

Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2006

Executive Summary

Introduction

The sixth Annual Report of the Process Review Panel for the Securities and Futures Commission (“PRP”) covers the work of the PRP from 1 January 2006 to 31 December 2006.

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. Anthony Chow Wing Kin, currently comprises ten members, including eight members from the financial sector, academia, the legal and accountancy professions, and two ex-officio members including the Chairman of the SFC and the representative of the Secretary for Justice.

Work of the PRP in 2006

5. In 2006, the PRP reviewed completed cases and/or procedures of the SFC in the following areas –

- (a) licensing of intermediaries;
- (b) inspection of 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.

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 of and checks and balances on 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 and suggestions from market practitioners and members of the public. In response to a request, the Panel reviewed two cases relating to suspected disclosure of false or misleading price sensitive information of listed companies and provided the SFC with its observations and comments.

Observations and recommendations

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

(1) Observations and recommendations that are accepted

(A) Inspection of intermediaries

Item (1)
<p><u>Case findings/market views</u></p> <p>The SFC selected intermediaries for inspection or prudential visit on the basis of the risk profile of these firms. Under this approach, firms which were inactive and hence were not assessed to be high risk would not be selected for inspection.</p>
<p><u>PRP recommendation/observation</u></p> <p>Since the risk profile of firms might change over time, the PRP invited the SFC to advise on the tools adopted to detect changes in a firm's risk profile. (Para. 3.4 of Chapter 3)</p>

SFC's response

The SFC explained that it could detect changes in a firm's risk profile by conducting analysis and review of the firm's monthly financial returns, which provided information on the financial position and business operation of the company. In addition, the SFC could review the annual audit report, which provided an independent assessment of the ability of the company in complying with the Securities and Futures (Financial Resources) Rules ("FRR") and client assets rules. Other sources of information that could help the SFC detect changes in a firm's risk profile included market news, complaints lodged with the SFC, enforcement action, changes in the licensing database and sharing of information with Hong Kong Exchanges and Clearing Limited and overseas regulators.

Item (2)

Case findings/market views

In an inspection case, the SFC had not issued an interim letter of deficiencies to an intermediary within four months in accordance with the procedural manual.

PRP recommendation/observation

The SFC should follow the procedures set out in the procedural manual and issue an interim letter of deficiencies in a timely manner. (Para. 3.7 of Chapter 3)

SFC's response

The case was an isolated incident having regard to the particular circumstances surrounding the case. In this case, the subject officer who conducted the inspection had resigned but other officers of the team managed to follow up the case, in particular to take control of the situation after the identification of the problem with the overseas parent company of the firm inspected. The final letter of deficiencies was issued to the firm five months after completion of fieldwork. The SFC agreed to follow the established procedures as far as possible in future.

(B) Authorisation of collective investment schemes

Item (3)

Case findings/market views

The processing work of an application for authorisation of a unit trust was put on hold for 13 months on the request of the applicant. The PRP noted that the procedural manual did not specify the time allowed for putting an application on hold.

PRP recommendation/observation

The PRP suggested introducing a time limit on putting an application on hold to avoid undue delay in the processing work. (Para. 3.9 of Chapter 3)

SFC's response

The SFC agreed that in normal cases, the SFC would only accept a holding request of up to three months, and request for putting an application on hold for more than three months would be accepted only in exceptional circumstances. The SFC would update the procedural manual accordingly.

Item (4)Case findings/market views

The SFC introduced five-day week in July 2006. In regard to the possible impact on the performance pledges given in the procedural manual, the SFC advised that the total number of working hours in a week remained the same and hence there should not be any changes in the processing time of application for authorisation of investment products.

PRP recommendation/observation

Instead of using “week” to indicate the processing timeframe, the PRP invited the SFC to consider reviewing the procedural manual and, where appropriate, setting out the processing milestones in terms of business days. (Para. 3.11 of Chapter 3)

SFC’s response

The performance pledges given on the SFC’s website and in its internal guidelines used either business days or working days. Nevertheless, the SFC agreed to review and, where appropriate, revise the procedural manual in the next revision.

(C) Handling of complaints against intermediaries**Item (5)**Case findings/market views

In the reply to a complainant, the SFC did not address the complaint about the long time taken by a securities company to process an authorisation for a representative of the account holder to trade in the account. The SFC explained that it was a quality of service issue. Therefore, the SFC in its reply to the complainant explained that it would only look into possible breaches of the rules and regulations administered by the SFC and would not be able to resolve commercial dispute which was outside the SFC’s jurisdiction.

PRP recommendation/observation

The PRP suggested that, where appropriate, the SFC consider providing additional information on the proper channels for the complainant to lodge a complaint about the quality of service of securities companies, which was outside the SFC’s jurisdiction. (Para. 3.13 of Chapter 3)

SFC’s response

The SFC agreed that where possible, it would explain to the complainant the proper channels to file his complaint on issues outside its jurisdiction.

Item (6)Case findings/market views

The SFC had introduced in March 2005 a new 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 procedural manual would be updated to reflect the arrangement.

PRP recommendation/observation

The PRP considered that the new practice an improvement in the handling of complaints. (Para. 3.14 of Chapter 3)

SFC's response

An updated procedural manual was provided to the PRP in November 2006.

