing definitions of "securities" or "futures contracts". For example, warrants and options derive their value from the underlying stocks, but often have time limitation features like futures.
14. In short, constant innovation in the marketplace in tradable financial instruments necessitates a more flexible approach to defining the Commission's regulatory jurisdiction. Accordingly, references to "securities, futures contracts and property investment arrangements" will be replaced by the inclusive term "financial products". Similarly, intermediaries, exchanges

and clearing houses will be referred to collectively as the “securities and futures industry” with an appropriate definition. These new references will better reflect the ambit of the role that the Commission is to fulfil.

*Flexibility and Due Process*

15. The rapid growth of financial innovation necessitates a certain degree of flexibility in the powers of the Commission. With the advent of Internet trading and the arrival of new players such as hedge funds, it is simply not possible to predict the future landscape of Hong Kong’s securities and futures markets. Crafting the Commission’s powers in rigid terms would at best allow things to slip through the cracks, and at worst create opportunities for fraud and abuse.
16. Flexibility, however, must exist only within the parameters of due process, and different problems require different approaches in rule making. The Composite Bill, as the primary legislation, will have under it subsidiary legislations, rules, codes of conduct, guidelines and statements of principle. The framework of “rules of the game” thus comprises of several levels, designed for the diverse as well as dynamic array of issues, and carrying an ascending degree of legislative backing.
17. The arrival of new financial products or players might not be covered by any particular legislation. At this initial stage, it may be more appropriate for the “rules” to be informal guidelines or statements of principles, worked out after consultation with the industry. Breaches of such guidelines typically do not carry sanctions.

18. Once the product or practice becomes more settled, the market might decide, either on a self-regulatory basis or with the help of the regulator, to evolve a code of conduct, the breach of which could carry some sanctions. However, codes typically do not have statutory backing. This allows for a cooperative approach in dealing with issues that are highly technical, less policy-oriented and require periodic review.
19. On the other hand, subsidiary legislations can give statutory sanctions upon a breach, and deal with issues of such importance that the legislature may wish to debate. They will therefore be proposed by the Commission through the Financial Secretary, and subject to vetting by the Legislative Council.
20. Currently, the powers of the Commission to make rules, codes and guidelines are dispersed among many different provisions. Such an approach confines the Commission's ability to make rules to those areas specifically covered in particular provisions. However, to be effective as a regulator, the Commission needs the flexibility to issue such rules, codes and guidelines as it considers necessary. Only in this way can new issues be addressed swiftly without the need for repeated amendments to the governing legislation.
21. It is therefore proposed that the Composite Bill provide a general power for the Commission to prescribe such rules, codes of conduct, guidelines and statements of principles in the performance of its functions. The Commission shall take great care in exercising this proposed power. Comments and views are welcome in particular on how to satisfy the need for this rule-making power and, at the same time, the need for transparency and accountability in regulation.

*Transparency and Accountability to the Public*

22. The Commission fully recognizes its responsibility to the public and to the securities and futures industry. Markets thrive on transparency. When the regulator expects market participants to be as transparent as possible, it must itself do the same. Setting out the objectives, functions and general duties of the Commission in the primary legislation will go a long way in this regard by helping everyone judge whether the Commission is acting within its mandate.
23. In addition, the Non-Executive Directors of the Commission, with their diverse background and expertise, will continue to play a major role in this area. The Advisory Committee and various specialized committees will also add their valuable insights.
24. The Commission recognizes that it must continually earn the public trust. This is essential not only as a matter of accountability, but also in order for the Commission to discharge its functions effectively. As in past years, the Commission will go beyond the statutory requirement of presenting annual audited accounts to the Legislative Council, and will make a comprehensive annual report available to all. It will also keep the public informed through frequent press announcements and releases, as well as by participating in public debates and discussions. The Commission is particularly pleased that its Internet webpage, in both Chinese and English, has been well received. The webpage is designed to be user-friendly, and contains detailed laws and rules as well as policy materials and simple explanations.
25. The Commission also expects to be called to give evidence and progress reports to the Financial Affairs Panel of the Legislative Council on a regular



basis, and will welcome any other opportunity to establish channels of communications with the legislators.

