Process Review Panel
for the
Securities and Futures Commission

Annual Report
to the Financial Secretary

For 2005

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Chapter 1 General Information

Background and purpose of the Process Review Panel

1.1 The Process Review Panel for the Securities and Futures Commission ("PRP") is an independent, non-statutory panel established by the Chief Executive in November 2000 to review the internal operational procedures of the Securities and Futures Commission ("SFC") and to determine whether the SFC has followed its internal procedures, including procedures for ensuring consistency and fairness.

1.2 Since its inception, the SFC has been subject to various checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal, judicial review, and scrutiny by The Ombudsman and the Independent Commission Against Corruption.

1.3 In the course of reforming the regulatory regime for the securities and futures markets in 1999, the regulatees pointed out to the Administration that the checks and balances set out in paragraph 1.2 above could only apply in specific cases. The Administration, in consultation with the SFC, concluded that it would be preferable to improve the transparency of the SFC's internal processes across the board, so that the public would be better able to see for itself that the SFC did indeed act fairly and consistently in the exercise of its powers.

1.4 The SFC's ability to demonstrate that it already operates in this fashion is however constrained by statutory secrecy obligations which limit the extent to which the SFC can divulge information to the public regarding what it has or has not done when performing its regulatory functions.

1.5 In order to enhance the transparency and public accountability of the SFC, without compromising its confidentiality, the Administration saw merit in establishing an independent body to review the fairness and reasonableness of the SFC's operational procedures on an on-going basis and to monitor whether its procedures are consistently followed and to make recommendations to the SFC in relation to these objectives.

1.6 The establishment of the PRP demonstrates the Administration's resolve to enhance the transparency of the SFC's operations, and the SFC's determination to strengthen public confidence and trust. The PRP supports the objective to ensure that the SFC exercises its regulatory powers in a fair and consistent manner.

Terms of reference

1.7 The PRP is tasked to review and advise the SFC upon the adequacy of the SFC's internal procedures and operational guidelines governing the action taken and operational decisions made by the SFC and its staff in the performance of its regulatory functions, including, for instance, the receipt and handling of complaints, licensing and inspection of intermediaries, and disciplinary action.

1.8 To carry out its work, the PRP receives and considers periodic reports from the SFC in respect of the manner in which complaints against the SFC or its staff have been considered and dealt with. In addition, the PRP may call for, and review, the SFC's files to verify that the action taken and decisions made in relation to any specific case or complaint are consistent with the relevant internal procedures and operational guidelines.

1.9 The PRP is required to submit its reports to the Financial Secretary annually or otherwise on a need basis. The Financial Secretary may cause these reports to be published as far as permitted under the law.

1.10 The terms of reference of the PRP, as approved by the Chief Executive, are at **Annex A**.

Constitution of the PRP and Working Groups

1.11 As at 31 December 2005, the PRP comprises twelve members, including nine members from the financial sector, academia and the legal and accountancy professions, and three ex-officio members including the Chairman of the SFC, a Non-Executive Director of the SFC and the Secretary for Justice (or his representative).

1.12 For better execution, the PRP has set up two working groups. The Working Group on Licensing, Intermediaries Supervision and Investment Products focuses on cases involving application for registration, approval of investment products and inspection of intermediaries. The Working Group on Corporate Finance and Enforcement focuses on cases concerning investigation and disciplinary action, takeovers and mergers transactions and prospectus-related matters.

1.13 The membership of the PRP and the two Working Groups is at **Annex B**.

Chapter 2 Work of the PRP in 2005

Highlights of work

2.1 This report covers the work of the PRP from 1 January 2005 to 31 December 2005.

2.2 In 2005, the PRP reviewed 58 completed cases to examine if the action taken and decisions made are consistent with the relevant internal procedures and operational guidelines. The case reviews included the following areas –

(a) licensing of intermediaries;

(b) inspection of and prudential visit to intermediaries;

(c) authorisation of collective investment schemes;

(d) handling of complaints;

(e) investigation and disciplinary action; and

(f) processing of listing applications under the Dual Filing regime.

2.3 The PRP continued to discuss with the SFC to see if there was any room for streamlining and improving the hearing and appellate process relating to the issue of warning letters; and for strengthening the checks and balances on its decisions relating to settlement of disciplinary action. The PRP has attended a briefing by the SFC on its policy and procedures for settlement of enforcement actions and conveyed their views and opinion to the SFC. The PRP has reviewed a number of cases in these areas and provided its observations and recommendations to the SFC arising from the review of these cases.

2.4 In addition to the review of completed cases, the PRP has also considered specific subjects including the length of consultation periods in the SFC's public consultation exercises, and the scope and approach in the SFC's annual review on the performance of The Stock Exchange of Hong Kong Limited in its regulation of listing matters.

Selection of cases for review

2.5 In accordance with its terms of reference, the PRP may select any completed SFC cases for review. The SFC provided the PRP with monthly reports on all cases completed within a month. The Working Groups then selected individual cases from these monthly reports for review with a view to covering cases of different nature and length of processing time. Apart from checking the file records against the standard procedures laid down in the operational manuals, the Working Groups also assessed the adequacy of the manuals from the perspective of fairness and reasonableness.

2.6 The SFC also provided the PRP with monthly reports on on-going investigation and inquiry cases that had been outstanding for more than one year. The PRP may also select these cases for review upon completion of these cases.

Meetings of the PRP and Working Groups

2.7 The PRP met three times in 2005. At the meetings, the PRP discussed specific issues relating to the SFC's internal procedures and considered reports submitted by the two Working Groups which set out observations and recommendations arising from the review of cases.

2.8 Each of the two Working Groups met twice during the period covered by this report and reviewed a total of 58 cases, which encompassed various areas of the SFC's work.

Table 1 – Breakdown of cases reviewed by the PRP

	No. of Cases
Licensing	8
Intermediaries supervision *(9 inspections; 6 prudential visits)*	15
Investment products	8
Complaints against intermediaries	6
Enforcement	17
Corporate finance *(processing of listing applications under the Dual Filing regime)*	4
Total	***58***

Engagement with the industry

2.9 The PRP attaches great importance to the views from all users of the market on issues within its terms of reference. The PRP received comments from the relevant industry associations and trade bodies on the internal operational procedures of the SFC and followed up on issues raised by market players.

2.10 The PRP welcomes public views on the SFC's operational procedures which fall within the PRP's terms of reference[1]. Suggestions and comments can be referred to the PRP Secretariat by post (Address: Secretariat of the Process Review Panel for the Securities and Futures Commission, 18th Floor, Tower 1, Admiralty Centre, 18 Harcourt Road, Admiralty, Hong Kong) or by email (email address: prp@fstb.gov.hk).

[1] The PRP reviews completed or discontinued cases of the SFC in order to assess whether the SFC has followed its internal procedures in handling the cases. Enquiries or complaints relating to non-procedural matters should be made to the SFC –

By post to : 8th Floor, Chater House, 8 Connaught Road, Central, Hong Kong
By telephone to : (852) 2840 9222
By fax to : (852) 2521 7836
By email to : enquiry@sfc.hk (for general enquiries, comments and suggestions, etc.)
: complaint@sfc.hk (for public complaints)

Chapter 3 Observations and recommendations arising from the review of completed cases

3.1 On the basis of the 58 cases reviewed in the period covered by this report, the PRP concluded that the SFC had generally followed its internal procedures in handling those cases. Yet there were certain areas where the PRP had made recommendations to the SFC for improvement. Where the SFC had difficulties in adopting a recommendation, detailed explanations were given. The observations and recommendations are summarised below. Details of the SFC's response to the recommendations accepted are at **Annex C**. Their response to the recommendations that have not been accepted in full is at **Annex D.**

(A) Licensing of intermediaries

3.2 The PRP reviewed eight cases on licensing of intermediaries. The PRP noted that the SFC had generally followed the standard procedures in processing these cases. The longer processing time in certain cases was mainly attributable to the time taken by the applicants in providing information and documents to the SFC, or in fulfilling the licensing requirements.

3.3 In the course of the review, the PRP noted that the SFC had revised its internal procedures in February 2005 to the effect that only a certain percentage of applications would be subject to police vetting[2]. As the revised procedures involved a shortlisting process, the PRP invited the SFC to advise on the measures in place to ensure fairness and consistency in the shortlisting process. In response, the SFC explained that it adopted a standard procedure[3] with pre-defined and objective criteria for shortlisting applicants for police vetting and the process did not require exercise of any discretion. Nonetheless, the SFC would also continue to arrange for police vetting on suspicious cases where the case officer had concern over an

[2] Personal data of an applicant for a licence are sent to the Police for checking whether the applicant has ever been convicted of an offence in Hong Kong, other than a traffic offence. Police vetting is conducted as part of the assessment of an applicant's fitness and properness.

[3] The PRP was briefed of the procedure and criteria for shortlisting. As this is sensitive information, it is considered not appropriate to disclose the information in the PRP annual report.

applicant's fitness for licensing purpose for reasons such as possible conviction record. This procedure for suspicious case was a standard arrangement already spelt out in the process manual and would run in parallel with the shortlisting process.

(B) Inspection of and prudential visit to intermediaries[4]

3.4 The PRP reviewed nine cases on inspection and six cases on prudential visit. The PRP noted that the SFC had generally followed the standard procedures in processing these cases. The longer processing time in certain cases was attributable to the time taken on the part of the intermediaries concerned to provide information and documents requested by SFC staff for reviewing issues identified in the inspections or visits.

Letter of deficiencies

3.5 In an inspection case, the PRP noted that the SFC had not issued an interim letter of deficiencies within four months upon completion of the inspection fieldwork and hence failed to comply with the standard procedures. The PRP considered that it would be in the interest of the investing public if the deficiencies, once identified, were made known to the company as soon as possible so that the company could take remedial actions immediately.

3.6 The SFC explained that there was a settlement negotiation in progress with the company's subsidiary, which shared the same management. It was necessary to defer issue of the letter of deficiencies in order to avoid jeopardising the negotiation and also to take into account the settlement terms in preparing the letter of deficiencies. The SFC accepted that the letter of deficiencies should generally be issued within four months upon completion of the inspection fieldwork but considered that this case should be taken as an exception having regard to the unusual circumstances.

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[4] The SFC monitors the financial position of intermediaries and supervises their conduct through inspection of or prudential visits to selected intermediaries. The SFC adopts a risk-based approach in selecting intermediaries for inspections or prudential visits. Generally speaking, prudential visits are more appropriate for firms which are considered to have lower risks. Prudential visits allow the SFC to gain an overall understanding of the business outlook and future viability of the companies through meetings with the senior management of the companies. Inspection involves on-site examination of the books and records of the firms and allows the SFC to examine the firm's compliance with legislation and rules, and evaluate the firm's financial position and internal control procedures. Inspection also acts as a deterrent against intermediaries undertaking dubious or illegal practices.

Completion summary

3.7 As a general practice, the results of an inspection or prudential visit were recorded in a completion summary. The PRP noted that the date of approval and the identity of the approving officer were not given in the completion summaries of some cases. The PRP considered that such information provide a more comprehensive record, and could help ensure clear accountability in respect of the decisions made.

3.8 The SFC advised that the date of approval and identity of the approving officer were actually featured in its case management system. Such information could be viewed on line but were not shown in the printout kept on file. The SFC would seek to add such information in future system enhancements for the sake of facilitating PRP reviews.

Selection of target for inspection or visit

3.9 It was noted in a case that a company was selected for a prudential visit instead of an inspection although it had not been inspected for more than six years. The PRP invited the SFC to advise on the considerations leading to the selection of companies for inspections or prudential visits, and the difference in the thresholds for initiating inspections and prudential visits. The SFC advised that in line with the practice of regulators in many developed financial markets, it adopted a risk-based approach in initiating an inspection vis-à-vis a prudential visit. The process took into account the unique circumstances of each case including the firm's business model, management quality and market significance etc. It was not practical to deploy a numerical threshold for initiating an inspection vis-à-vis a prudential visit mechanically nor was it appropriate to set a rigid inspection cycle as it would be inconsistent with the risk-based approach. The selection relied on the case officers' knowledge of the firms under their portfolio and their assessment of the risk profiles of these firms by taking into account all relevant qualitative and quantitative factors. The selection process was subject to checks and balances since the lists of companies selected for inspection or prudential visit were submitted to the senior management for approval. In preparing the lists of companies, the case officer was required, where applicable, to give the reasons in writing for selecting an intermediary for inspection.

