

Guide to

Legislative Proposals on

Disciplinary Powers of

the Securities and Futures Commission

(to be included in the Securities and Futures Bill)

5th July 1999

Introduction

1. The disciplinary powers of the Securities and Futures Commission (the “Commission”) are presently set out in the Securities Ordinance (“SO”), the Commodities Trading Ordinance (“CTO”) and the Leveraged Foreign Exchange Trading Ordinance (“LFETO”). Under these ordinances, the Commission has the power to impose certain sanctions on registered/licensed persons for misconduct (a defined term that includes a disparate range of activities and conduct in relation to securities, commodities and leveraged foreign exchange trading) or where their “fitness and properness” has been impugned. These sanctions are:

- Private or public reprimand;¹ or
- Revocation or suspension of registration or licence.

The Commission may also reprimand unregistered/non-licensed persons such as directors, secretaries or persons in management of registered/licensed persons where the misconduct occurred with the “fault” of such unregistered/non-licensed persons. The Commission currently has no power to fine.

2. Where, in relation to particular conduct, a reprimand is too light but a suspension or revocation is too harsh, there is no “intermediate” disciplinary sanction that the Commission may impose. For many firms, reprimands may not provide sufficient deterrence against future violations. Yet, revoking a firm’s registration, or even suspending its operations temporarily, may cause disproportionate harm to third parties such as the firm’s customers, employees and shareholders.
3. The result of the restricted range of the Commission’s existing enforcement sanctions is that on a number of occasions, the Commission has had to face very difficult decisions where a sanction more severe than reprimand might have been appropriate given the gravity of the misconduct or the importance of the rule that was infringed. Yet, a suspension or revocation was not

¹ In general, a public reprimand is appropriate when the misconduct has not seriously affected the market, no person has suffered injury, and adequate measures have been taken to address the issues. Private reprimands are rarely given, and are used only when the transgression is very minor and that there is no need to raise the industry’s attention to the relevant regulatory requirements or prohibitions.

imposed as that was considered too harsh. Of the 284 disciplinary actions taken by the Commission in the period 1 April 1996 to 31 March 1999, 127 were sanctioned by way of a public reprimand, 117 were given a suspension and 31 had their registrations revoked. A number of the 127 cases in which the Commission imposed a public reprimand involved large brokerage firms whose misconduct was such that they might have deserved a heavier penalty than a public reprimand. Yet due to the size of their business in Hong Kong, it would not have been possible to revoke or suspend their licence without creating undue hardship on innocent third parties. Apart from the inadequacy and consequently ineffectiveness of a reprimand as a deterrent, this could also give rise to the erroneous perception that large firms get away with light penalties.

4. To effectively enforce Hong Kong's securities laws and regulations, the Commission needs to be given a wider range of disciplinary tools so that it may flexibly fashion proportionate and where necessary significant penalties. This paper will recommend that, in addition to the present sanctions, the Commission be given the power to also impose civil fines or make orders for only partial suspension of a registered/licensed person's business and issue orders prohibiting responsible officers from seeking to be licensed or approved by the Commission.

Civil Fines

A. *Civil Fines Recognized in other International Markets*

5. Civil fines are an enforcement sanction that both the US Securities and Exchange Commission ("SEC")² and the US Commodity Futures Trading Commission ("CFTC")³ are empowered under

² The Securities Enforcement Remedies and Penny Stock Reform Act 1990 ("1990 Act") gives the SEC the power in administrative proceedings to impose, *inter alia*, civil penalties and accounting and disgorgement orders against regulated entities such as dealers and investment advisers. The 1990 Act adopted a three-tiered penalty structure: US\$5,000 for a natural person and US\$50,000 for any other person in respect of each violation in the first tier (where there is no fraud), US\$ 50,000 for a natural person and US\$250,000 for any other person in the second tier in respect of each violation where there is fraud or reckless disregard, and to US\$100,000 for a natural person and US\$500,000 for any other person in the third tier in respect of each violation where there is fraud and resulting losses to other persons.