26. The Commission strives to be responsive to industry comments, especially when exercising its ruling-making and other regulatory powers. It will, in many instances, draft rules or codes of conduct along the lines of accepted market practice. Industry participants are encouraged to provide comments and criticisms at any time. In addition, market professionals with different perspectives and areas of expertise will be specifically consulted from time to time on particular issues.

*The Proposed Securities and Futures Appeals Tribunal*

27. As added discipline on the Commission and an important mechanism in a system of checks and balances, the Composite Bill will upgrade the current Securities and Futures Appeals Panel to a statutory tribunal, to be called the Securities and Futures Appeals Tribunal. In order to underscore the accountability of the Commission, it is proposed that the tribunal be chaired by a judge or deputy judge of the Court of First Instance, who would be assisted by several prominent market practitioners.
28. Compared with the existing panel, the tribunal will have an expanded jurisdiction, covering all disciplinary actions, licensing determinations, and certain other important decisions of the Commission. Its oversight authority will also be enhanced. For more details, please see *Guide to Legislative Proposals on Establishing a Securities and Futures Appeals Tribunal*.
29. In effect, the new Securities and Futures Appeals Tribunal will be an institutionalized joint effort in regulation by the judiciary, the securities and

futures industry and the Commission. As such, it exemplifies the philosophy of accountability and checks and balances behind the new Composite Bill as well as the role the Commission views itself to have.

#### *Process Review Panel*

30. The Commission strongly believes that it should be accountable to the public. However, part of its work is necessarily subject to privacy and confidentiality requirements of law, and specific information cannot always be publicly disclosed. To bridge this gap, an independent panel will be established to review aspects of the Commission's internal processes, including investigatory procedures, to ensure that, in making its decisions, the Commission follows proper due process procedures, and acts impartially and consistently.
31. As currently envisaged, the panel will comprise a majority of independent, prominent public persons, as well as some non-executive directors of the Commission. All members will be appointed by the Chief Executive. The panel will make its report to the Financial Secretary.

#### **Functions of the Commission**

32. The Commission strongly believes that effective regulation begins with a clear understanding, on the part of those being regulated, of the purpose of regulation and the role of the regulator. The regulatory objectives of the Composite Bill are already detailed above. How the Commission plans to carry out its functions, conferred by legislation, in its pursuit of the regulatory objectives is explained in the paragraphs below. In general, the approach will

be to promote self-responsibility on the part of the investor, self-regulation by the industry and, where prescribed by law, regulation by the Commission.

### *Supervision of the Marketplace*

33. Integral to any healthy financial system are fair, efficient, competitive and informed markets. The Commission therefore has a function to ensure that transactions in securities, futures contracts and other financial products, as well as takeovers and mergers involving corporations that have securities outstanding in public hands, take place in such markets.<sup>1</sup>
34. More specifically, the Commission will have a function to supervise and monitor the activities of market entities including the exchanges, clearing houses, licensed persons and other persons conducting business regulated by the Commission.<sup>2</sup>
35. While the Commission has a general function to promote, encourage and enforce proper conduct by all market participants, the Commission also recognizes that professionals in particular play a crucial role in today's complex financial world – whether as dealers executing transactions for investors, as advisors providing knowledge and informed judgment, or in any other way helping their clients and adding to the marketplace. The Commission therefore has a separate function to promote, maintain and enforce the professional standards and integrity of these persons.<sup>3</sup>

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<sup>1</sup> For details related to certain aspects of the Commission's work in this regard, please see *Guide to Legislative Proposals on Offers of Investment*, and *Guide to Legislative Proposals on Supervision and Investigation of Listed Corporations and Intermediaries*.

<sup>2</sup> Separate legislation is being prepared for the demutualisation/merger of the stock and options exchanges together with their associated clearing houses.