(C) Authorisation of collective investment schemes

3.10 The PRP reviewed eight cases on authorisation of collective investment schemes and noted that the SFC had generally followed the standard procedures in processing these cases. The longer processing time in certain cases was attributable to the time taken on the part of the applicants to respond to the SFC's enquiries and requests for information.

3.11 In one case, the processing time took almost a year because the applicant failed to provide substantive responses to the SFC's comments in time despite the issue of several reminder letters by the SFC. According to the SFC's standard procedures, an application would be deemed to have been withdrawn if a substantive reply from the applicant remained outstanding three months after the SFC had asked for a response. In this case, the applicant on two occasions, did not reply to the SFC until after the receipt of reminder letters informing that the application would be deemed to have been withdrawn by a certain date. The applicant appeared to be taking advantage of the application system to ensure that the application, which might have been submitted pre-maturely, would remain valid. Although there was no evidence to suggest a serious abuse of the system, the PRP invited the SFC to continue to monitor the situation and consult the PRP if the situation had deteriorated to the extent that modification of the procedures would be warranted.

(D) Handling of complaints

3.12 The PRP reviewed a total of six cases of complaint against intermediaries and concluded that the SFC had generally followed the standard procedures in handling these cases. The PRP was informed that the SFC had since March 2005 adopted the requirement to issue an interim reply to a complainant at quarterly intervals so as to keep the complainant informed that the case was receiving attention. The PRP considered the new practice an improvement in the handling of complaints. The SFC would review and update the complaint handling procedures to reflect the change.

(E) Investigation and disciplinary action

3.13 In 2004, the PRP discussed with the SFC on the hearing and appellate process in the issue of warning letters and the procedures for entering into settlement of disciplinary action. The PRP undertook to continue to discuss with the SFC on how the existing process could be improved to provide an opportunity to be heard before a warning letter was issued, and to strengthen the checks and balances on its decisions relating to settlement agreements. In 2005, the PRP continued to examine the issue through the review of 17 cases, which consisted of eight cases relating to issue of warning letters and nine cases on settlement of disciplinary action.

Warning cases

Co-ordination with Hong Kong Monetary Authority

3.14 The PRP reviewed eight cases on issue of warning letters without commencement of formal disciplinary process. In one case, the SFC's investigation revealed that there were manipulative activities in the trading of shares placed with a broker house through the internet by two persons who were residing in the Mainland China. The SFC decided to take no further action against these two persons having regard to the difficulties to pursue the case outside the jurisdiction. The SFC issued a warning letter to the broker house for its failure to fulfil its responsibility in monitoring clients' trading activities. The broker house wrote to the SFC twice to explain that the orders were made via an omnibus account of an institutional client. The company could only see the total amount of transactions in the institutional account and was unable to segregate the trades conducted by individuals. The broker house also complained that they were not interviewed nor given an opportunity to address any matters the SFC took into account in its inquiry. They also complained about the absence of any guidelines issued by the regulator relating to the monitoring of irregular trading activities. The broker house requested the SFC to review the issue of the warning letters and to consider issuing guidelines in this area. The SFC maintained its decision and informed the company that the warning had no immediate effect, whilst its responses to the warning would be kept on file together with the warning letter and would probably

be referred to in case the company committed the same or similar misconduct in future.

3.15 The PRP noted that the institutional client was a bank and the deliberation as to whether the case should be brought to the attention of the Hong Kong Monetary Authority ("HKMA") was not clear in the record. The PRP invited the SFC to consider giving proper documentation of the deliberation in this regard. The SFC explained that the broker house had a duty to maintain the integrity of the market regardless of the medium of transactions and the way in which the business was conducted and that its industry guidance made this clear. If the broker house could not implement any effective measures to monitor the trading activities of an omnibus account due to the lack of information about the identities of the ultimate clients, they should put in place an agreement with the omnibus account operator to hold it responsible for monitoring the trading activities of their clients on behalf of the broker house. With hindsight, the SFC agreed that it would have been appropriate to bring the case to the attention of the HKMA of the possible lack of complementary measures on the part of the bank to monitor the trading activities of its clients on behalf of the broker house.

Promotion of awareness of prevailing guidelines and regulations

3.16 In regard to the broker house's claim of a lack of relevant guidelines on monitoring of irregular trading activities in the case mentioned in paragraph 3.14 above, the SFC clarified that the responsibilities of brokers and omnibus account operators in monitoring the trading activities of their clients on behalf of the licensee were given in the Code of Conduct which applied to all regulatees' conduct irrespective of the mode of execution, and that the Guidance Note on Internet Regulation stated that the SFC's regulation would not vary with the medium by which activities were facilitated, such as on the internet. As it transpired in this case that some market practitioners were not aware of such guidelines, the PRP invited the SFC to consider promoting awareness of these guidelines, those concerning the responsibility to monitor client accounts in particular. The SFC explained that it was the duty of all industry regulatees to know and understand the prevailing regulations. The SFC had also frequently reminded the practitioners about their duty to monitor client accounts and

frequently published punishment for non-compliance through press releases and on its website. Notwithstanding the above, the SFC would consider taking further actions to raise industry awareness in this regard.

Advice given in a warning letter

3.17 In another case, the SFC's routine inspection revealed several internal control problems of a broker house. Following internal consultation, the Investigation Department issued a warning letter to the company. The warning letter included a criticism on the content of the company's internal guidelines. The company appealed against the warning on the grounds that it had already taken remedial actions of its own volition and the warning relating to the content of its internal guidelines was unfair and unwarranted. The SFC replied to clarify that its comment on the internal guidelines set out in the warning letter only served as an advice and did not form part of the warning and it was unfortunate that the distinction was not made clear in the letter. The PRP considered that the misunderstanding could have been avoided had there been communication with the company prior to issue of the warning letter. The PRP invited the SFC to consider ways to improve communication with the recipients of warning letters.

3.18 The SFC agreed to remind its staff to make clear in the warning letter the distinction between an advice and a warning when a single letter contained both. Nonetheless, the SFC believed that in the case mentioned in paragraph 3.17 above, early communication with the company might not have helped remove the misunderstanding as the failure to properly distinguish the advice from the warning was relatively minor and was not something that a prior opportunity to be heard on a warning letter would probably have corrected or would justify an opportunity to be heard being universally offered – it would be better corrected by more express guidance to SFC staff to be more careful to distinguish advice from warnings.

Consideration of remedial measures taken before giving a warning

3.19 In one case, the SFC found that several investment consultants of a company had engaged in promoting mutual funds without valid licence. The SFC's investigation concluded that while there was insufficient

evidence to prove the misconduct conclusively, there was concern over the adequacy of the company's internal control. Warning letters were issued to the company and its six employees. The company and three employees reacted strongly to the warning letters or said that they took them seriously. The company submitted representations and stressed that its senior management took the warning letters very seriously and it had taken remedial actions including a compliance audit to address the issues raised in the warning letter. Three employees submitted representations and requested either withdrawal of the warning letters or a meeting with the SFC to discuss the issue. The PRP considered that, had the SFC communicated sufficiently with the company before issuing the warning letters, the SFC might have been informed of the company's initiative to conduct a compliance audit, and might have considered a deferral of the decision to issue a warning until completion of the compliance audit. The SFC should therefore critically reconsider the PRP's recommendation regarding the provision of a fair hearing and appellate procedure for the issue of warning letters.

3.20 The SFC advised that the fact that the company initiated remedial actions upon receipt of the warning letter demonstrated that the warning letter was a sufficient response to the situation. The SFC noted that, given the compliance audit was prompted by the warning, it was not possible for the SFC to have taken it into account before issuing the warning. Further, the SFC believed that the company's revelation that there were further technical breaches discovered as a result of the compliance audit would have been unlikely to change its assessment and decision to issue a warning letter to the company, because the further breaches were technical and so, in the circumstances of this case, unlikely to be the subject of formal disciplinary action or prosecution.

Hearing and appellate process relating to issue of warning letter

3.21 The case mentioned in paragraph 3.19 above revealed that the recipients of warning letters in that particular case did take the warning seriously and some[5] of them made representations and appealed against the warnings notwithstanding the SFC's views that warning letters were only

[5] The SFC advised that only a few warning letters were disputed or replied to each year. In the fourth quarter of 2005, only 8% of the warnings issued were disputed or replied to.

meant to be informal. The PRP reiterated their concern over the lack of a fair hearing and appellate process for the issue of warning letters in the absence of a formal disciplinary process. Although the subjects of warnings might be aware of the investigation by the SFC and might have presented their side of the story during the investigation, they were not given a chance formally to make representations before the warning was issued. Having regard to the strong reaction of the recipients in this case, the PRP invited the SFC to critically reconsider the PRP's previous suggestion of allowing the recipients of warning letter to indicate whether he/she accepted the proposed warning within a reasonable period of time (which could be 10 to 14 days). In order to avoid abuse of the process, the SFC could inform the person concerned that it might, upon consideration of the responses made, confirm or set aside the decision for the issue of a warning letter or substitute it with other disciplinary sanctions. In this way, the person would be given a chance to make representations which would be taken into account in the decision for the warning. This approach would not necessarily lengthen the processing time for uncomplicated cases such as technical breaches.

3.22 The PRP noted that the SFC maintained its stance as reported in the PRP annual report for 2004 i.e. that the provision of fair hearing and appellate procedures for the issue of warning letters were akin to formal disciplinary process and it would impose a substantial burden on the SFC. Having regard to the SFC's concern about resource constraints, the PRP invited the SFC to advise on the resource implications of the proposal. The PRP has also invited the SFC to advise on the safeguards currently in place to ensure procedural fairness for warning letters issued as an alternative to formal disciplinary process.

3.23 In response, the SFC clarified that they had difficulties with the PRP's proposal not only on grounds of resource implications but that their existing procedures reflected an appropriate balance of fairness versus resource implications with due regard to the purpose of a warning letter i.e. it was private and could be disputed in future regulatory proceedings when the SFC attempted to use them. The SFC had previously noted that, in administrative law, the content of hearing and appeal procedures may vary depending on the seriousness of the consequences of the administrative action to be taken. On resource implications, the SFC issued

approximately 300 warnings in a year, whereas the number of criminal prosecutions and formal disciplinary action taken in each year was approximately 200. In the SFC's experience, granting a hearing prior to issue of a warning would consume as much resources as a formal disciplinary action and would substantially increase the workload of the Enforcement Division. Moreover, there could be abuse of the process and their experience suggested that a threat to take formal disciplinary action would not dissuade unmeritorious representations. In any event, reverting to formal disciplinary action after issue of a warning letter would defeat the original arguments and justifications for the issue of a warning letter, instead of instigating formal disciplinary process, in the first place.

Settlement of disciplinary action (including fining)

3.24 To better understand the SFC's policy and procedures for settlement of disciplinary action, the PRP attended a briefing in September 2005 in which the SFC briefed members on the principles underpinning settlement agreements and the safeguards in place to ensure proper checks and balances in the decision making process. Members conveyed to the SFC their concerns and explained their comments and observations as spelt out in the PRP annual report for 2004.

3.25 Members reiterated their concern expressed in 2004 that licensees who were subjects of disciplinary action could in effect "buy" themselves out from liability through a settlement if they could afford to make a payment. In response, the SFC explained that substituting a suspension with a voluntary payment in a settlement agreement was in line with the purpose of introducing fines as a disciplinary option under the Securities and Futures Ordinance ("SFO"). The purpose of introducing fines was to bridge the gap under the old legislation which empowered the regulator to impose a reprimand which was too light a penalty, or a suspension of licence which might be too harsh in the circumstances. This was a feature in the transition from the previous legislation to the SFO and was diminishing in frequency. In determining the amount of voluntary payment, the SFC would carefully calibrate the payment to match the economic effect that a suspension originally proposed could have brought about, i.e. in terms of a denial of a person or entity the right to pursue business and derive profit from it. As the economic effect on the person or

the entity arising from a suspension or voluntary payment would be more or less the same, there was no question of "buying out" a liability. Moreover, as the length of suspension had already taken into account the seriousness of the misconduct, the size of voluntary payment would vary according to the gravity of the misconduct. Regarding no-admission settlement, the SFC had also taken note of public concern and had become more cautious in accepting no-admission settlements, which in fact had never been frequent. There was only one case of no-admission settlement in the financial year 2005-06. However, the SFC noted that it would continue to pursue no-admission settlements in appropriate cases and that such settlements enabled the regulator to achieve outcomes in the public interest that sometimes would not otherwise be obtainable (e.g. large compensation payments in some cases).

