

Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2005

Executive Summary

Introduction

The fifth Annual Report of the Process Review Panel for the Securities and Futures Commission (“PRP”) covers the work of the PRP from 1 January 2005 to 31 December 2005.

Background and Terms of Reference of the PRP

2. The 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.

3. Under its Terms of Reference, the PRP may review files of the SFC to verify that the action taken and decisions made in relation to any specific completed case are consistent with the relevant internal procedures and operational guidelines. The PRP is required to submit its reports to the Financial Secretary annually or otherwise on a need basis.

Constitution of the PRP

4. The PRP, chaired by Mr. Vincent Cheng Hoi-chuen, currently comprises twelve members, including nine members from the financial services sector, academia, the legal and accountancy professions, and three ex-officio members including the Chairman of the SFC¹, a Non-Executive Director of the SFC and a representative of the Secretary for Justice.

Work of the PRP in 2005

5. In 2005, the PRP reviewed completed cases and/or procedures of the SFC in the following areas –

- (a) licensing of intermediaries;
- (b) inspection of and prudential visit to intermediaries;

¹ For the period covered by the annual report, the Chairman of the SFC was an ex-officio member of the PRP.

- (c) authorisation of collective investment schemes;
- (d) handling of complaints;
- (e) investigation and disciplinary action;
- (f) processing of listing applications under the Dual Filing regime;

6. The PRP concluded that the SFC had generally followed its internal procedures in handling cases. The PRP also made a number of recommendations for improvement covering a wide range of the SFC's regulatory activities for improving the transparency, efficiency, consistency and checks and balances of the SFC's processes. Where the SFC has difficulties to adopt a recommendation, detailed explanations were given.

Engagement with the industry

7. The PRP attaches great importance to 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 the issues raised by market players. The issues that the PRP has followed up are –

- (a) SFC to conduct more briefings on subjects of concern to the industry;
- (b) SFC to disclose the exemptive reliefs granted under the Code on Takeovers and Mergers;
- (c) SFC to minimise the level of information required from broker houses on details of transactions for the purpose of its investigations; and
- (d) SFC to ensure sufficient time is allowed for the public to submit response in its public consultation exercises.

Observations and recommendations

8. The observations and recommendations made by the PRP are summarised below.

(1) *Observations and recommendations that are accepted*

(A) Licensing of Intermediaries

Item (1)
<p><u>Case findings/market views</u></p> <p>The SFC revised its internal procedure in February 2005 to the effect that only a certain percentage of licence applications would be subject to police vetting.</p>
<p><u>PRP recommendation/observation</u></p> <p>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)</p>
<p><u>SFC's response</u></p> <p>The SFC explained that it adopted a standard procedure 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 police vetting on suspicious cases where the case officer had concern over an applicant's fitness for licensing purpose for reasons such as possible conviction record.</p>

(B) Inspection of and prudential visit to intermediaries

Item (2)
<p><u>Case findings/market views</u></p> <p>In an inspection case, the SFC did not issue an interim letter of deficiencies within four months after completion of the inspection fieldwork and hence failed to comply with the standard procedures.</p>
<p><u>PRP recommendation/observation</u></p> <p>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)</p>
<p><u>SFC's response</u></p> <p>The SFC explained that it was necessary to defer issue of the letter of deficiencies in order to avoid jeopardising the negotiation with the company's subsidiary 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.</p>

Item (3)
<p><u>Case findings/market views</u></p> <p>As a general practice, the results of an inspection or prudential visit were recorded in a completion summary. However, the date of approval and the identity of the approving officer were not given in the completion summaries of some cases.</p>
<p><u>PRP recommendation/observation</u></p> <p>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)</p>

SFC's response

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.

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 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

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. It was not practical to deploy a numerical threshold mechanically nor was it appropriate to set a rigid inspection cycle as it would be inconsistent with the risk-based approach.

(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 SFC has 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

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.

PRP recommendation/observation

As it transpired in this case that some market practitioners were not aware of relevant guidelines on monitoring of irregular trading activities, 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

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. The SFC explained that it was the duty of all industry regulatees to know and understand the prevailing regulations. Notwithstanding the above, the SFC would consider taking further actions to raise industry awareness in this regard.

