

Overview Guide to
The Proposed Securities and Futures Bill

5th July 1999

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1. This Overview Guide

The Government has recently presented an information paper to the Financial Affairs Panel of LegCo, highlighting the major proposals that will be included in the proposed Securities and Futures Bill. The bill is scheduled for introduction into LegCo by the end of this year.

This Guide provides an overview of the proposed law, explains the reasons for the new legislation, what it hopes to achieve, and the public consultation that now begins.

More details of the major proposals in the draft bill are available in a series of Guides, which can be found on the Commission's website at www.hksfc.org.hk.

You are welcome to comment on the issues raised in this Overview Guide or any of the individual Guides. Please write to the Securities and Futures Commission, 12th floor, Edinburgh Tower, The Landmark, 15 Queen's Road, Central, Hong Kong or e-mail to newbill@hksfc.org.hk. In view of the tight legislative timetable, we would be grateful if your comments and suggestions could reach the Commission before 6 August 1999.

2. Securities and Futures Markets and Hong Kong

The securities and futures industry is one of the key sectors of Hong Kong's economy. It is a high value added service industry and serves as a central pillar to our status as an international financial centre. It provides jobs and helps to promote other related service sectors, such as accounting, law, media, trade, communications, and commerce.

Well-functioning securities and futures markets serve to channel capital to listed companies to fuel growth, help investors save for the future and diversify their risks, facilitate price discovery, and generate economic growth by attracting foreign capital. But markets only function well if they are open, fair, efficient, liquid, and transparent. Investors choose those markets in which they have trust and confidence. Sound regulation, therefore, is important to the wellbeing of the securities and futures business, investors, and the Hong Kong community.

As a financial centre, Hong Kong serves three key roles:

- The premier fund-raising centre for Mainland China;
- A regional financial centre in the Asia-Pacific time zone; and
- An international financial centre straddling between the London and New York time zones.

Globalisation of financial services, coupled with advances in information technology, mean investors are no longer geographically bound. Cross-border, 24-hour trading is already common practice. If our markets are healthy and vibrant, investors will pick Hong Kong as their base in the Asia-Pacific time zone and as the key hub to Mainland China as well as East Asia. Conversely, if our markets do not measure up to international standards, investors will bypass Hong Kong and seek quality elsewhere.

Recent years also witnessed the arrival of new financial products, new market participants, and new trading methods. Competition through technology, financial innovation, and new tools of risk management have brought new business and eroded traditional franchises. Such financial innovation reduces costs, enables investors large and small to better manage their money, and should be encouraged. However, it also gives rise to new concerns about investor protection, volatility, speculation, and market abuses. There must, therefore, be a balance between facilitating innovation and growth on the one hand, and minimising market misconduct and financial crime, together with providing an adequate degree of investor protection on the other.

Hong Kong's securities and futures markets have enjoyed tremendous growth in the past decade. Continuous changes in financial innovation and market structure mean that the regulatory framework must evolve flexibly with the times. The current securities legislation has served Hong Kong well, but must now be updated in response to rapid changes brought by globalisation, computer usage, and new products and services.

It is to this end that the Government and the Commission have proposed the new Securities and Futures Bill. We must modernise our regulatory framework to keep it on par with the best of international standards, and to provide an environment where our securities and futures industry and markets can compete effectively in the new Millennium.

3. The Proposed Securities and Futures Bill

The securities and futures industry in Hong Kong is currently governed by nine different ordinances (plus parts of the Companies Ordinance). The core piece of legislation, the Securities Ordinance, is already a quarter century old. Many of the concepts and definitions in use are out of date. Financial instruments and practices have evolved far beyond those originally envisaged, creating gaps in the legal framework and rendering certain regulatory approaches ineffective or inappropriate.

The proposed Securities and Futures Bill (the “Composite Bill”) will consolidate, update, and amend the nine ordinances. Many of the changes were included in an initial draft bill that was released for public consultation in 1996. The current draft takes into account industry and public comments then made, with additional changes in response to growing international practice, experience gained during the Asian financial turmoil, and recent market developments.