Documentation of the settlement process

3.26 The PRP reviewed two cases in which disciplinary action was settled on a no-admission basis. In one case, a sponsor was found to have breached the Listing Rules and the case called into question the fitness and properness of two licensees[6]. The SFC originally proposed a suspension of engagement as sponsors of two persons for several months each. The SFC subsequently entered into settlement with the parties concerned and the disciplinary action was settled on a no-admission basis with the suspension period reduced to reflect their cooperation. In another case, an underwriter in a listing offer was found to have failed to monitor the receipts of subscription proceeds and to keep proper records. The SFC originally proposed to impose a public reprimand on the company and a director, and a suspension of the licence of a responsible officer of the company for a certain period. The case was subsequently settled on a no-admission basis in which the company was given a public reprimand, its responsible officer voluntarily refrained from carrying out any regulated functions, and a warning was given to the director. After defence representations, the SFC concluded that it could only establish lesser allegations than those on which the proposed suspension period was based and that the initially proposed suspension period had to be reduced accordingly and that a reprimand of the director was no longer appropriate because her role in the matter was minor.

[6] Although the case concerns a breach of the Listing Rules and falls into HKEx's jurisdiction as far as the work as sponsor is concerned, the SFC's jurisdiction covers all the regulated activities of the persons concerned as licensees of the SFC.

3.27 The PRP noted that in both cases, the deliberation for accepting the settlement on a no-admission basis was not documented on file. It was recommended that the SFC should take steps to keep a complete audit trail of the reasons why a settlement on a no-admission basis was accepted. Such an audit trail could help ensure that the same set of considerations for settlement agreements in particular for those made on a no-admission basis, would be applied consistently.

3.28 The SFC believed that there was no suggestion that it did not apply the same set of considerations for settlement agreements in the two cases mentioned in paragraph 3.26. The SFC agreed that deliberation in relation to a settlement agreement should be sufficiently documented and noted that, but for the reasons for the acceptance of a no-admission settlement, they were documented in reasonable detail. To address the PRP's concern, the SFC had revised its internal procedures in April 2006 to require the subject officer and decision maker to work on a proforma checklist which captured the relevant factors considered in settlement deliberation, including whether to settle on a no-admission basis.

Fine and public reprimand

3.29 Under sections 194 and 196 of the SFO, the SFC may impose a fine up to $10 million on licensed corporations and licensed persons either on its own or together with other disciplinary sanctions. The PRP reviewed two cases of fining for breach of the Financial Resources Rules. In both cases, the SFC originally proposed to impose a fine of a certain amount and a public reprimand. The SFC subsequently entered into settlement with the parties and the penalty was revised to public reprimand and a substantially reduced fine.

3.30 The PRP invited the SFC to consider the following recommendations –

(a) The basis for setting the amount of a fine originally proposed and the justifications for its subsequent variation should be sufficiently documented to provide an audit trail of the decisions.

(b) In both cases, the fine following the settlement negotiation was substantially reduced by nearly 50% from the amount originally proposed. There should be a maximum ceiling of such discount as in the case of Financial Services Authority in the United Kingdom which stipulated a ceiling of 30%.

(c) There should be a scientific model encompassing all relevant factors to provide a consistent and objective basis for the calculation of a fine. Noting the SFC's advice that it was more practical to make comparison with other fining cases and consider the specific circumstances of each case to determine the level of a fine for a case, the PRP considered that there should be measures in place to ensure consistency in application and to promote transparency of the SFC's decision making in this respect.

(d) The SFC should disclose to the public the aggravating and mitigating factors leading to a public reprimand and for arriving at a certain size of a fine to enable market players to better understand the penalty that could be imposed for different types of misconduct.

(e) In line with the arrangement under the fining regime where a checklist has been used for the evaluation on fining, there should be a similar checklist to assist the SFC's subject officer and decision maker in the evaluation on a public reprimand so as to ensure consistency in actions taken in different cases.

3.31 The SFC accepted that an audit trail on the deliberation and justifications for arriving at a certain level of a fine and also for its subsequent variation had to be sufficiently documented, and would take steps to ensure improvement in the future. The SFC already had a procedure to document the considerations relevant to a fine in the light of

the Disciplinary Fining Guidelines[7] in the form of a proforma checklist. In the case of settlement, the SFC also introduced a new procedure on documentation of settlement process which provided a template to capture the relevant factors considered so that there would be a relatively standard record. The SFC had also published a guidance note on its cooperation policy in March 2006 to clarify its practice of giving credit to regulated persons for their cooperation with the SFC by imposing lighter disciplinary sanctions than would be imposed in the absence of cooperation.

3.32 The SFC also agreed that, as a guideline, a maximum discount for cooperation should be fixed and 30% appeared to be a reasonable benchmark. However, the scale of reduction might go beyond 30% when there were other factors coming into consideration in the process, such as representations or mitigating factors that warranted a downward revision of the initial figure from which the 30% discount was calculated (e.g. where the case was finally determined not to be as serious as it initially appeared to be or where new mitigating factors came to light which the SFC was previously unaware of).

3.33 The SFC advised that it had in fact worked on a few approaches for the calculation of a fine and considered that working on a scientific model was not viable because the considerations for fining primarily worked on the Disciplinary Fining Guidelines which could not be translated into mechanical formulae. The SFC also noted that the circumstances of cases did not easily fit mechanical formulae as they were too varied and that the SFC's experiments with a number of different means of calculating fines by reference to specific considerations such as profit tended to establish this. With more experience in fining, the SFC considered that the most practical means of assessing how much to fine in each case would be by making comparison with other cases and consideration of the specific circumstances of each case. In response to the PRP's question on how it could ensure consistency in application by referring to precedent cases, the SFC advised that there was already a mandatory requirement in the process manual that a comparison with similar previous cases should be made in a

[7] The Disciplinary Fining Guidelines were published and gazetted in February 2003 pursuant to section 199(1)(a) of the SFO to indicate the manner in which the SFC will perform its function of imposing a fine on a regulated person under the relevant sections in the SFO. The guidelines set out the factors that the SFC take into account in exercising its fining power among other factors that the SFC may consider.

recommendation for penalty and that this was uniformly observed. On transparency of the decision making process, the SFC advised that it was its standing practice to disclose as far as possible its deliberation on penalty in its notice of decision and statement of reasons. But it would be inappropriate to discuss and disclose its comparison with precedent cases in its public statements.

3.34 Regarding the suggestion on publicising the aggravating and mitigating factors leading to a public reprimand and/or to a certain amount of a fine, the SFC explained that it was required under section 199 of the SFO to create and publish guidelines on the aggravating and mitigating factors relevant to fining. Accordingly, the SFC published the Disciplinary Fining Guidelines in February 2003. But there was no similar requirements in the case of public reprimand and the SFC did not intend to go further than the law required. Nonetheless, the Disciplinary Fining Guidelines were a useful guide to sentencing principles for all disciplinary penalties including fines, reprimands, suspensions and revocations. Moreover, the SFC did and would continue to endeavour to ensure that its press releases on public reprimand mentioned all key relevant mitigating and aggravating factors. These press releases would be reviewed by several lawyers and the press office of the SFC before issue to ensure that the relevant factors were highlighted. On the suggestion that a checklist be devised for public reprimand, the SFC considered that a standard checklist would be of limited use given each case was unique and each reprimand uniquely suited to the factors of each case (unlike fining cases, where the comparison with previous cases and resulting decision on what fine to impose in a particular case focused on the presence or absence of factors common to many, if not most, cases).

<u>Checks and balances on settlement decisions</u>

3.35 The PRP noted that, in three cases, the Discipline Unit consulted the decision maker, i.e. the Executive Director of Enforcement, on the parameters for negotiation and led the negotiation. The decision maker of the settlement was not involved in the negotiation. However, in two fining cases, the decision maker had substantially involved himself in the negotiation process. The PRP noted that there was clear segregation of duties in the settlement negotiation in the former three cases and the practice

helped strengthen the checks and balances on the decision making process and such practice should be followed in settlement cases. In particular, for very fluid situations which required exercise of a wide discretionary power, the SFC might need to consider introducing a mandatory cross-divisional consultation process.

3.36 The SFC advised that the person to be disciplined and their lawyers usually preferred direct discussion and negotiation with the decision maker. While it was at the SFC's discretion to accept or decline such requests, the SFC's past experience suggested that, in complex compensation negotiations, such direct dialogue with the senior management of the regulatees helped establish a personal rapport and demonstrate the commitment of the SFC to the position the SFC adopted in the negotiation. These factors were conducive to achieving a satisfactory outcome more quickly. As such, the SFC considered that the decision maker's participation in the negotiation process was actually in the interests of the industry and the public.

3.37 Regarding the suggestion for mandatory cross-divisional consultation, the SFC considered it not viable because –

(a) the decision to settle was a decision to bring a disciplinary action to an end. Legally, the decision maker could not abdicate a decision to settle to another party (i.e. another division within the SFC), or rely too heavily on another party.

(b) decisions on enforcement cases required an understanding of litigation procedures, and tactics and expertise in deciding penalty. Other divisions would not have the relevant experience or expertise in these areas, cases involving market misconduct and fraud in particular. As such, a requirement for mandatory consultation in these areas would not necessarily produce a better informed decision.

3.38 Decision makers in enforcement cases did frequently consult other divisions where it was believed that other divisions had an interest or

expertise in an area relevant to a decision to settle a particular case. The Enforcement Division would continue to consult other divisions at its discretion as at present. In any event, enforcement cases were regularly reported at cross-divisional meetings. Other divisions and the senior management could monitor enforcement cases and offer opinion on cases at these meetings.

Settlement could achieve comparable punitive and deterrent results

3.39 The PRP noted the SFC's advice that the punitive and deterrent results in settlement were comparable to those resulting from other disciplinary action that did not settle. The PRP suggested that the same message be conveyed to the public so as to improve transparency of the SFC's decision. The SFC agreed to emphasise this point in its public statements and would ensure that its senior officers and publications would continue this practice in future.

Calculation of ex-gratia payments

3.40 In one case, an asset management company was found to have made its daily valuation of several funds at a time different from the specifications given in the offer documents of the funds concerned. The SFC entered into settlement with the company which was required to make an ex-gratia payment to the funds concerned as a compensation to the notional loss to the investors. The ex-gratia payment was calculated mainly with reference to the administration fees charged by the company. Noting the SFC's advice that there was no way to accurately establish the extent of loss, if any, to investors, the PRP invited the SFC to consider other factors such as the practice in other jurisdictions in calculating the size of the ex-gratia payment in similar cases.

3.41 The SFC agreed to consider other measures in future cases, where appropriate, and would consider the practice in other jurisdictions if relevant. The SFC explained that its objective in determining the level of payment was to find a sum that was proportionate to any notional loss investors might have suffered and noted that the difficulty in calculating the notional loss meant that the SFC had to use another reference point to calculate the payment. More importantly, the level of payment had already

taken into account the fact that the breaches were technical and inadvertent, and that the size of payment could produce a deterrent effect to future breaches by others. The final payment, though calculated by reference to the administration fees, was considered proportionate to the seriousness of the breaches, which was the overriding consideration.

3.42 The PRP noted the SFC's response[8] to its recommendations and observations and would continue to examine issues relating to settlement of disciplinary action and warning letters through case reviews.

(F) Processing of listing applications under the Dual Filing regime

3.43 The Securities and Futures (Stock Market Listing) Rules ("the Rules") require a corporation applying for listing of its shares to file copies of its listing application to the SFC after the same is submitted to a recognised exchange company. To facilitate compliance and minimise any additional cost to a listing applicant, the Rules enable the applicant to fulfil this obligation by authorising the exchange company to file the material with the SFC on its behalf. This arrangement is known as "Dual Filing".