<sup>3</sup> For details on the different aspects of the Commission's work in this area, please see *Guide to Legislative Proposals on the Disciplinary Powers of the Securities and Futures Commission* and *Guide to Legislative Proposals on Powers of Intervention and Proceedings*. For details on a

### *Consumer Protection*

36. The consumer protection functions link closely with the other functions and lie at the heart of the work of the Commission. In broad strokes, the Commission will perform its functions along four basic themes.
37. Proper Conduct by Intermediaries. Effective protection must begin with ensuring proper conduct on the part of the intermediaries and other professionals whose job it is to assist consumers. In addition to the procedures and mechanisms discussed in paragraph 35 above, the Commission will also perform its functions in this respect by stressing the importance of good books and records as well as other internal controls.
38. Different Degrees of Protection for Different Kinds of Customers. It is neither possible nor appropriate to offer complete protection to customers of financial institutions. Different degrees of protection are needed for different kinds of customers. This principle will be recognized both in the Commission's overall regulatory philosophy and in the legislation. For example, financial professionals themselves require little protection from the Commission against each other. Hence, as in the case under existing law, persons who service only professionals will not be subject to the full licensing regime.
39. Self-Responsibility Based on Better Understanding. Thirdly, it must be stressed that investors must take responsibility for their own investment decisions. To help investors make informed decisions, the Commission has a function to foster understanding by the public of the risks and liabilities involved in the different kinds of financial instruments, as well as of the

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proposed framework for licensing of intermediaries, please see *Consultation Paper on Review of*

Commission's role, powers and limitations. The Commission will continue to commit resources to its investor education program, and is taking the current public consultation exercise for the Composite Bill as an opportunity to increase investors' awareness of the scope of regulation of the securities and futures industry, the risks and limitations involved, and other related issues.

40. Investor Compensation. Lastly, when intermediaries fail, some investor compensation may be appropriate. The existing regime treats clients of different markets differently. In addition, as recent cases such as CA Pacific have shown, the arrangements are legally complex and could be confusing to investors. The Composite Bill will include an enabling provision to provide a uniform basis for establishing a mechanism that will avoid moral hazard, yet allow for adequate levels of compensation and equitable treatment of different types of investors. The Commission published a consultation paper in September 1998, seeking comments on various approaches. It is currently studying the public comments received in order to determine how best to achieve the stated goals in light of the demutualisation/merger of the stock and options exchanges.

#### *Fighting Financial Crime and Checking Market Misconduct*

41. None of the regulatory objectives can be achieved if financial crime or market misconduct is tolerated. The Commission will continue to place a high priority on its enforcement function, and will coordinate its efforts with those of other criminal law intelligence, investigation and prosecution agencies.

42. However, experience has demonstrated that criminal prosecution, even where major resource commitments are made, can be difficult. Modern sophisticated practices and systems can make it extremely difficult to obtain sufficient evidence to prove matters beyond reasonable doubt. The fact that a wrongdoer might have harmed the market in general, but not any particular counterparty, also presents a potential mismatch with criminal law norms.
43. Hong Kong has successfully led the world in the treatment of insider dealing cases through the Insider Dealing Tribunal. The Composite Bill will build on this model, expanding it into a Market Misconduct Tribunal to serve as an efficient and effective substitute for criminal prosecution of market misconduct. The details are set out in *Guide on Legislative Proposals on Establishing a Market Misconduct Tribunal*, published in the same series as the present paper.

#### *Working with Other Regulatory Bodies*

44. The financial world is a complex place, and no single regulator can undertake all the necessary work. It is often more efficient for the securities and futures industry to deal with certain issues by self-regulation. As IOSCO puts it: Self-Regulatory Organizations (“SROs”) “can be a valuable complement to the regulator in achieving the objectives of securities regulation” and “the regulatory regime should make appropriate use of (such SROs)”. The Composite Bill will recognize this, and the Commission will have a function to promote and develop self-regulation when consistent with its regulatory objectives, functions and powers.