Drafting of the Composite Bill has been guided by the following principles:

- The new regulatory framework should be technology friendly;
- It should keep pace with market developments;
- It should be on par with international best practice;
- It should facilitate and be able to address future financial innovation;
- It should minimise legal uncertainty;
- Gaps in the existing regulatory regime should be filled;
- The regulator should be as accountable and transparent as practicable, subject to privacy and confidentiality restrictions;
- Regulatory procedures and processes should be simplified and made user-friendly wherever possible;
- There should be a smooth transition from the existing to the new regulatory framework.

The Composite Bill will provide a thoroughly efficient and modern securities and futures regulatory regime, under which our financial services industry can remain competitive.

4. Other Measures to Improve Our Markets

The Composite Bill is one of three proposals, announced by the Government in March of this year, for reforming our securities and futures market. The second reform proposal focuses on the upgrading of our market technology

infrastructure. A Steering Committee on the Enhancement of Financial Infrastructure has been studying ways to utilise technology to make our markets more efficient, information more accessible, clearing process faster, and settlement more secure. The committee will make its report to the Government by 30 September 1999.

The third proposal calls for the demutualisation and merger of the stock and futures exchanges and their associated clearing houses, followed by a public listing of the new single entity. The horizontal and vertical integration of our exchanges and clearing houses will lead to better synergies, facilitating the pursuit of new business initiatives and enhancing competitiveness. The demutualisation exercise will require separate enabling legislation. This is being pursued in parallel with the Composite Bill.

All three reform proposals will be subject to public consultation, being key components to an overall strategy towards the same goal – to make Hong Kong a better international financial centre.

5. Objectives, Functions, and General Duties of the SFC

The proposed Composite Bill will set out at its beginning the objectives, functions, and general duties of the regulator, the Securities and Futures Commission.

Taken together, the objectives embody the vision of the regulatory regime and the purpose of the Commission. As enumerated in the bill, they are:

- to maintain and promote fair, efficient, transparent and orderly securities, futures and related financial markets;
- 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;
- to minimise crime and misconduct in the securities, futures and related financial markets;
- to reduce systemic risks in the securities, futures and related markets; and
- to assist the Government in maintaining the stability and integrity of the monetary and financial systems in Hong Kong.

In order to pursue the above objectives, the Commission will be endowed with a set of functions under the Composite Bill. These functions, in effect, express the general powers of the Commission relating to supervision of the marketplace, regulation of the securities and futures industry, investor protection, suppression of financial crime and market misconduct, cooperation with other securities and futures regulators, promotion of Hong Kong's competitiveness as a financial centre, and expert support to the Government.

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.

6. Transparency and Accountability

One of the key principles reflected in the Composite Bill is that the regulator should be both transparent and accountable, subject to proper considerations of privacy and confidentiality. The Composite Bill's clear statement of the Commission's objectives, functions, and general duties will go a long way towards providing a set of benchmarks by which the public and the industry can judge the performance of their regulator.

As a more direct mechanism of check and balance, the Composite Bill will expand the current Securities and Futures Appeals Panel into a Securities and Futures Appeals Tribunal. The tribunal will be chaired by a High Court judge and will include a number of prominent market practitioners. It will have jurisdiction to review many important decisions of the Commission, including all licensing and disciplinary decisions. The tribunal's review will cover the full merits of each case, with the power to substitute its own decision for that of the Commission.

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. As currently envisaged, the panel will comprise a majority of independent, prominent public persons, to be appointed by the Chief Executive, as well as some non-executive directors of the Commission. The panel will make its report to the Financial Secretary.