3.44 Section 6 of the Rules stipulates that the SFC may, within ten business days of an applicant filing an application for listing or supplying further information, require the applicant to supply further information, or object to the listing application under certain circumstances as stipulated in the Rules. In order to ensure that the SFC's ability to follow the ten-day framework set out in the Rules would not be jeopardised, the SFC sought and received a reaffirmation from The Stock Exchange of Hong Kong Limited ("SEHK") in early 2004 of its commitment to forwarding listing applications and related documents to the SFC as soon as practicable.

3.45 The PRP reviewed a total of four cases relating to the processing of listing applications under the Dual Filing regime. The PRP noted that the SFC followed the standard procedure in handling these cases. It was however noted in two cases that there was a delay in the despatch of listing applications and related documents from the SEHK to the SFC. The PRP was concerned that the delay might prejudice the SFC's ability to invoke its power under the Rules and invited the SFC to review its

[8] The PRP has yet to discuss the SFC's responses to the recommendations relating to enforcement issues.

communication with the SEHK to see if the process could be expedited. In response, the SFC explained that the ten-day time frame would restart with each submission of written material by the applicant or sponsor to the SEHK. As the SEHK was in frequent contact with the applicant or sponsor, the ten-day time frame would be refreshed successively during the course of an active listing application. Therefore, in practice, the delay in passing one of the submissions to the SFC would not normally prevent the SFC from raising further comments. Whilst the timeliness in passing the listing applications to the SFC had been improving, the SFC would, in their regular liaison, remind the SEHK to expedite the process.

3.46 In another two cases, the PRP noted that the SFC was not updated on the progress of listing applications. The PRP invited the SFC to consider the need for putting in place a proper procedure to keep them updated of the progress of listing applications. The SFC has responded to this suggestion positively. Noting that the SEHK has been providing updates on the status of all listing applications in its Weekly Report and Monthly Report to the SFC, the SFC has agreed with the SEHK certain milestones upon which the SEHK would furnish the SFC with information about the listing applications including the submission of reports to the Listing Committee. On the other hand, in view of the SEHK's frontline role in dealing with listing applications, the SFC did not consider it necessary to actively seek further updates prior to an agreed milestone after giving a no-comment letter on a case to the SEHK. Where necessary, the SFC's subject officer might make enquiries with the SEHK on the progress of a particular listing application.

Chapter 4 Observations and recommendations arising from the review of specific subjects

4.1 In addition to the review of completed cases, the PRP has also examined specific areas of the SFC's procedures. The aim is to identify areas for improvement with a view to reducing unnecessary compliance burden without compromising the quality and integrity of regulation.

4.2 The PRP attaches great importance to views from the industry on possible areas for improvement to the SFC's procedures. In 2005, the PRP received several comments and suggestions from market practitioners and referred these comments and suggestions to the SFC for consideration and response. The issues that the PRP has discussed are –

(a) more briefings on subjects of concern to the industry;

(b) publicising exemptive reliefs granted under the Code on Takeovers and Mergers ("Takeovers Code");

(c) the SFC's collection of information on transactions; and

(d) length of consultation periods in the SFC's public consultation exercises.

4.3 The PRP has also followed up a recommendation in the *Consultation Conclusions on Proposals to Enhance the Regulation of Listing* ("Consultation Conclusions on Listing") published by the Government in March 2004. The Consultation Conclusions on Listing recommended, amongst other things, that the SFC prepare and submit annual reports to the Financial Secretary on its audit reviews on the SEHK's performance of listing functions. To ensure procedural fairness and reasonableness in conducting the audit reviews, it was further recommended that the SFC's regulatory oversight of the SEHK's performance of listing functions, including the conduct of the annual audits, should be a subject of regular review by the PRP. Against this background, the PRP studied the

SFC's *2005 Annual review on the SEHK's performance in its regulation of listing matters*.

4.4 The PRP's discussions and views on these issues are summarised below. Details of the SFC's response to the recommendations accepted are at **Annex C**. Their response to the recommendations that have not been accepted in full is at **Annex D**.

(A) More briefings on subjects of concern to the industry

4.5 There was a comment that although members of the SFC did speak at various seminars, conferences and public fora, it would be helpful if the SFC could organise or participate in more talks and briefings on specific areas of concern to the industry.

4.6 The SFC replied that they sponsored (in the form of providing speakers) quite a number of seminars in conjunction with industry associations and professional bodies on subjects that specific sectors of the industry would be interested in or concerned about. Examples of topics discussed recently were the Takeovers Code at the seminars organised by professional accounting bodies; the new anti-money laundering guidelines at the seminar of Hong Kong Securities Institute; and disclosure of interest under the SFO at the seminar for listed companies. The SFC would continue to provide training to the industry either by organising its own training sessions or by delivering talks at seminars or courses organised by industry groups, subject to the availability of resources and speakers from the SFC.

(B) Publicising exemptive reliefs granted under the Takeovers Code

4.7 A comment received from the industry indicated that while the SFC had done a lot of work to streamline the process for obtaining exemptions under the Takeovers Code, the SFC did not publish all the exemptive reliefs that had been granted. It was considered that

information such as the status of "exempt principal trader"[9] was non-controversial and could be published.

4.8 The SFC advised that since the introduction of the "exempt principal trader" and "exempt fund manager" ("EPT/EFM") status in April 2001, the SFC has granted exempt status to entities belonging to six international financial groups. In line with the practice of the London Takeovers Panel, the SFC did not as a matter of practice publish the names of the exempt entities. However, in view of the suggestion from the industry, the SFC started publish the names of entities which have been granted EPT/EFM status on the SFC website from 1 June 2006. The SFC agreed that this would enhance transparency during takeovers offers.

4.9 Regarding other waivers or exemptions granted such as placing and top-up waivers and relaxation of timetable requirements, the SFC noted that the majority of these would be published by listed companies or by unlisted offerors in their own documents. The SFC normally requires the applicants or relevant listed companies to publish the waivers or exemptions granted by the SFC if they are price sensitive or relevant for shareholders to reach informed decisions. The SFC's other rulings which are not published often involve the applicants' or other parties' confidential information.

(C) SFC's collection of information on transactions

4.10 Another comment received from the industry referred to the SFC's requests under section 181 of the SFO to require broker houses to provide details of transactions over a particular period of time, including the

[9] By way of background, the Takeovers Code imposes certain prohibitions, restrictions and obligations in respect of particular dealings by the principal parties in takeovers offers and by persons acting in concert with them. The Takeovers Code treats financial and other professional advisers to corporate clients as acting in concert with those clients. Accordingly, where the adviser forms part of a large organisation, the presumption of acting in concert extends to all entities within that group including principal traders and fund managers which are within the group. The concept of exempt principal trader status and exempt fund manager status recognises that within certain multi-service organisations, certain trading and fund management activities may be conducted on a day-to-day basis quite separately from the other activities of that organisation, including most importantly its corporate finance activities. Essentially, this separation is achieved through effective Chinese walls and compliance procedures. Once granted, the status would normally mean that a principal trader or a fund manager would no longer be regarded as acting in concert with the corporate finance operations of its organisation or with the corporate finance operation's clients who are connected to a general offer. As such they would be subject to far less stringent provisions under the Takeovers Code. Their dealings, for instance, in the offeree or offeror company would not be regarded as concert party dealings for the purposes of the Takeovers Code.

ultimate beneficiaries of the transactions, for the purpose of its investigation on suspicious transactions. Broker houses had practical difficulties to comply with these requests, especially where the transactions involved overseas institutions and the process naturally involved a huge amount of time and resources. It was suggested that, instead of asking for a comprehensive set of records, the SFC might consider setting a threshold on the level of information required in the light of a risk-based analysis. This approach could reduce both the compliance costs of broker houses and the load of raw data for the SFC without necessarily reducing the effectiveness of the SFC's surveillance regime. The specific suggestions made in this regard were –

(a) the SFC might focus more on relatively larger transactions, especially in its early phase of surveillance and investigation efforts;

(b) the selling transactions prior to a price hike might not be as relevant as those buying transactions in an investigation of insider dealing; and

(c) where transactions were initiated by a fund management company on behalf of sub-accounts under its discretionary management, the SFC did not need to collect information about the name of sub-accounts being managed by the fund management company.

4.11 The SFC explained that at present, the available information that could be obtained from the SEHK was only up to the broker (and not the client) level. In line with international practices, it was mandatory for market intermediaries to produce information on ultimate beneficiaries at the request of the regulator to facilitate investigations. Where the transactions involved clients of overseas financial intermediary, the SFC only required the local broker to provide the name of the overseas intermediary to the SFC and to put in place legal arrangements to ensure that the financial intermediary would provide the client's information to the regulator in Hong Kong upon request. The burden on the local broker should not be overwhelming since the local broker might refer the SFC's

requests to the overseas entities and ask them to provide the information on the ultimate beneficiaries to the SFC direct.

4.12 Regarding the suggestions to minimise the level of information requested on the basis of a risk-based analysis, the SFC explained that they already adopted a risk-based approach in deciding which broker to be issued with a section 181 notice by referring to the percentage of transactions conducted by the brokers involved as compared to the total market turnover. Requests would only be issued to those brokers who had actively participated in the trading of the relevant securities. At the client level, the SFC could start to rule out clients from being a focus of further investigatory scrutiny only when the brokers concerned made available the information on the ultimate beneficiaries.

4.13 The SFC had also considered the two suggestions that it should exclude selling transactions before a price hike or names of sub-accounts managed by fund management company in its requests for information. The SFC concluded that these suggestions were not viable because in insider dealing cases, an analysis of the sales of the stock helped exonerate possible insider dealing suspects who had previously bought that stock, and such analysis was essential for investigation in market manipulation cases. Moreover, the situation was more complicated in inquiries relating to a combination of different forms of market misconduct. Regarding the suggestion to exclude sub-accounts managed by fund management companies, the SFC explained that the suggestion would stand only if it was clear that the fund was a mutual fund with a sufficiently wide spectrum of investors and that the fund had exercised clear discretionary authority without direction by their clients. It would be risky not to obtain information about the names of the sub-accounts as the fund management companies might themselves be involved in market manipulation activities, or the fund managers might not, in some cases, be truly independent of the beneficiaries of the funds.

4.14 Having regard to the concern of the industry, the SFC said that they were always willing to be flexible in accepting an extension of the response time to the SFC's requests if a reasonable justification was given.

(D) Length of consultation periods in the SFC's public consultation exercises

4.15 There was a comment that the SFC did not give sufficient time for the public to respond to the public consultations conducted by the SFC. It was claimed that the consultation period given in the SFC's consultation exercises since January 2003 was on average less than 45 days, which was too short for the public to study and assess the proposals. The actual period available was further reduced since there were always intervening public holidays. Moreover, the length of the consultation period made no reference to the length and complexity of the consultation papers. The short period available for the public to send in their comments suggested that the SFC was not committed to listening to public opinions.

4.16 The SFC explained that it was acutely aware that sufficient time should be given to the public to submit response to consultation papers and would give long consultation periods as far as practicable. In determining the length of a consultation period, the SFC would take into account factors such as the urgency, complexity and impact of the issues involved. The SFC generally gave longer consultation periods in respect of matters of significance and a shorter period for matters involving mere technical changes to the existing framework. There was however little flexibility in some cases where the SFC had to work within a tight legislative timetable relating to the proposed changes to relevant rules or provisions in the law. The SFC conducted 24 consultation exercises in the 2½ years between January 2003 and June 2005. The consultation periods in these exercises ranged from 21 days to 92 days (42.5 days on average). As the SFC had a busy consultation schedule, it was inevitable that some of the response periods overlapped with public holidays. Nonetheless, the SFC had been amenable to extend the consultation period. In fact, the SFC's consultation process started well before the publication of a consultation paper and market participants and interested parties would be consulted through various channels before a consultation paper was finalised.

4.17 The PRP noted the response from the SFC and agreed that it was important that the SFC would bring the matters to the attention of the

right group of stakeholders in good time, and monitor the public's feedback and sentiments during the consultation exercises. The PRP also noted that the SFC was prepared to accept late submissions and to extend the deadline where appropriate.

(E) Regulatory oversight of the SEHK's performance of listing functions

4.18 The PRP studied the SFC's *2005 Annual review on the SEHK's performance in its regulation of listing matters* ("the report") published in October 2005. In line with the PRP's terms of reference, the PRP focused on the scope and approach of the SFC's audit, instead of the recommendations made in the report.