³ The Futures trading Practices Act 1992 empowers the CFTC to impose in administrative proceedings civil money penalties up to the higher of US\$100,000 per violation or triple the monetary gain.

relevant US statutes to impose on regulated persons found by the SEC or CFTC to be or to have been in violation of relevant statutory or regulatory requirements, or if the conduct of such persons demonstrates a lack of fitness.

6. The experience of the SEC and CFTC is that the power to impose significant civil fines has proven to be an effective enforcement remedy which both regulators have used to penalize and deter violations and misconduct.
7. The United Kingdom's proposed Financial Services and Markets Bill ("FSM Bill"), which was published for consultation in July 1998, recognises civil fines as one of the enforcement tools with which the Financial Services Authority ("FSA") should be equipped in order that it may take effective but proportionate disciplinary action where necessary. The need for the FSA to be equipped with a range of disciplinary powers, including civil fines, was generally accepted by those who were consulted.⁴

B. Regulatory Objectives For Civil Fines

8. The Commission believes that the principal objectives of any disciplinary sanctions are to secure compliance, protect investors and maintain confidence in Hong Kong's financial system and markets. The exercise by the Commission of the power to impose a financial penalty in appropriate cases will serve to:
 - Deter the relevant firm or individual from repeating the misconduct.
 - Deter other firms and individuals from committing such or similar misconduct.
 - Punish the offender in a manner that is proportionate to the gravity of his misconduct, particularly where the sanction of reprimand is unduly light but the penalty of revocation or suspension would be unfair to innocent persons such as clients and employees of particular offenders, or where such a drastic measure would be disproportionate to the misconduct committed.

⁴ See Financial Services and Markets Bill Progress Report, March 1999, paras. 6.1 and 6.2.

- Protect other participants in the market and ensure that they are not placed in a disadvantage by the misconduct of the offender(s).
 - Maintain a level playing field by ensuring that a person guilty of misconduct does not benefit from the misconduct.
9. On the basis of the US and UK models, the Commission believes that it would be appropriate for the Securities and Futures Bill to give the Commission the power, subject to requirements of fairness and due process, to impose civil fines on registered/licensed persons in respect of misconduct. This will underscore the importance of compliance and convey to all relevant persons the seriousness with which the Commission views misconduct.

C. Persons on Whom Civil Fines should be Imposed

10. The Commission proposes that the power to impose civil fines should extend not only to registered firms and individuals but also persons who, though not registered with the Commission, are involved in the management of registered persons, and the misconduct occurred with the consent or connivance, or was attributable to any neglect on the part of, such persons. Under present legislation the Commission has no power to discipline (except to reprimand) these persons if they are not also registered with the Commission.
11. While the Commission envisages that in most cases it would seek to impose civil fines where it considers that the sanctions of reprimand, revocation or suspension are not appropriate or proportionate to the misconduct, there may be occasions when the misconduct is such that the Commission may impose both a fine and a reprimand or a revocation or suspension (whether partial or total). However, no fine will be imposed where the misconduct in question also constitutes an offence and the person guilty of the offence has been convicted.

D. Criteria for Determining and Calibrating Civil Fines

12. In determining whether to impose a civil fine and the amount thereof, the Commission will consider the full circumstances of

each case and take into consideration, in the context of its overall policy objectives, a range of factors. These will include:

- The nature and severity of the breach or misconduct. Any disciplinary sanction must be proportionate to the nature and seriousness of the misconduct in question. This involves questions of whether there was any fraud or reckless disregard of applicable rules, loss to other customers, the amount of any benefit gained or loss avoided as a result of such misconduct and whether confidence in or the orderliness of the financial markets has been damaged as a result.
 - The existence of any mitigating or aggravating factors. This involves questions such as whether the firm continued the misconduct after discovery or brought it to the attention of the Commission, degree of cooperation shown during the investigation of the misconduct or any attempt to conceal it, evidence of restitution by the party/parties guilty of the misconduct and steps taken to address the concerns since the misconduct was identified and ensure that similar problems do not arise in the future.
 - Other relevant factors such as the size and financial resources of the firm or individual and the ability of such firm or individual to pay a fine and the sanction imposed by the Commission in similar cases that it has dealt with in the past.
13. These considerations are essentially similar to those that the SEC and CFTC take into account in determining whether to impose a fine and, within the limits or tier structures under relevant statute, the size of the fine. Similar factors have also been suggested by the UK Government as the criteria that the FSA should take into consideration when determining whether to impose a civil fine.⁵
14. The Commission does not propose to set any tariff or tier structures for different kinds of misconduct. That would take away the flexibility that the Commission needs in order to tailor and fine-tune the monetary sanction to address each specific breach in the context in which it arose to ensure that the penalty is effective, proportionate and fair.