In addition, the Commission will continue to use existing channels of communication with the industry and the public, including:

- Presentation of its annual accounts to LegCo and making regular reports to the Financial Affairs Panel;
- Publication of comprehensive annual reports;
- Frequent press releases and announcements;
- Participation in discussions in public forums;
- Internet website, containing up-to-date policy as well as legal materials;
- Consultation with professional groups and advisory committees to seek market perspectives, and public consultation of policy proposals at the earliest practicable opportunity;
- Drafting rules and codes of conduct along accepted market practice wherever appropriate.

An ongoing dialogue with the industry and general public is essential not only as a matter of accountability, but also in order for the Commission to discharge its functions effectively. Indeed, to achieve the objectives of the Composite Bill and maintain Hong Kong's competitive position as an international financial centre, the public, the industry, the Government, and the Commission will need to work together with a common vision.

7. Key Proposals of the Composite Bill

The proposed Composite Bill consolidates and updates nine existing ordinances to create a thoroughly modern and efficient regulatory framework on par with international best practice. The key policy proposals are:

- Streamlining the present regime for licensing intermediaries;
- Laying the groundwork for regulating electronic trading facilities;
- Creating a Securities and Futures Appeals Tribunal with jurisdiction to review many important decisions of the Commission;
- Creating a Market Misconduct Tribunal to deal responsively and effectively with cases of insider dealing, market manipulation, and other market misconduct;
- Enhancing the disclosure of interests regime as the foundation for investors making informed decisions (subject of prior public consultation);
- Enhancing the ability to supervise intermediaries and to ascertain their compliance with relevant regulatory requirements;

- Providing a fuller range of the disciplinary sanctions for improper conduct of intermediaries by including civil fines and partial suspension of business;
- Rationalising the necessary powers for making a preliminary inquiry into any suspected fraud, misfeasance, or other misconduct in the management of a listed corporation;
- Giving statutory backing to the Listing Rules;
- Ensuring that the legislation allows for effective regulation of all types of investment products and arrangements;
- Establishing a unified framework to facilitate a future new compensation scheme for investors who suffer losses as a result of the failure of an intermediary (subject of prior public consultation);
- Creating a statutory right of action for private litigants;
- Giving the Commission the ability to intervene in court proceedings between private litigants for the protection of public interest.

Licensing of Intermediaries

Financial innovation and growing investor sophistication have blurred the lines between traditionally separate categories of products, giving rise to the need for many intermediaries to simultaneously deal in and advise on securities, futures, foreign exchange, as well as other investment products.

For Hong Kong to stay ahead of external competition, our industry participants must have the requisite knowledge and expertise, and our

regulatory regime must minimise the administrative burden on our market wherever possible.

To this end, the Composite Bill will provide that:

- A single licence will be issued to each intermediary, specifying the scope of permitted business. This approach will eliminate the duplication of procedures and documents under the present multiple-registration requirements;
- Activities within different categories of permitted business will be redrawn to follow actual practice and to reflect market development, with grandfathering arrangements for present registrants;
- Applicants for representative status will be able to obtain a provisional licence (while pending detailed review of application materials) in order to save time and costs;
- Licensed status (other than for representatives) will be limited to corporate entities, with transition arrangements for existing sole proprietorships and partnerships;
- The Commission may issue banning orders against persons who are not fit and proper to participate in the industry;
- Exempt dealer status will be limited to Authorised Institutions (*i.e.*, banks and other deposit taking companies regulated by the Hong Kong Monetary Authority), and such persons will be subject to the Commission's power of inquiry;
- Persons who act as principals and deal solely with professionals will continue not to need a license, but will be required to notify the

Commission of their existence and be subject to certain reporting and Code of Conduct requirements.

In addition, in order to enhance the quality of our industry, the Commission proposes to revise the Fit and Proper Criteria to include certain professional education, training, and experience requirements.

Regulation of Electronic Trading Facilities

Advances in information technology and demands of increasingly sophisticated investors are spurring a diverse array of electronic trading facilities (sometimes referred to as electronic communications networks (“ECNs”) or automated trading systems (“ATs”)). The activities and services of these facilities must be subject to proper regulatory supervision. The Commission’s experience, in line with that of other leading jurisdictions, is that no single set of rules is appropriate for the whole range of facilities and services on offer.