45. Many transactions today are cross-border in nature or involve parties with different home jurisdictions. As IOSCO has observed, joint efforts among regulators have become critical in many areas including detection of fraud or money laundering, law enforcement, management of systemic risks, even licensing. The Composite Bill will recognize the importance of international cooperation, and acknowledge this explicitly as a function of the Commission.

*Competitiveness of Hong Kong's Securities and Futures Industry*

46. Markets are moving fast to those venues that are most transparent, liquid, efficient, competitive, fair and robust in terms of financial infrastructure and regulation. As an international financial centre with relatively high costs, Hong Kong must recognize that its capital raising capability is facing many challenges and severe competition – functionally as well as geographically. In light of the keen competition from other venues, the Composite Bill will make clear that the Commission has a function to promote, facilitate and maintain the efficiency, transparency and competitiveness of Hong Kong's securities and futures markets.

*Commission and the Wider Government Machinery*

47. The Commission is part of the whole government machinery. It communicates with the Financial Services Bureau, the Hong Kong Monetary Authority, the Department of Justice, the police as well as other government agencies regularly, and reports to the Financial Secretary when appropriate. Furthermore, as the relevant specialist agency charged with the regulation of

the securities and futures markets, it has a function to advise the Financial Secretary on all matters relating to these markets.

### **General Duties of the Commission**

48. The Composite Bill will also set out certain general factors that the Commission must take into account when pursuing its regulatory objectives and performing its functions. These factors are included in the bill as reminders of how a regulator should act – it should facilitate innovation, not impede competition except where necessary, be as transparent as practicable, and employ its resources efficiently.

### *Innovation*

49. The modern financial industry depends upon technology for delivery of services and execution of transactions. New technology has not only transcended geography and created new products; it is also facilitating the flow of information, speeding up transactions, driving down costs and expanding access. Hong Kong's regulatory regime must keep this in mind as it pursues its objectives and perform its functions.
50. The Commission will work with the securities and futures industry to facilitate innovation. Participants are encouraged to discuss new product ideas and new market developments with the Commission at an early stage to ensure that the risks, for themselves and for their customers, as well as the regulatory implications are properly understood and managed.



### *Competition in the Marketplace*

51. Competition is the main engine for innovation and in general works to consumers' best interests. The Commission will seek to ensure that its rules and guidance do not impede or distort competition, in particular by maintaining a level playing field among all participants, whether large or small, local or international, and among intermediaries that provide services to the different demands of different categories of customers.

### *Transparency*

52. The Commission is committed to being as transparent as possible to the securities and futures industry and to the public at large. A number of mechanisms and practices designed to maximize transparency in this regard are discussed in detail in paragraphs 22 to 31 above.

### *Efficient Use of Resources*

53. Regulation necessarily means a certain degree of burden and restriction. The important question is whether the benefits of regulation outweigh the costs, taking into account probabilities and risks. It will make such cost-benefit analysis an integral part of its process of setting regulatory standards, and invites the public to evaluate its performance against these criteria.

### **Public Consultation**

54. The financial world is developing at an ever-increasing pace. In order for Hong Kong to retain its prominence in this changing landscape, it must have a sensible, flexible and user-friendly securities regulatory framework. The

proposed Composite Bill will set up such a framework. It will describe at its outset the diverse but interrelated objectives that a securities regulator must pursue, delineate the main functional lines that the regulator should follow in order to achieve the objectives, and state the important considerations that the Commission must take into account when performing its functions.

55. The Government and the Commission believe that the proposed Composite Bill will inject into the regulatory regime more clarity of vision as well as transparency about the role of the Commission, thereby enabling the Commission to work more closely and effectively with the securities and futures industry as well as the public at large, and ensuring Hong Kong's continuing success as an international financial centre.
56. Comments and views are sought from the financial community and general public. Please write to the Securities and Futures Commission, 12<sup>th</sup> Floor, Edinburgh Tower, The Landmark, 15 Queen's Road Central, Hong Kong, or email to <[newbill@hksfc.org.hk](mailto: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.