4.19 On the scope of the review, the PRP noted that the 2005 review was the first of the SFC's annual reviews. The SFC's review report focused only on the structure and procedures in several key functional areas. The SFC undertook to review other aspects of the SEHK's listing functions, including quality of execution, in its future reviews. The PRP noted that contrary to the recommendations on areas to be covered in the SFC's review published in the Consultation Conclusions on Listing, the adequacy of the SEHK's staff professionalism and experience in the discharge of its listing functions and the co-operation, co-ordination and the exchange of information with other regulators (such as Hong Kong Institute of Certified Public Accountants) were not covered in the current review nor in the list of areas for future reviews. Noting that the staff turnover of the SEHK had been high, the PRP considered that it would be useful for the SFC to review also the impact of staff turnover on the SEHK's performance in regulation of listing matters.

4.20 The PRP also noted that the report had set out the number of cases reviewed for the respective units in the Listing Division but no information was given relating to the criteria and methodology for the selection of cases for review. The PRP considered that the number of cases reviewed should be measured against the total number of cases processed in the unit to reflect the actual scope of the review. It was also suggested that

the SFC might set a target percentage of cases for review beforehand and the selection might take into account the market impact of the cases.

4.21 In response, the SFC explained that it did make an assessment on the SEHK's staff professionalism and experience and the adequacy of the current level of manpower by reference to the practices and procedures in the areas covered by the review. The SFC did not observe anything calling these matters into question. The SFC had considered the issue of high staff turnover, particularly in the Compliance and Monitoring Department and concluded that there was insufficient evidence to show that performance was adversely affected or to draw any other conclusions. As such, no comment was made in the report.

4.22 Regarding liaison with other regulators, the SFC did not consider this an area of priority in the review given the SEHK in fact had regular meetings with other regulators to discuss regulatory matters.

4.23 Regarding the suggestion to set a target percentage of cases to be reviewed, the SFC explained that case review was only a part of the audit process. The objective of case review was to understand how the SEHK's policies work in practice and to verify whether the practices follow its policies. Having regard to the voluminous number of cases handled and in accordance with established practice for auditors, the SFC's approach was to consider the controls and systems established and to form a view as to whether these were appropriate. The SFC considered this a more efficient approach to establish its conclusions for the audit review rather than limiting the scope to a target percentage of cases. Regarding the suggestion on selection of high risk cases, the SFC advised that it adopted a risk-based approach and did review cases which might pose a regulatory risk.

Chapter 5 Way forward

5.1 In 2005, the PRP performed its functions through the review of completed cases and selected topics of the SFC's operational procedures and made relevant recommendations to the SFC. The PRP also maintained a dialogue with the industry with a view to gauging the industry's views on procedural matters.

5.2 For 2006, the PRP will follow up a number of the recommendations made in 2005. These include the SFC's internal procedures on the issue of warning letters to intermediaries and the determination of the amount of fines for breaches of rules.

5.3 The PRP will continue its work on the review of completed cases to ensure that the SFC follows its internal procedures consistently, and will maintain dialogue with market players affected by the SFC regulatory processes and procedures.

5.4 The PRP will continue to engage the industry to listen to their concerns about the exercise of powers by the SFC, and welcome views from the general public, especially the users of the securities and futures markets, on the performance of functions by the SFC with a view to identifying any areas of improvement to the procedures and processes.

Chapter 6 Acknowledgement

6.1 The PRP would like to express its gratitude to the Chairman of the SFC and his staff for their assistance in facilitating the review work, and their co-operation in responding to the PRP's enquiries and recommendations in the past year. The PRP is also grateful to members of the industry who have offered valuable comments on the possible areas of improvement to the SFC's internal procedures and processes.

6.2 The PRP has also passed a vote of thanks to two ex-officio members, Mr Andrew Sheng, ex-Chairman of the SFC and Mr Ian Wingfield, representative of the Secretary for Justice, for their dedicated service and valuable contributions to the work of the PRP.

Annex A

Process Review Panel for the Securities and Futures Commission

Terms of reference

1. To review and advise the Commission upon the adequacy of the Commission's internal procedures and operational guidelines governing the action taken and operational decisions made by the Commission and its staff in the performance of the Commission's regulatory functions in relation to the following areas-

   (a) receipt and handling of complaints;

   (b) licensing of intermediaries and associated matters;

   (c) inspection of licensed intermediaries;

   (d) taking of disciplinary action;

   (e) authorisation of unit trusts and mutual funds and advertisements relating to investment arrangements and agreements;

   (f) exercise of statutory powers of investigation, inquiry and prosecution;

   (g) suspension of dealings in listed securities;

   (h) administration of the Hong Kong Codes on Takeovers and Mergers and Share Repurchases;

   (i) administration of non-statutory listing rules;

   (j) authorisation of prospectuses for registration and associated matters; and

   (k) granting of exemption from statutory disclosure requirements in respect of interests in listed securities.

2. To receive and consider periodic reports from the Commission on all completed or discontinued cases in the above-mentioned areas, including reports on the results of prosecutions of offences within the Commission's jurisdiction and of any subsequent appeals.

3. To receive and consider periodic reports from the Commission in respect of the manner in which complaints against the Commission or its staff have been considered and dealt with.

4. To call for and review the Commission's files relating to any case or complaint referred to in the periodic reports mentioned in paragraphs 2 and 3 above for the purpose of verifying that the action taken and decisions made in relation to that case or complaint adhered to and are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly.

5. To receive and consider periodic reports from the Commission on all investigations and inquiries lasting more than one year.

6. To advise the Commission on such other matters as the Commission may refer to the Panel or on which the Panel may wish to advise.

7. To submit annual reports and, if appropriate, special reports (including reports on problems encountered by the Panel) to the Financial Secretary which, subject to applicable statutory secrecy provisions and other confidentiality requirements, should be published.

8. The above terms of reference do not apply to committees, panels or other bodies set up under the Commission the majority of which members are independent of the Commission.

Annex B

Membership
of the Process Review Panel
for the Securities and Futures Commission
(as at 31 December 2005)

Chairman:	Mr. CHENG Hoi Chuen, Vincent, GBS, JP
Members:	Professor CHAN Yuk Shee, BBS, JP
	Mr. CHEONG Ying Chew, Henry
	Mr. CHOW Wing Kin, Anthony, SBS, JP
	The Honourable EU Yuet Mee, Audrey, SC, JP
	Mr. FONG Hup, MH
	Mr. KAM Pok Man
	Mr. KWAN Pak Chung, Edward
	Mr. PANG Yuk Wing, Joseph, JP
Ex-officio members:	Chairman, Securities and Futures Commission (Mr. Martin WHEATLEY) *(with effect from 1 October 2005)* (Mr. Andrew SHENG, BBS, JP) *(up to 30 September 2005)*
	Non-Executive Director, Securities and Futures Commission (Dr. York LIAO, SBS, JP)
	Representative of Secretary for Justice (Mr. Ian G M WINGFIELD, GBS, JP)

Membership of Working Groups
(as at 31 December 2005)

Working Group on Corporate Finance and Enforcement

Chairman:	Mr. KWAN Pak Chung, Edward
Members:	Mr. CHENG Hoi Chuen, Vincent, GBS, JP
	Professor CHAN Yuk Shee, BBS, JP
	Mr. CHOW Wing Kin, Anthony, SBS, JP
	The Honourable EU Yuet Mee, Audrey, SC, JP
	Mr. Ian G M WINGFIELD, GBS, JP
	Mr. Martin WHEATLEY *(with effect from 1 October 2005)*

Working Group on Licensing, Intermediaries Supervision and Investment Products

Chairman:	Mr. FONG Hup, MH
Members:	Mr. CHEONG Ying Chew, Henry
	Mr. KAM Pok Man
	Dr. York LIAO, SBS, JP
	Mr. PANG Yuk Wing, Joseph, JP
	Mr. Martin WHEATLEY *(with effect from 1 October 2005)*
	Mr. Andrew SHENG, BBS, JP *(up to 30 September 2005)*

Annex C

Securities and Futures Commission's responses[10] to the observations and recommendations that are accepted

(A) Licensing of Intermediaries

Item (1)
Case findings/market views The PRP noted that the SFC had revised its internal procedure in February 2005 to the effect that only a certain percentage of licence applications would be subject to police vetting.
PRP recommendation/observation As the revised procedures involved a shortlisting process, the PRP invited the SFC to advise the measures in place to ensure fairness and consistency in the shortlisting process. (Para. 3.3 of Chapter 3)
SFC's response The Licensing Department had established standard procedures with pre-defined and objective criteria on initiating police vetting. The applicants were not shortlisted at will nor would the selection process involved any discretion. This procedure is in addition to the existing process for suspicious cases where the SFC would seek confirmation from the police regarding an applicant's conviction record. This is stated in the PRP manual which provides that where a Licensing Department case officer has concerns over an applicant's fitness and properness for reasons such as possible conviction record, police vetting is conducted.

(B) Inspection of and prudential visit to intermediaries

Item (2)
Case findings/market views In an inspection case, the PRP noted that the SFC had not issued an interim letter of deficiencies within four months upon completion of the inspection fieldwork and hence failed to comply with the standard procedures.
PRP recommendation/observation The PRP considered that it would be in the interest of the investing public if the deficiencies, once identified, were made known to the company as soon as possible so that the company could take remedial action immediately. (Para. 3.5 of Chapter 3)

[10] Editorial changes are made mainly to remove case specific information.

SFC's response

The SFC explained that there was a settlement negotiation in progress with the company's subsidiary. Both firms were however operated by the same personnel and from the same office premises, and had been inspected by the SFC at the same time. The responsible Senior Manager In Charge decided to defer the issue of any letter of inspection findings in order to avoid jeopardising the negotiations with the company's subsidiary that involved a voluntary payment. The SFC accepted that the interim letter of deficiencies should generally be issued within four months but the SFC should have the flexibility to make exceptions in unusual circumstances such as in this case.

Item (3)

Case findings/market views

As a general practice, the results of an inspection or prudential visit were recorded in a completion summary. The PRP noted that the date of approval and the identity of the approving officer were not given in the completion summaries of some cases.

PRP recommendation/observation

The PRP considered that such information provide a more comprehensive record and could help ensure clear accountability in respect of the decisions made. (Para. 3.7 of Chapter 3)

SFC's response

The system in question is a case management system with built-in access controls and clearly defined user rights to establish accountability and ensure proper authorisation of the respective steps in the inspection process. The system has been programmed to permit only the officer entered under the Basic Information tab as Senior Manager In Charge to approve the completion summary. Any change in the Senior Manager In Charge of an inspection is also logged in the system. The Senior Manager In Charge must approve the completion summary before a case can be closed in the system. Managers and directors in Intermediaries Supervision Department can readily view the date of approval and the identity of the approving officer in the system on their desktop computers as and when the need arises. The SFC has not printed out the information under the Basic Information tab for filing so as to save paper consumption.

Notwithstanding, the SFC agrees to add these date and identity information to the completion summary in its next system enhancement for the sake of facilitating PRP reviews.

Item (4)

Case findings/market views

A company was selected for a prudential visit instead of an inspection although it had not been inspected for more than six years.

PRP recommendation / observation

The PRP invited the SFC to advise on the considerations leading to the selection of companies for inspections or prudential visits, and the difference in the thresholds for initiating inspections and prudential visits. (Para. 3.9 of Chapter 3)

SFC's response

Supervision of licensed firms is an art and not a science. It is not practical to rely only on some specific numerical triggering point for initiating an inspection vis-à-vis a prudential visit as the SFC needs to take into account the unique circumstances of each case including the firm's business model, management quality, market significance, etc. The SFC adopts a risk-based approach and relies to a large extent on the responsible case officers to know the firms under their portfolio and assess their risk profiles by taking into account all relevant qualitative and quantitative factors. Many regulators in the developed financial markets also adopt a similar approach.

Given its limited resources, the SFC needs to channel its regulatory efforts to firms that it classifies as high risk and / or high impact.

In all, the SFC does not think it appropriate to set a rigid inspection cycle, may it be 6 years or 7 years, as this may be inconsistent with the risk-based approach which drives the SFC's priority setting and resource allocation. For example, in cases where a brokerage firm runs a simple business by serving a handful of clients doing very low volume of trading, it may suffice just to call the firm's management from time to time to check on things rather than to conduct an onsite inspection.