Accordingly, the Composite Bill will ensure that the Commission has a sufficient range of powers to facilitate and regulate these trading facilities. The particular characteristics of a facility will determine how it is to be regulated so that its operation is fair, efficient, and transparent, and that its risks are properly managed. The Commission will work with members of the industry and other professions on setting guidance for potential applicants who wish to offer such services.

Market Misconduct Tribunal

No market can maintain its reputation and standing if effective enforcement is not taken against manipulation and other market misconduct. However, experience has shown that investigating such conduct with a view to criminal prosecution is fraught with difficulties. Sophisticated practices and techniques can make it extremely difficult to obtain sufficient evidence to prove certain matters to the criminal standard (*i.e.*, beyond all reasonable doubt).

The Composite Bill will build on the success of the present Insider Dealing Tribunal, expanding it into a Market Misconduct Tribunal to handle cases of insider dealing, manipulation, as well as other market misconduct. The tribunal will be chaired by a High Court judge, and will include two prominent market practitioners with market expertise. The civil standard of proof (*i.e.*, balance of probability) will apply. Sanctions that the tribunal may impose will include disgorgement of profits made or losses avoided as a result of the misconduct, as well as a pecuniary penalty of up to the higher of three times that amount or \$10 million. Fines will be paid into the Government's general revenue.

Disclosure of Interests in Securities

Information is at the centre of an efficient market. It enables investors to make better decisions, and maintains a level playing field among different participants. The international trend is to move to full disclosure of relevant information, so that investors may take responsibility for themselves in

assessing the risks and returns. Hong Kong already has a disclosure-based regulatory regime, but the Commission believes further enhancements are possible. In June 1998, the Commission published a public consultation paper making a series of proposals in this regard. Conclusions of the consultation were published in March of this year. The main elements are:

- Lower the initial shareholding disclosure threshold for persons other than directors from 10% to 5%;
- Shorten the disclosure notification period from 5 days to 3 days;
- Increase the disclosure requirements for derivative products; and
- Level the disclosure obligations of local and overseas trustees and investment advisors.

Legal provisions to implement the enhancements will be included in the Composite Bill.

Disciplinary Inquiries

Current law provides that before the Commission takes disciplinary action against any intermediary for suspected improper conduct, it shall first conduct an inquiry specifically for such purpose. In practice, however, misconduct may be identified in the course of other investigations or inspections, and a separate inquiry is not always necessary. Furthermore, under current law, a disciplinary inquiry depends on the voluntary cooperation of the intermediary and other persons with relevant information. Such cooperation might not necessarily be forthcoming.

The Composite Bill will therefore streamline the disciplinary process; a separate inquiry will no longer be a prerequisite. Procedural fairness requirements on the Commission, however, will continue to apply throughout the disciplinary process:

- The Commission must advise the intermediary of its concerns in writing;
- It must afford the intermediary an opportunity to present its case;
- It must give the intermediary written notice of its decision, with reasoning clearly stated.

In circumstances that warrant an inquiry, the Commission will have the necessary powers under the bill to compel production of information, explanations, or answers to specific questions. The exercise of these powers will be subject to a number of safeguards.

Additional Sanctions in Disciplinary Actions

When an intermediary fails to conduct its business in a proper manner, the Commission should be able to discipline that intermediary with meaningful sanctions. At present, the sanctions available to the Commission are public or private reprimands and suspension or revocation of the intermediary's registration.

These limited categories of sanctions do not always give the Commission appropriate tools to deal with misconduct. For example, a public reprimand may not sufficiently punish an intermediary for its improper conduct or adequately deter similar acts in the future. Yet suspending or revoking an

intermediary's registration may be too draconian, and could cause disproportionate harm to third parties, such as customers, employees, shareholders, and counter-parties. Intermediate options are needed so that the Commission can set sanctions appropriate for the improper conduct committed. To this end, the Composite Bill will introduce two new sanctions: civil fines and partial suspension.