⁵ See *Financial Service Regulation: Enforcing the New Regime*, issued by the FSA in December 1998 as one of the consultation papers for the FSM Bill.

15. The FSM Bill does not propose to set any maximum limit for the civil fines that the FSA may impose. The SEC's power however is subject to statutory limits, the maximum being US\$100,000 for a natural person and US\$500,000 for any other person in respect of each violation where such violation involves fraud or reckless disregard and directly or indirectly resulted in or created a significant risk of substantial losses to other persons. The CFTC's power, on the other hand, is subject to the maximum limit of the higher of US\$100,000 or triple the monetary gain for each violation.
16. The Commission believes that the law should set the maximum limit for a civil fine that the Commission may impose. An accepted approach in using civil fines to "remedy" a wrong and deter future violations is to set the penalty as some multiple of profit gained or loss avoided as a result of the improper conduct. A three-times multiple has been used by the Insider Dealing Tribunal when handing down awards in insider dealing cases, and is proposed for the new Market Misconduct Tribunal. (For details, see the *Guide to Legislative Proposals on Establishing a Market Misconduct Tribunal*.) The Commission believes a similar approach would be appropriate for disciplinary matters. However, as some instances of misconduct may not have a (or an identifiable) profit or loss component, there is a need to also set an alternative maximum amount. The Commission has tentatively proposed a limit of HK\$10,000,000. The Commission believes that this maximum limit would be adequate for most cases. In the more serious cases, where the maximum fine might be considered insufficient, an additional suspension or revocation would also be considered.
17. In order to ensure consistency and fairness in the imposition of fines, the Commission will also have regard to the amount of any fines previously imposed by the Commission (including any amounts imposed, affirmed or amended by the proposed Securities and Futures Appeals Tribunal (see paragraphs 20 and 21)) in relation to similar conduct. Disciplinary decisions (save for private reprimands) will continue to be publicised.

E. Fair and Accountable Process

18. Under current legislation there are established procedures that ensure that an affected person is entitled to due process and is dealt with fairly. In exercising its enforcement and disciplinary powers, the Commission has adhered to these procedures. The Commission discloses to each affected person the basis for the Commission's intended action and gives such person the right to present his case before the Commission makes a final decision. This process will continue to be followed by the Commission when it exercises the additional disciplinary powers sought under the Securities and Futures Bill.
19. Currently, the majority of disciplinary decisions are made by the Executive Director or the Senior Director of the Enforcement Division on behalf of the Commission. It is proposed that these persons continue to make disciplinary decisions once civil fines are introduced.
20. The Commission believes that it should be accountable to the public. In this regard, an independent process review panel will be established to review aspects of the Commission's internal processes, including the decision-making process in disciplinary actions, to ensure impartiality, fairness, consistency and accountability. 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.
21. Currently, any disciplinary decision of the Commission (except reprimands) can be challenged by the affected party by way of an application to the Securities and Futures Appeals Panel ("SFAP") for a merits review. It is proposed that this right of merits review shall continue to be available and that all applications for review shall be heard by the proposed Securities and Futures Appeals Tribunal ("SFAT"). For more details of the proposals with respect to the SFAT, please see the *Guide to Legislative Proposals on Establishing a Securities and Futures Appeals Tribunal*.
22. The Commission is committed to maintaining a fair and transparent enforcement process. Currently the following steps are taken by the Commission in every enforcement action. The Commission shall

ensure that these steps shall continue to be taken in all future actions:

- No action to discipline can be taken without first giving the person against whom the action is proposed the opportunity of being heard. Under the Securities and Futures Bill, this will take the form of a paper hearing, which will afford the person concerned the opportunity to think through the representations he wishes to make and to take advice from his lawyers where necessary.
- Every decision made by the Commission is in writing and states the reasons on which the decision is based, the date it is to take effect, the duration and terms of any suspension or prohibition and the amount of any monetary penalty the date by which it is to be paid.
- Disciplinary decisions cannot be enforced until the statutory time period for appeal to the SFAP (or the SFAT once that tribunal is formed) has elapsed and the affected party has not given notice of appeal. The present allowed period of 30 days is unnecessarily long and the proposed Bill will shorten it to 14 days. Under the Bill, the Commission will, however, be able to enforce the terms of a settlement immediately.

Partial Suspensions

23. It is proposed that the Commission may suspend a registered person's licence only in relation to a part of the business for which that person is licensed. This will give the Commission a greater degree of flexibility in ensuring that an appropriate and effective sanction, no more and no less, is imposed. Given the realities of today's market and the diverse activities of some of the big brokerage firms, there may be occasions that only a partial suspension is warranted. This will have less of an impact on innocent third parties and could mitigate the otherwise draconian effect of a suspension.

Prohibition Orders

24. Another tool that the Commission seeks is the power to issue orders prohibiting a person who is a responsible officer and who is (or in the past has been) guilty of misconduct from applying to be licensed or approved as a responsible officer for such period as the Commission may specify.
25. Under the new licensing regime proposed in the Securities and Futures Bill, there will no longer be separate types of licences, such as dealers licences, investment adviser licenses, dealer's representatives licences, etc. The proposed prohibition order will give the Commission the flexibility to prohibit an individual from being a responsible officer while at the same time allowing him to act in a lesser capacity, such as a representative, if the responsible officer is or has been guilty of misconduct.
26. For more details about the proposals on the licensing regime as well as on the use of prohibited orders, please see *Consultation Paper on Review of Licensing Regime*, published in June 1999.

Negotiated Settlements

27. Current legislation does not provide an explicit power for the Commission to negotiate a settlement of a disciplinary case. This omission must be rectified because there are cases the circumstances of which give rise to the desirability of a settlement which will provide a satisfactory outcome and sufficient regulatory comfort.
28. Further, the finality of negotiated and signed settlements between the Commission and affected persons in disciplinary cases is not recognized in the legislation. This has led to the practice that notwithstanding a settlement, the Commission is unable to immediately enforce the settlement terms as technically the affected party has 30 days within which to seek judicial review or appeal to the SFAP within that time limit. This is unsatisfactory and defeats the purpose of a settlement.
29. The Commission proposes that the new law makes clear that signed settlements are final and binding. Since in reaching settlement the

parties agreed to forego any right of judicial review or appeal, the settlement may be enforced immediately.

30. Given that an affected person will have the time and opportunity to consider the acceptability of the terms of settlement, the statutory requirement that the Commission give the person concerned the opportunity of being heard shall not apply. Also, the right to appeal a decision made by the Commission can be abrogated by agreement.

Public Consultation

31. The proposed additional powers to impose civil fines, partial suspension, and prohibition orders are needed to provide the Commission with a broader and more flexible range of disciplinary tools so that it can function properly as the regulator of Hong Kong's increasingly complex securities market.
32. Administrative authority should be placed within a system of checks and balances. As discussed above, the Securities and Futures Bill will establish a Securities and Futures Appeals Tribunal with jurisdiction to review, *inter alia*, all disciplinary decisions of the Commission. Furthermore, an independent, external panel will be established to review key aspects of the Commission's internal processes, including the disciplinary decision-making process. These mechanisms will ensure that the Commission exercises its disciplinary powers fairly, responsibly and consistently in furtherance of maintaining the integrity and health of the financial markets as well as a level playing field for all participants.
33. The Government and the Commission believe the proposals detailed in this Guide will improve the regulatory framework and put it on a par with the best of international standards, thereby enhancing Hong Kong's competitiveness as an international financial centre. Comments and views are sought from the financial community and general public. 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.