Furthermore, the selection is already subject to checks and balances whereby as per its internal procedures, a designated Senior Manager is responsible for proposing a list of inspection targets for each quarter which must in turn be approved by a Senior Director of the Intermediaries and Investment Products Division. In this process, the responsible Senior Manager will, where applicable, give the reasons in writing for selecting an intermediary for inspection.

To conclude, the SFC must have the flexibility to determine which regulatory tools – outside inspection or prudential visit – to use after carefully considering the key risks at both the industry's and firm's level and how best to deploy its limited resources.

(C) Authorisation of collective investment schemes

Item (5)

Case findings / market views

In one case, the applicant on two occasions, did not reply to the SFC until after the receipt of reminder letters informing that the application would be deemed to have been withdrawn by a certain date. The applicant appeared to be taking advantage of the application system to ensure that the application, which might have been submitted pre-maturely, would remain valid.

PRP recommendation / observation

Although there was no evidence to suggest a serious abuse of the system, the PRP invited the SFC to continue to monitor the situation and consult the PRP if the situation had

deteriorated to the extent that modification of the procedures would be warranted. (Para. 3.11 of Chapter 3)
SFC's response The SFC noted the recommendation.

(D) Handling of complaints

Item (6)
Case findings / market views The PRP was informed that the SFC had since March 2005 adopted the requirement to issue an interim reply to a complainant at quarterly intervals so as to keep the complainant informed that the case was receiving attention.
PRP recommendation / observation The PRP considered the new practice an improvement in the handling of complaints. (Para. 3.12 of Chapter 3)
SFC's response The SFC would review and update the complaint handling procedures to reflect the change.

(E) Investigation and disciplinary action

Items (7) and (8)
Case findings / market views The SFC issued a warning letter to a broker house for its failure to fulfil its responsibility to monitor clients' trading activities. The broker house wrote to the SFC twice to explain that the orders were made via an omnibus account of an institutional client. The company could only see the total amount of transactions in the institutional account and was unable to segregate the trades conducted by individuals. The broker house requested the SFC to review the issue of the warning letters and to consider issuing guidelines in this area.
PRP recommendation / observation The PRP noted that the institutional client was a bank and the deliberation as to whether the case should be brought to the attention of the Hong Kong Monetary Authority ("HKMA") was not clear in the record. The PRP invited the SFC to consider giving proper documentation of the deliberation in this regard. (Para. 3.15 of Chapter 3)

SFC's response

The SFC agreed that, with hindsight, it would have been appropriate to inform the HKMA of the know your client and trading malpractices monitoring of the broker house caused by the bank's lack of complementary measures.

PRP recommendation/observation

As it transpired in this case that some market practitioners were not aware of such guidelines, the PRP invited the SFC to consider promoting awareness of these guidelines, those concerning the responsibility to monitor client accounts in particular. (Para. 3.16 of Chapter 3)

SFC's response

It is the duty of all industry regulatees to know and understand the regulations that govern them. The SFC has frequently publicly commented on the duty to monitor client accounts for market misconduct and has frequently punished for failure to adhere to it and there are many press releases on the SFC's website relating to disciplinary action for failures of this type. Nevertheless, the SFC will consider what further it can do to raise industry awareness of this duty.

Item (9)

Case findings/market views

The SFC issued a warning letter to a company. The warning letter included a criticism on the content of the company's internal guidelines. The company appealed against the warning on the grounds that it had already taken remedial actions of its own volition and the warning relating to the content of its internal guidelines was unfair and unwarranted. The SFC replied to clarify that its comment on the internal guidelines only served as an advice and did not form part of the warning and it was unfortunate that the distinction was not made clear in the letter.

PRP recommendation/observation

The PRP considered that the misunderstanding could have been avoided had there been communication with the company prior to issue of the warning letter. The PRP invited the SFC to consider ways to improve communication with the recipients of warning letters. (Para. 3.17 of Chapter 3)

SFC's response

The SFC did not agree that giving a prior opportunity to be heard would have affected the case. The question is more of being clearer about what is a warning and what is advice in a letter that combines both. The SFC will instruct its staff to be clearer about this in future.

The SFC believed that in this case, early communication with the company might not have helped remove the misunderstanding as the failure to properly distinguish the advice from the warning was relatively minor and is not something that a prior opportunity to be heard on a warning letter would probably have corrected or would justify an opportunity to be heard being universally offered – it is better corrected by more express guidance to SFC staff to be more careful to distinguish advice from warnings.

Items (10)

Case findings/market views

The PRP reviewed two cases in which disciplinary action was settled on a no-admission basis. It was noted that the deliberation for accepting the settlement on a no-admission basis was not documented on file.

PRP recommendation/observation

The PRP recommended that the SFC should take steps to keep a complete audit trail of the reasons why a settlement on a no-admission basis was accepted. Such an audit trail could help ensure that the same set of considerations for settlement agreements in particular for those made on a no-admission basis, would be applied consistently. (Para. 3.27 of Chapter 3)

SFC's response

The SFC agrees that the reasons for settlement, in particular a reduction of suspension and acceptance of a "no-admission" settlement must be sufficiently documented. However, for one case, the SFC does not consider that it has changed its stance from "admission" to "no-admission" basis because the initial position was open as to whether the settlement be with admissions or without.

The SFC believes that it has consistently applied criteria for no-admission settlement. It has also taken note of the concern of some in the community on this issue and become more cautious in accepting no-admission settlements, though it notes that they were never frequent. While the SFC will not resile from its stance that no-admission settlements may, in appropriate circumstances, secure benefits that would otherwise be unachievable, it notes that it only settled one case on a no-admission basis in 2005/06 financial year. The SFC agrees that there should be a consistent audit trail of settlement considerations.

This recommendation is addressed by a new procedure under which the SFC has prepared a proforma checklist to capture consideration of the relevant factors in settlement deliberation, including whether to settle on a no-admission basis. This should help ensure a consistent audit trail.

Item (11)

PRP recommendation/observation

The PRP recommended that the basis for setting the amount of a fine originally proposed and the justification for its subsequent variation should be sufficiently documented to provide an audit trail of the decisions. (Para. 3.30(a) of Chapter 3)

SFC's response

The SFC accepted that these matters must be sufficiently documented and will take steps to ensure that this is done better in future. The SFC already had a procedure to document the considerations relevant to a fine in the light of the Disciplinary Fining Guidelines in the form of a proforma checklist.

Item (12)

Case findings/market views

In two fining cases, the fine following the settlement negotiation was substantially reduced by nearly 50% from the amount originally proposed.

PRP recommendation/observation

The PRP considered that there should be a maximum ceiling of such discount as in the case of Financial Services Authority in the United Kingdom which stipulates a ceiling of 30%. (Para. 3.30(b) of Chapter 3)

SFC's response

The SFC agrees that a maximum discount for cooperation should be fixed as a guideline. (generally the SFC sees that as 30%) However, three other factors come into consideration during a settlement that influence penalty. First, representations made may cause the SFC to reconsider the seriousness of the case and the initial figure from which it calculates a maximum 30% discount may be revised downwards. Second, mitigating factors may be raised which the SFC was previously unaware of, which would again cause it to revise the penalty from which the 30% discount for settlement is considered. Lastly, it is a question of judgement of whether to accept settlement if the final offer of the defendant to settle is marginally lower than what a 30% discount would reflect. The SFC will consider developing a template to capture documentation of the relevant factors considered so that there is a relatively standard record.

Item (13)

PRP recommendation/observation

There should be a scientific model encompassing all relevant factors to provide a consistent and objective basis for the calculation of a fine. Noting the SFC's advice that it was more practical to make comparison with other fining cases and consider the specific circumstances of each case to determine the level of a fine for a case, the PRP considered that there should be measures in place to ensure consistency in application and to promote transparency of the SFC's decision making in this respect. (Para. 3.30(c) of Chapter 3)

SFC's response

The SFC notes that the existing process review manual already requires mandatory penalty comparisons with similar previous cases when making penalty recommendations. The SFC believes that this is uniformly done and uniformly recorded on the file. The SFC already discloses an appropriate level of penalty deliberation in its notices of decision and statements of reasons. It does not propose to discuss its penalty comparisons in its decisions and note that the judiciary do not usually do so when sentencing either.

Item (14)

PRP recommendation / observation

The PRP considered that the SFC should disclose to the public the aggravating and mitigating factors leading to a public reprimand and for arriving at a certain size of a fine to enable market players to better understand the penalty that could be imposed for particular misconduct. (Para. 3.30(d) of Chapter 3)

SFC's response

The aggravating and mitigating factors leading to a fine are already known to the public in the SFC Disciplinary Fining Guidelines. Under section 199 of the SFO, the SFC was required to create and publish guidelines on this. This is not the case with public reprimands. The SFC does not intend to go further than the law requires here. Nevertheless, the SFC notes that senior enforcement officers regularly emphasise to defence lawyers that the Disciplinary Fining Guidelines are a useful guide to sentencing principles for all disciplinary penalties (fines, reprimands, suspensions, revocations and banning orders). Many defence lawyers and defendants (including unrepresented ones) already make submissions by analogy to the Guidelines or submissions on the basis of considerations very similar to them, as the Guidelines merely state fairly obvious factors that are commonly considered in most sentencing environments.

The SFC believes that it has already endeavoured to ensure that public reprimand press releases, as do all press releases, mention all key relevant mitigating and aggravating factors. Press releases are already reviewed by 3 to 4 lawyers and the SFC's press office before being issued. This multiple scrutiny helps ensure that relevant factors are highlighted. In the SFC's experience, defendants and their lawyers regularly make comparisons to previous press releases and the enforcement reporter when making defence submissions in order to distinguish or support their own case.

Item (15)

Case findings / market views

The PRP was advised that the punitive and deterrent results in settlement were comparable to those resulting from other disciplinary action that did not settle.

PRP recommendation / observation

The PRP suggested that the same message should be conveyed to the public to improve transparency of the SFC's decision. (Para. 3.39 of Chapter 3)

SFC's response

The SFC does not disagree that the message should be conveyed that settlement may result in comparable punitive and deterrent outcomes to formal discipline. The SFC believes that it is already conveying this message to the public and other stakeholders since the PRP raised the issue and will ensure that publications and senior officers in Enforcement Division continue to emphasise this point.

Item (16)
Case findings/market views In one case, an asset management company was found to have made its daily valuation of several funds at a time different from the specifications given in the offer documents of the funds concerned. The SFC entered into settlement with the company which was required to make an ex-gratia payment to the funds concerned as a compensation to the notional loss to the investors. The ex-gratia payment was calculated mainly with reference to the administration fees charged by the company.
PRP recommendation/observation Noting the SFC's advice that there was no way to accurately establish the extent of loss, if any, to investors, the PRP invited the SFC to consider other factors such as the practice in other jurisdictions in calculating the size of the ex-gratia payment in similar cases. (Para. 3.40 of Chapter 3)
SFC's response The SFC's goal in determining the level of payment was to find a sum that was proportionate to any notional loss investors in the relevant funds may have suffered and noted that the difficulty in calculating loss meant that the SFC had to use another reference point to calculate the payment (though an analysis indicated that no material loss was suffered). This involved considering the factors that the breaches were technical and inadvertent and so not serious. The calculation also had to result in a payment that would be a deterrent to future breaches by others. The final payment was considered proportionate to the seriousness of the breaches and this was the overriding consideration. The SFC will consider other measures in future cases, as appropriate, and will consider foreign practice if relevant.

(F) Processing of listing applications under the Dual Filing regime

Item (17)
Case findings/market views The PRP noted in two cases that there was a delay in the despatch of listing applications and related documents from The Stock Exchange of Hong Kong Limited ("SEHK") to the SFC. The PRP was concerned that the delay might prejudice the SFC's ability to invoke its power under section 6 of the Securities (Stock Market Listing) Rules to require the applicant to supply further information, or object to the listing under certain circumstances.
PRP recommendation/observation The PRP invited the SFC to review its communication with the SEHK to see if the process could be expedited. (Para. 3.45 of Chapter 3)

SFC's response

The ten-day time frame restarts with each submission of written material by the applicant or sponsor to the SEHK. As the SEHK is in frequent contact with the applicant and the sponsor, the ten-day timeframe is refreshed successively during the course of an active listing application. Therefore, the SEHK's delay in passing one of the submissions to the SFC would not normally prevent the SFC from raising further comments. Whilst the SFC noted some improvements in the timeliness of the SEHK passing listing applications to the SFC, the SFC would in their regular liaison remind the SEHK to expedite the process.