In line with generally accepted practice in the United States, and as proposed in the United Kingdom, the Composite Bill will introduce civil fines for improper conduct by intermediaries. The maximum monetary penalty that the Commission may impose will be clearly set out in the legislation. Fines will be paid into the Government's general revenue.

In addition, the Composite Bill will also provide for suspension of part of an intermediary's business. This will give the Commission greater flexibility in imposing a suspension, so as to target the specific area of an intermediary's business in which improper conduct has occurred as well as to minimise any incidental effects on third parties.

All disciplinary decisions of the Commission, including the imposition of civil fines or partial suspension, will be appealable to the new Securities and Futures Appeals Tribunal. This review will be a fresh look by an independent body at the full merits of the case.

Preliminary Inquiry of Misconduct in Management of a Listed Company

Current law allows the Commission to seek the production of books and records when it has reasons to suspect fraud, misfeasance, or other misconduct in the management of a listed company. The Commission, however, has only limited ability to place the entries in the books and records in any meaningful context or to check their veracity.

To rectify these problems, the Composite Bill will provide that:

- The Commission may ask for an explanation as to the circumstances, reasons, and instructions for the making of an entry in the books and records;
- It may make enquiries of parties with which the company purports to have had contractual relationships, so that the veracity of the information in the books and records could be confirmed;
- It may access the working papers of the company's auditors, which could contain helpful information that is not otherwise available or that could curtail the need for further inquiry. To exercise this power, the Commission must first certify in writing to the auditors that it has initiated an inquiry into the management of the listed company (by imposing a requirement on the company to produce its books and records). It should be stressed that this power is not aimed at assessing the quality of audit work performed;
- The Commission may access the banking records of the company. This power is available under current law, but unclear wording has impeded its use. To exercise this power, the Commission must first certify in writing to the bank that it has initiated an inquiry into the management of

the listed company and that the banking records are relevant to the inquiry.

Statutory Backing for Listing Rules and Liability for Misstatements

Two essentials of every vibrant securities market are the observance by listed companies of their listing obligations under the rules of the stock exchange, and the accuracy and completeness of disclosures to the investing public. Experience in recent years shows that enforcement of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “Listing Rules”) as well as the quality of disclosures as required under the Listing Rules and the Hong Kong Code on Takeovers and Mergers (the “Takeovers Code”) need to be strengthened. Conduct in violation of these rules and poor disclosure harm investor interest, undermine the integrity of our market, and must be discouraged.

As mentioned in the *Report on Financial Market Review*, published in April 1998, the Commission embarked some time ago on a study to put more “teeth” in the Listing Rules. In considering ways to strengthen the enforcement of the Listing Rules, it is also recognised that the rules should be market-oriented and should contain flexibility to allow for the different circumstances of each case. Accordingly, the Composite Bill will not alter the nonstatutory nature of the Listing Rules.

The framework presently under consideration comprises two main areas:

- (a) *Court-orders* – Authorising the court, upon application of the Commission (which may delegate this power to apply to the Stock Exchange) to make an order:
- compelling compliance with the Listing Rules. Non-compliance with the order will constitute a contempt of court, and the court may at its discretion impose appropriate sanctions on those in breach;
 - disqualifying a director of a listed company who has wilfully or persistently failed to discharge his duties under the Listing Rules or the Takeovers Code from being a director of any listed company for a period of time.
- (b) *Disclosure-related* – Establishing specific civil liability for:
- omissions and misstatements in statements made under the Listing Rules or the Takeovers Code; and
 - failure to proceed with an announced takeover offer without the consent of the Takeovers Executive or Takeovers Panel.

The specific civil liability provisions will seek to simplify the judicial process that an injured person has to go through to obtain redress.