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 SFC should consider ways to improve communication with the recipients of warning letters. (Para. 3.17 of Chapter 3)

SFC's response

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.

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. (Para. 3.27 of Chapter 3)

SFC's response

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.

Item (11)

Case findings/market views

In a fining case, the basis for setting the amount of a fine originally proposed and the justifications for its subsequent variation were not fully documented on file.

PRP recommendation/observation

The PRP recommended that the basis for setting the amount of 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 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 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, 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 warrant a downward revision of the initial figure from which the 30% discount was calculated.

Item (13)

PRP recommendation/observation

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 advised that there was already a mandatory requirement in the process manual that a comparison with similar previous cases should be made in a 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.

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 SFC published the Disciplinary Fining Guidelines which contained guidelines on the aggravating and mitigating factors relevant to fining. The Disciplinary Fining Guidelines were a useful guide to sentencing principles for all disciplinary penalties including fines, reprimands, suspensions and revocations. 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.

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 actions 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 agreed to emphasise this point in its public statements and would ensure that its senior officers and publications would continue this practice in future.

Item (16)

Case findings/market views

The SFC entered into settlement with a company which was required to make an ex-gratia payment as a compensation to the notional loss to 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 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 loss meant that the SFC had to use another reference point to calculate the payment.

(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 SFC explained that the ten-day time frame would restart with each submission of written material by the applicant or sponsor to the SEHK. Therefore, 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.

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 advised that it has agreed with SEHK certain milestones upon which SEHK would furnish the SFC with information about the listing applications including the submission of reports to the Listing Committee. SEHK has also been providing updates on the status of all listing applications in its Weekly Report and Monthly Report to the SFC. Where necessary, the SFC's subject officer might make enquiries with SEHK on the progress of a particular listing application.

(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 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. 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.

(H) Publicising exemptive reliefs granted under the Takeovers Code**Item (20)**Case findings/market views

The SFC did not publish all the exemptive reliefs that had been granted under the Code on Takeovers and Mergers ("the Takeovers Code"). 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

The SFC started publishing the names of entities which have been granted "exempt principal trader" and "exempt fund manager" status on the SFC website from 1 June 2006. Regarding other waivers or exemptions granted, the SFC noted that the majority of these would be published by listed companies or by unlisted offerors in their own documents. Other 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. 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

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. The SFC generally gave longer consultation periods in respect of matters of significance. Further, 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.

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

Item (22)

PRP recommendation/observation

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

SFC's 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 as well as the issue of high staff turnover. As there was insufficient evidence to show that performance was adversely affected or to draw any other conclusions, no comment was made in the report. 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.

(2) *Observations and recommendations that have not been accepted in full*

(A) Warning letters

Item (1)

Case findings/market views

In a warning case, some recipients of warning letters reacted strongly to the warning letters or said that they took them seriously.

PRP recommendation/observation

The PRP considered that had the SFC communicated sufficiently with the company before the 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. 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 advised that the fact that the company initiated remedial action upon receipt of the warning letter demonstrated that the warning letter was a sufficient regulatory response to the situation. 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.

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. In response 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 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. 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.

(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

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.

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

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.

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

In the SFC’s experience, direct dialogue between the SFC’s decision maker and 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.

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

The SFC considered the suggestion for mandatory cross-divisional consultation not viable because –

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

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 opinions on cases at these meetings.

(C) SFC's collection of information on details of 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 offshore financial institutions and the process naturally involved huge amounts 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 surveillance regime. (Para. 4.10 of Chapter 4)

SFC's response

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 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.

The SFC explained that they already adopted a risk-based approach in deciding which broker to be issued with a section 181 notice. 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.

(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 case. (Para. 4.20 of Chapter 4)

SFC's response

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. 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. The SFC also advised that it adopted a risk-based approach and did review cases which might pose a regulatory risk.

Way forward

9. Looking ahead, the PRP will follow up a number of 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. The PRP will continue its work on the review of completed cases, maintain dialogue with market players, and engage the industry to listen to their concerns and welcome views from the general public with a view to identifying any areas of improvement to the SFC's procedures and processes.