Item (18)

Case findings/market views

Arising from the review of two cases, the PRP noted that the SFC was not updated on the progress of listing applications.

PRP recommendation/observation

The PRP invited the SFC to consider the need for putting in place a proper procedure to keep them updated of the progress of listing applications. (Para. 3.46 of Chapter 3)

SFC's response

The SFC agrees that it needs to be kept updated on the progress of listing applications and believes that a proper procedure has already been established in the MOU with SEHK for the SFC to be kept appropriately informed of the major developments in respect of listing applications, having regard to the need to avoid duplication of work with SEHK the frontline regulator of the listing process.

By way of background, each listing application has a validity of 6 months, after which period it will lapse. To avoid any duplication of work and to maintain the SEHK's frontline role in dealing with the applications, the SFC has agreed with SEHK certain milestones upon which SEHK will provide information about the application including when the Listing Division despatches its report to the Listing Committee. After giving a no comment letter to the SEHK on a case, the SFC does not consider it necessary to actively monitor the listing progress (including the listing timetable) by regularly obtaining further updates from SEHK prior to the agreed milestone when the application was still ongoing. Where a case is rejected or withdrawn, the SEHK will inform the SFC.

SEHK updates the SFC weekly and monthly on the status of all its listing applications in its Weekly Report and Monthly Report to the SFC respectively. The responsible case officer may also liaise with the responsible SEHK staff where necessary to enquire on the progress of the listing application. Where it is noted that a case has lapsed (which normally is 6 months after the listing application was filed), the case officer does check with SEHK whether the application is likely to be pursued further by the applicant, in which event the officer will handle the resubmitted application as a continuation of the same file rather than closing the case.

(G) More briefings on subjects of concern to the industry

Item (19)
Case findings/market views Although members of the SFC did speak at various seminars, conferences and public fora, it would be helpful if the SFC could organise or participate in more talks or briefings on specific areas of concern to the industry. (Para. 4.5 of Chapter 4)
SFC's response The SFC has sponsored (in the form of providing speakers) quite a lot of seminars in response to industry's request. These are generally areas that specific sectors of the industry are interested in or concerned about. Some recent examples are seminars on the new Takeovers Code requested by Hong Kong Institute of Certified Public Accountants ("HKICPA") and Association of Chartered Certified Accountants, the new anti-money laundering guidelines for the Hong Kong Securities Institute and HKICPA and Part XV of the SFO on disclosure of interests for listed companies. Back in 2003 when the SFO was introduced, the SFC did a lot of training for the industry in conjunction with the industry associations and professional associations. The SFC will continue to provide training to the industry either by organising its own training sessions or by giving speeches at seminars/courses organised by the industry groups subject to resources constraints and the availability of SFC colleagues.

(H) Publicising exemptive reliefs granted under the Takeovers Code

Item (20)
Case findings/market views A comment received from the industry indicated that while the SFC had done a lot of work to streamline the process for obtaining exemptions under the Code on Takeovers and Mergers ("the Takeovers Code"), it did not publish all the exemptive reliefs that had been granted. It was considered that information such as the status of "exempt principal trader" was non-controversial and could be published. (Para. 4.7 of Chapter 4)
SFC's response By way of background, the Code imposes certain prohibitions, restrictions and obligations in respect of particular dealings by the principal parties in takeovers offers and by persons acting in concert with them. The Code treats financial and other professional advisers to corporate clients as acting in concert with those clients. Accordingly where the adviser forms part of a larger organisation, the presumption of acting in concert extends to all entities within that group including principal traders and fund managers which are within the group. The concept of exempt principal trader status ("EPT") and exempt fund manager status ("EFM") recognises that within certain multi-service organisations certain trading and fund management activities may be conducted on a day-to-day basis quite separately from the other activities of that organisation including most importantly its corporate finance activities. Essentially this separation is achieved through efficient Chinese Walls and compliance procedures. Once granted, the status would normally mean that a principal trader or a fund manager

would no longer be regarded as acting in concert with the corporate finance operations of its organisation or with the corporate finance operation's clients who are connected to a general offer. As such they would be subject to far less stringent provisions under the Code. Their dealings, for instance, in the offeree or offeror company would not be regarded as concert party dealings for the purposes of the Code.

Since the introduction of the EPT/EFM status following a Code amendment in April 2001, the SFC has granted exempt status to entities belonging to six international financial groups. The first exempt status was granted in October 2003. It has not as a matter of practice published the names of exempt entities on the SFC website. The SFC notes that this practice is consistent with the London Takeovers Panel's practice.

However, in view of the suggestion from the industry, the SFC proposes to start publishing the names of entities which have been granted EPT/EFM status on the SFC website by 1 June 2006. The SFC considers that this will enhance greater transparency during takeovers offers.

In respect of other waivers or exemptions granted by the Takeovers Executive, e.g. whitewash waivers, placing and top-up waivers and relaxation of timetable requirements, the majority of them are published by listed companies themselves, or by unlisted offerors in their own documents. The SFC normally requires the applicants or the relevant listed companies to publish waivers or exemptions granted if they are price sensitive or relevant for shareholders to reach their informed decisions. Other SFC rulings which are not published often involve the applicants' or other parties' confidential information.

(I) Length of consultation periods in the SFC's public consultation exercises

Item (21)

Case findings/market views

There was a comment that the SFC did not give sufficient time for the public to respond to the public consultations conducted by the SFC. It was claimed that the consultation period given in the SFC's consultation exercises since January 2003 was on average less than 45 days, which was too short for the public to study and assess the proposals. The actual period available was further reduced since there were always intervening public holidays. Moreover, the length of the consultation period made no reference to the length and complexity of the consultation papers. The short period available for the public to send in their comments suggested that the SFC was not committed to listening to public opinions. (Para. 4.15 of Chapter 4)

SFC's response

As a market regulator that places great importance on transparency and accountability, the SFC is acutely conscious of the need to give sufficient time to the public to respond to its consultation papers. The SFC believes that the views of the public are vital in helping it achieve the right balance of regulation.

So far as practicable, the SFC gives long consultation periods for the public to respond to its papers. In determining the length of a consultation period, the SFC takes into account factors such as the urgency, complexity and impact of the issues involved. The SFC generally gives longer consultation periods in respect of matters of significance.

For matters involving mere technical changes to the existing framework, shorter consultation periods will be warranted. The SFC believes that it should be flexible on consultation deadlines. In fact, they are always amenable to extend the consultation periods where necessary. Submissions received after the consultation deadline will also be considered before the issuance of consultation conclusions.

However, SFC's ability to give long consultation periods is at times restricted by the tight legislative timetable relating to the proposed changes to the relevant rules or provisions in the law. For any joint consultation with other agencies, such as the Government or the Hong Kong Exchanges Limited, the SFC needs to coordinate with the relevant party and work out an appropriate consultation deadline.

The SFC has a very busy consultation schedule in the past few years, issuing 27 consultation papers in 2002, 11 in 2003, 5 in 2004 and 8 so far up to August 2005. Since there are public consultation on different topics all year round, it is inevitable that some of the response periods may overlap with public holidays.

The SFC would like to point out that its consultation process in fact begins well before the publication of a consultation paper. The SFC engages industry representatives, academics and interested parties in various stages of formulating policy proposals, sometimes as early as the concept development stage. It also seeks advice from the SFC's Advisory Committee, which comprises representatives from the industry, the Public Shareholders' Group and the Consumer Council before finalising a consultation paper. The consultation process does not end with the public consultation. The SFC continues to soft consult market participants and interested parties in finalising conclusions to consultation papers.

(J) Regulatory oversight of the SEHK's performance of listing functions

Item (22)

PRP recommendation/observation

On the scope of the review, the PRP noted that contrary to the recommendations on areas to be covered in the SFC's review published in the *Consultation Conclusions on Proposals to Enhance the Regulation of Listing*, the adequacy of the SEHK's staff professionalism and experience in the discharge of its listing functions and the co-operation, co-ordination and the exchange of information with other regulators (such as the Hong Kong Institute of Certified Public Accountants) were not covered in the current review nor in the list of areas for future reviews.

Noting that the staff turnover of SEHK had been high, the PRP considered that it would be useful for the SFC to review also the impact of staff turnover on the SEHK's performance of the regulation of listing matters. (Para. 4.19 of Chapter 4)

SFC's response

Although the SFC did not formally identify staff professionalism and experience as a primary area for review, it did assess the SEHK's staff professionalism and experience by reference to the procedures in the areas covered by the review. The SFC concluded that it did not observe anything calling into question the SEHK's staff professionalism and experience.

The SFC did not formally assess manpower adequacy as a primary area of the review but did monitor it as part of its review of SEHK's work and procedures.

The Audit Team considered the issue of high staff turnover in the 2005 annual review, particularly in the Compliance and Monitoring Department. However, there was insufficient evidence to show that performance was adversely affected or to draw any other conclusions, so no comment was made in the SFC's report.

The SEHK's liaison with other regulators is not seen as an area of priority (particularly given that the SEHK in fact regularly meets with the SFC and the HKICPA to discuss regulatory matters).

Annex D

Securities and Futures Commission's responses[11] to the observations and recommendations that have not been accepted in full

(A) Warning cases

Item (1)
Case findings/market views The SFC found that several investment consultants of a company had engaged in promoting mutual funds without valid licence. Warning letters were issued to the company and its six employees. The company and three employees reacted strongly to the warning letters or said that they took them seriously. The company submitted representations and stressed that its senior management took the warning letters seriously and it had taken remedial actions including a compliance audit to address the issues raised in the warning letter. Three employees submitted representations and requested either withdrawal of the warning letters or a meeting with the SFC to discuss the issue.
PRP recommendation/observation The PRP considered that, had the SFC communicated sufficiently with the company before issuing the warning letter, the SFC might have been informed of the company's initiative to conduct a compliance audit, and might have considered a deferral of the decision to issue a warning until completion of the compliance audit. The SFC should therefore critically reconsider the PRP's recommendation regarding the provision of a fair hearing and appellate procedure for the issue of warning letters. (Para. 3.19 of Chapter 3)
SFC's response The SFC noted that the company conducted the compliance audit as a result of its receipt of the warning letter, so it was not possible for the SFC to have considered the compliance audit before issuing the warning letter. Further, the company's detection of further possible technical breaches would have been unlikely to change the SFC's assessment of the matter even had the SFC known of them before issuing the warning letter because the further breaches were technical and so, in the circumstances of this case, unlikely to be the subject of formal disciplinary action or prosecution. Indeed, the company's responsible remedial steps and compliance minded response to the warning letter demonstrated that the warning letter was a sufficient regulatory response to the situation. The SFC entered into further correspondence with one of the employees after the receipt of his response to the warning letter. The SFC noted to him that, contrary to his reaction to the warning letter, the SFC did not regard a warning letter as warranting his removal from the industry but that employers were free to make their own decisions and gave him consent to present the response to his employer. The SFC noted that this officer remained employed by the company. The SFC noted to the officer that it

[11] Editorial changes are made mainly to remove case specific information.

considered the evidence against him as clear and likely to sustain a formal disciplinary sanction against him. The SFC also noted that the company's statement that it took a warning letter very seriously was likely to have been an attempt to establish to the SFC that it was taking appropriate remedial measures to rectify the identified compliance deficiencies which the company did not deny and also an attempt to avoid further regulatory action by indicating appropriate remedial actions.

The SFC has made its views on the appropriate balance of fairness and the public interest in relation to warning letters matter plain to the PRP and, even after critical reflection, does not consider that this case gives good reason to reconsider its position.

Item (2)

Case findings/market views

It transpired in a warning case that the recipients of warning letters in that particular case did take the warning seriously and some of them made representations and appealed against the warnings notwithstanding the SFC's views that warning letters were only meant to be informal.