Concern has been expressed that the manner in which support for the Listing Rules is provided should not render the application of the Listing Rules unduly legalistic. The views of the market will be taken into account in any legislative proposals ultimately put forward.

Offers of Investments

Financial innovation is creating a wide variety of investment products and arrangements that do not fall within traditional definitions. This has resulted in certain loopholes and areas of uncertainty in current law with regard to the Commission's power to facilitate and regulate the offering of new types of investment products and arrangements. The Composite Bill will rectify these deficiencies by:

- Expanding the definition of “investment arrangements”;
- Using a new term “collective investment schemes” to include unit trusts, mutual funds, and all other similar arrangements.

The Composite Bill will also expressly empower the Commission to withdraw an authorisation for an investment arrangement when the product or its operator no longer satisfy the criteria and conditions for authorisation.

Investor Compensation Fund

In the interest of systemic stability and fairness, it is sometimes appropriate to compensate clients of failed intermediaries. On the other hand, compensation for loss of investments could generate moral hazard, where investors might overlook the fundamental principle of self-responsibility for both the risks and rewards of investment.

After the failure of CA Pacific, it has become apparent that the existing compensation arrangements are legally complex, confusing to investors, and in need of reform. 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.

Statutory Private Right of Action

One of the key objectives of the Composite Bill is to encourage and enable investors to take charge of their investments and to protect their interest. The Composite Bill will create a statutory right of action for any person who is or may be materially affected by another person's market misconduct or market malpractice (such terms as defined in the Composite Bill). The injured person may apply to the Court of First Instance for an injunction as well as other remedies.

At present, a person who suffers loss as a result of another's misconduct in the securities and futures market may be able to seek redress under common law or rules of equity. However, he or she will have to fashion the claim within the traditional parameters of contract, tort, or breach of fiduciary duty, and in many cases will have to face a number of procedural as well as legal challenges.

Other jurisdictions, including the United States, the United Kingdom, and Australia, provide a simple statutory cause of action for injury resulting from another person's violation of securities laws. The Composite Bill will put Hong Kong more in line with this accepted international practice.

This private cause of action is created only to eliminate the unreasonable necessity of fitting an act that contravenes securities regulation into traditional common law or equity precepts. An applicant for relief will still have to prove the defendant's violation of regulatory requirements, causation of harm to the applicant, and materiality of injury. Persons other than the injured party, including the Commission, will not be entitled to bring a claim under the proposed statutory cause of action, whether for themselves or on behalf of other persons as a class.

Commission's Intervention in Third Party Litigation

Litigation where the Commission is not a party may nevertheless involve points of law that are relevant to the Commission's functions and responsibilities as regulator. The recent investor compensation litigation provides an apt example where a private suit involves wider public interest issues, and in which the Court might find it helpful for to have the Commission's regulatory perspective or expert opinion.

At present, there is no simple mechanism whereby the Commission can submit its expert views for the benefit of the court. We propose that the Composite Bill include a new section giving the Commission standing to intervene and be heard in relevant third-party proceedings (other than

criminal proceedings) where it has an interest in the matter by virtue of its statutory powers and functions.

8. The Process Ahead

The above policy proposals, the presentation to the Financial Affairs Panel of LegCo, and the publication of this Overview and detailed Guides to the draft Composite Bill are all part of the public consultation process before the bill is submitted to LegCo by the end of this year.

The Commission will be consulting participants in the securities and futures industry, related professions, and other public circles for their views. We welcome your comments and suggestions. They can be submitted to the Commission in writing or by electronic mail. (The relevant addresses are stated on page 1.)

Taking into account the comments and suggestions collected, the Commission and the Government will work together to finalise the draft bill. It is anticipated that the bill will be introduced in LegCo for its first reading in December of this year.

Much is at stake. External competition and the accelerating pace of change require that we act quickly and decisively. The time has come for the public, the industry, the Government, and the Commission to join in their efforts to

support and foster Hong Kong's drive for excellence in financial services, and to secure our position as a premier international financial centre.