PRP recommendation/observation

Having regard to the strong reaction of the recipients in this case, the PRP invited the SFC to critically reconsider the PRP's previous suggestion of allowing the recipients of warning letter to indicate whether he/she accepted the proposed warning within a reasonable period of time. The PRP noted that the SFC maintained its stance as reported in the PRP annual report for 2004. Having regard to the SFC's concern about resource constraints, the PRP invited the SFC to advise on the resource implications of the proposal. The PRP has also invited the SFC to advise on the safeguards currently in place to ensure procedural fairness for warning letters issued as an alternative to formal disciplinary process. (Para. 3.22 of Chapter 3)

SFC's response

The SFC explained that its objection to the PRP's proposal on warning letters was not merely resource implications but that its current procedures reflected an appropriate balance of fairness versus resource cost particularly as warnings were private and could be disputed in future regulatory proceedings when the SFC attempted to use them. The SFC had previously noted that, in administrative law, the content of hearing and appeal procedures may vary depending on the seriousness of the consequences of the administrative action to be taken. On resource implications, the SFC noted that it issued approximately 300 warnings a year in Enforcement alone and that this was 50% more than the number of criminal prosecutions and formal disciplinary action the SFC took in each year, which is approximately 200. The SFC noted that in its experience, if it were to grant a prior hearing over a warning before issuing it, it would consume as much resources as a formal disciplinary action as the process would effectively be the same, absent the right of appeal (relatively few disciplinary action are appealed every year). This would represent almost a 150% increase in work in Enforcement. The SFC also noted that, in its experience, it would be difficult to characterise representations in response to a prior hearing as an abuse of process and that a threat to formally discipline for unmeritorious representations, as suggested by the PRP, would not dissuade unmeritorious representations. Indeed, in the SFC's experience, many of the after the

event responses to the warnings are unmeritorious. In any event, to discipline or prosecute in such cases after the SFC has already determined that it should not discipline or prosecute, considering the circumstances of the case, seems to fail to give sufficient weight to what initially prompted the need to warn in the first place.

(B) Settlement of disciplinary action

Item (3)

PRP recommendation/observation

The PRP reiterated its concern expressed in 2004 that licensees who were subjects of disciplinary action could in effect 'buy' themselves out from liability through a settlement if they could afford to make a payment. (Para. 3.25 of Chapter 3)

SFC's response

The SFC explained that suspensions primarily have an economic effect in that they deny a person or an entity the right to pursue business and derive profit from it, so it is incorrect to talk of buying a way out of liability. When the SFC substitutes a suspension with a voluntary payment, something that is a feature of the transition from the previous legislation to the SFO and is diminishing in frequency, it carefully calibrates the payment to match the economic effect of the suspension previously proposed to be imposed, which is itself already carefully calibrated to the seriousness of the conduct. Given this, talking of "buying a way out of liability" is inappropriate.

Item (4)

PRP recommendation/observation

In line with the arrangement in the fining regime where a checklist has been used for the evaluation on fining, the PRP considered that there should be a similar checklist to assist the SFC's subject officer and decision maker in the evaluation for a public reprimand so as to ensure consistency in actions taken in different cases. (Para. 3.30(e) of Chapter 3)

SFC's response

Given that each case is unique and each reprimand uniquely suited to the facts of each case, the SFC thinks a standard checklist will be of limited value given that public reprimand press releases focus particularly on describing specific factual aspects of a defendant's conduct. By contrast, when assessing a fine, one focuses on the absence or presence of certain standardised general factors in a defendant's conduct in order to reach more standardised assessments of the seriousness of a defendant's conduct and how that should be punished in order to reach some degree of consistency in outcomes between fines for different cases. As such, the SFC thinks that a checklist if prepared would be so general as to be of little guidance as to the content of public reprimand.

Item (5) and (6)

Case findings / market views

In two fining cases, the decision maker had substantially involved himself in the negotiation process.

PRP recommendation / observation

The PRP noted that there was clear segregation of duties in the settlement negotiation in some cases and the practice helped strengthen the checks and balances on decision making process and such practice should be followed in settlement cases. (Para 3.35 of Chapter 3)

SFC's response

The SFC explained that, as reported to the PRP before, defendants and their lawyers generally tend to prefer the opportunity, subject to the SFC's discretion, to interact directly with the decision maker in settlement negotiations. Indeed, in some of the most major cases, the ability of the SFC's decision maker to directly participate in settlement negotiations (e.g. complex compensation negotiations) with the senior management of defendants has helped establish a personal rapport and evidence SFC management's commitment to positions the SFC adopts in settlement negotiations that have assisted in negotiating a satisfactory outcome more quickly. In light of this, the SFC thinks that not segregating the decision maker from participation in settlement negotiations is in fact in the interests of the industry and the public in terms of ensuring frank dialogue and more rapid outcomes. The SFC, while it respects the PRP's recommendation, declines to adopt it.

PRP Recommendation / observation

For very fluid situations which required exercise of wide discretionary power, the SFC might need to consider introducing a mandatory cross-divisional consultation process. (Para. 3.35 of Chapter 3)

SFC's response

On mandatory cross-divisional consultation, the SFC has previously noted to the PRP several factors it wishes to reiterate:

- the decision to settle is legally a decision to end a case with an outcome. Legally, an SFC decision maker cannot abdicate their decision to settle to another party or rely too heavily on another such that they can be accused of having abdicated their discretion to decide the case.
- SFC enforcement decision makers do frequently consult other divisions where they believe that the other division has an interest or expertise in an area that is relevant to a decision to settle a particular case.
- enforcement decisions are specialised decisions in terms of understanding of litigation procedures and tactics and expertise in deciding penalty and other divisions will not have experience or expertise in these areas. That is why an Enforcement Division is established to exercise these decisions in the first place. Further, some areas of conduct, e.g. market misconduct, fraud, etc, are areas in which no division other than the Enforcement Division will have relevant expertise and to require mandatory consultation in these areas will not necessarily produce a better informed decision.

For these reasons, the SFC considers mandatory cross-divisional consultation is not desirable but that the Enforcement Division should continue to consult other divisions at its discretion as currently occurs. The Enforcement Division notes that cases in progress are regularly reported in cross-divisional meetings and that other divisions and senior management are able and free to monitor enforcement cases and offer opinions on them in these forum.

(C) SFC's collection of information on transactions

Item (7)

Case findings / market views

An industry comment referred to the SFC's requests under section 181 of the SFO to require broker houses to provide details of transactions over a particular period of time, including the ultimate beneficiaries of the transactions, for the purpose of its investigation on suspicious transactions. Broker houses had practical difficulties to comply with such requests where the transactions involved overseas financial institutions and the process naturally involved a huge amount of time and resources.

It is suggested that, instead of asking for a comprehensive set of records, the SFC might consider setting a threshold on the level of information required in the light of a risk-based analysis. This approach could reduce both the compliance costs of broker houses and the load of raw data for the SFC without necessarily reducing the effectiveness of the SFC's surveillance regime. (Para. 4.10 of Chapter 4)

SFC's response

Beneficial owner information is an essential element in conducting market crime and misconduct investigations, as endorsed by the Financial Action Task Force ("FATF") and the International Organisation of Securities Commissions ("IOSCO"). Market intermediaries must be able to produce this information in an investigation at the request of the regulator, even if their client is a foreign financial intermediary. This is a standard FATF and IOSCO requirement.

Failure to keep this information by an industry intermediary is a breach of Hong Kong regulatory requirements. Failure by Hong Kong authorities to enforce these regulatory requirements would risk putting Hong Kong in breach of its FATF and IOSCO obligations and result in FATF and IOSCO taking action against Hong Kong in response.

For overseas financial intermediary clients, it is up to the local broker to refer the SFC's s. 181 requests to the overseas entities and ask them to provide the ultimate beneficiary's information to the SFC direct. The SFC cannot see how that would increase the time and resources for the local broker. The SFC only requires the local broker to provide the name of the overseas intermediary to the SFC and that the local brokers have in place legal arrangements that they are satisfied on a reasonable basis to ensure that the foreign financial intermediary client will provide the client information sought direct to the Hong Kong regulators upon request.

At the moment, when the SFC decides to issue s. 181 requests, it only issues requests to those brokers who have actively participated in the trading of the relevant securities. It will not pursue very small purchases or sales in terms of broker activities. The SFC cannot adopt a risk-based approach to information at the client level, until it receives the

ultimate client information from the brokers involved by issuing s. 181 requests and getting responses. It can then start to rule out clients from being a focus of further investigatory scrutiny.

The view that the SFC only needs to focus on buying transaction before a price hike is an oversimplification. When investigating insider dealing, the SFC has to eliminate possible suspects just as much as identifying possible suspects. Sales of stocks that are the subject of a subsequent price sensitive information ("PSI") announcement may help exonerate possible insider dealing suspects who had previously bought that stock. It cannot identify who bought or sold a stock until it issues s. 181 requests to and get replies from brokers as to who their clients were, so this is a necessary part of the elimination process. If the SFC only sought buyers' identities without seeking sellers' identities, it may wrongly accuse some buyers of insider dealing. Further, the proposed approach of not analysing sales before PSI announcements is clearly wrong for market manipulation cases.

The industry is probably unable to determine whether the SFC's inquiries are related to insider dealing, market manipulation or false and misleading information as the SFC does not have to announce this at the time it issues s. 181 requests. It sometimes will not be clear from the trading behaviour which wrong is involved and all these forms of conduct may be co-mingled. For example, insider dealing today is not as pure as it used to be in the past. Insider dealing cases nowadays may also be connected with market manipulation as the inside information itself is sometimes not genuine information but is leaked to create market anxiety.

The SFC does not agree that fund management companies should be exempted from providing information about their ultimate clients unless it is clear that the fund was a mutual fund with a sufficiently wide spectrum of investors and that the fund had exercised that clear discretionary authority without direction by their clients. The SFC notices that more and more market manipulators may hide behind fund management companies. Small boutique fund management companies are set up with a few funds under management and its activities largely involve investing in highly speculative stocks. A few individuals might provide the bulk of the seed money for the operation and it is questionable whether the fund managers are truly independent of the beneficiaries of the funds. Fund management companies should have very good record keeping systems via their custodians and it should not be difficult for them to name the sub-accounts on behalf of which they have placed orders.

The SFC is always willing to compromise on the response time to investigatory requests if it is approached by the subject of an investigatory request and a reasonable reason is given for delay in supplying the information.

(D) Regulatory oversight of the SEHK's performance of listing functions

Item (8)

Case findings/market views

The report had set out the number of cases reviewed for the respective units in the Listing Division but no information was given relating to the criteria and methodology for the selection of cases for review.

PRP recommendation / observation

The PRP considered that the number of cases reviewed should be measured against the total number of cases processed in the unit to reflect the actual scope of the review. It was suggested that the SFC might set a target percentage of cases for review beforehand and the selection might take into account the market impact of the cases. (Para. 4.20 of Chapter 4)

SFC's response

The SFC explained that it takes a risk-based approach when it reviews the SEHK's performance. In drawing up the scope of a review, the SFC focused on the areas of concern that may pose a regulatory risk. The review process looks at the SEHK's policy processes, adopted approach and relevant cases. The proportion of cases reviewed is small in keeping with the limited resources available for carrying out the review, but reviewing cases is only a limited part of the audit process. The objective of selecting the cases for review is to understand how the SEHK's policies work in practice and to verify whether the SEHK's practices follow its policies. The number of cases handled by the Listing Division is voluminous. In 2005, the Initial Public Offering Department vetted 162 listing applications, the Compliance and Monitoring Department vetted 13,501 documents (11,092 announcements and 2409 circulars), and the Listing Enforcement Division investigated 232 cases. Hence, in accordance with established practice for auditors, the SFC's approach is to consider the controls and systems established by the SEHK and to determine whether these are appropriate. The SFC believes this is a more efficient approach than the alternative of testing a sufficiently representative sample of cases to be able to draw conclusions as to the whole population of cases. Through adopting this approach, the SFC did note and comment in the report that one of the operational departments in the Listing Division lacked management controls.

The SFC does review "high risk cases" it is aware of which pose a regulatory risk, though such cases are often handled as part of its daily work during the year and it also seeks to sample cases across the spectrum. The criterion of selecting companies whose performance fell substantially below the pledges made in the prospectus is narrow as it only targets newly listed companies. Furthermore, it is not the SEHK's role to perform due diligence on listing applicants to ensure that their pledges are reasonable or to follow up to make sure they meet the pledges made in their prospectuses. Thus if a company does not meet a pledge in its prospectus, that does not necessarily reflect badly on the SEHK's performance. Such cases may be appropriate for inclusion in the SFC's review of the SEHK, but more often lead to investigation of the relevant companies / sponsors themselves, initiated by the SFC's Dual Filing team.