(D) Investigation and disciplinary action

Items (7) and (8)

Case findings/market views

The SFC invited a company, which failed to maintain the level of liquid capital required by the FRR, to a without prejudice meeting for the purpose of resolving the matter by settlement. The PRP noted that there was a change in the SFC's standing policy, as reported in the PRP Annual Report for 2004, that it was not appropriate for the regulator to actively solicit settlement.

PRP recommendation/observation

The PRP invited the SFC to clarify any change in their policy regarding settlement. (Para. 3.17 of Chapter 3)

SFC's response

The SFC advised that since 2005, they started on an experimental basis to approach persons proposed to be disciplined in certain circumstances to see if they were receptive to early settlement before starting formal disciplinary action. The SFC pointed out that the relevant policy had been disclosed in the SFC Annual Report for 2005-06.

PRP recommendation/observation

The PRP considered that the criteria for the SFC to initiate settlement negotiation under the new policy should be set out properly in the procedural manual in order to ensure consistency in application. (Para. 3.19 of Chapter 3)

SFC's response

The SFC agreed and would include the relevant criteria in the procedural manual subject to the ongoing review of the settlement practices.

Item (9)

Case findings/market views

The SFC entered into settlement agreement with a securities company and its two responsible officers for breaching the FRR and failed to report to the SFC within the required time limit. It was difficult to see a consistent pattern on the amount of fines in this case and the fines imposed in the context of the two cases involving breaches of the FRR reviewed by the PRP in 2005. The PRP noted that there could be inherent difficulty in specifying the amount of fines for each type of misconduct having regard to the difference in circumstances in each case.

PRP recommendation/observation

The SFC should make reference to a database of precedent cases in considering the penalty and to maintain proper audit trails of such comparison and deliberation. The database could be refined in the light of experience with a view to developing a benchmark to determine the level of fines for different types of misconduct. In case the proposed penalty would deviate from the benchmark of precedent cases, the reasons for such deviation should also be properly documented. (Para. 3.20 of Chapter 3)

SFC's response

The SFC agreed with the tenor of the PRP's recommendation. In fact, the SFC has all along kept a database of precedent cases. The SFC has also been requiring its staff to make reference to similar precedent cases before making any penalty proposal, and to document the process on file. Instead of using earlier decisions as benchmarks in the sense of binding precedents, the SFC aimed to achieve greater consistency in penalties by adopting the same approach and a consistent set of criteria for their decisions, including comparison with previous similar cases.

Item (10)

Case findings/market views

Following conviction of a company and a responsible officer for breaching the FRR, the SFC considered disciplinary action and initiated settlement negotiation with the persons concerned. The PRP noted that in two cases reviewed in 2005 concerning breaches of FRR, the SFC did not initiate prosecution.

PRP recommendation/observation

The PRP invited the SFC to consider putting in place a due process and introducing working tools such as a checklist of considerations to ensure consistency in the decision as to whether disciplinary action should be initiated in addition to prosecution (Para. 3.22 of Chapter 3)

SFC's response

The SFC agreed to develop a policy that would guide its staff in deciding when to take or recommend criminal proceedings in lieu of or in addition to disciplinary proceedings.

Item (11)

Case findings/market views

The disciplinary process against a securities company and several persons involved in internal control deficiencies took 18 months to complete. One of the reasons for the delay was that the solicitors of the persons proposed to be disciplined had made repeated requests for documents of all kinds and sought extension for submission of representations.

PRP recommendation/observation

The PRP invited the SFC to consider introducing suitable steps in the procedures to guard against delaying tactics used by defendants causing inordinate delay in disciplinary proceedings. (Para. 3.23 of Chapter 3)

SFC's response

The SFC agreed.

Item (12)

Case findings/market views

An account executive of a securities company was found to have used client accounts to place personal orders and discretionary orders without authorisation from the clients. The SFC's investigation revealed that a responsible officer of the company was aware of the misconduct but did not report to the SFC until nearly a year later. The responsible officer was subsequently given a public reprimand.

PRP recommendation/observation

The PRP considered that the penalty should be proportionate to the gravity of the misconduct which, in the case in question, could possibly amount to harbouring of misconduct. The PRP invited the SFC to clarify whether the process in determining the penalty included comparison with precedent cases and if the penalty in the case in question was more lenient compared to similar cases in the past, whether the reasons for such deviation had been documented properly. (Para. 3.28 of Chapter 3)

SFC's response

The SFC explained that in the absence of conclusive evidence, the SFC did not consider the responsible officer had been harbouring the misconduct. In considering the penalty, the SFC had made a comparison with another case involving diligence failings. The SFC explained that in principle, penalty decisions would be made in the light of precedent cases. However, it was not always possible to find precedent cases so alike that a comparison of outcome or penalty would be helpful or meaningful.

(E) Audit trail of decision to take no further action

Item (13)

Case findings/market views

A listed company had overstated its unaudited profits given in its announcement. There were comments that disclosure of incorrect information in this respect could potentially mislead investors. The PRP invited the SFC to provide the relevant case files for review. However, the SFC advised that the matters were discussed and assessed amongst senior members of the Surveillance Department who decided that the matters did not warrant a formal inquiry or investigation. Since no follow up action was required, no case file had been opened. Nonetheless, for the purpose of PRP review, the SFC provided a chronology of events of the case.

<p><u>PRP recommendation/observation</u></p> <p>The PRP recommended that, as far as the decision making process was concerned, a proper audit trail on the considerations leading to the SFC’s decisions should be maintained. (Para. 4.4 of Chapter 4)</p>
<p><u>SFC’s response</u></p> <p>The SFC advised that ensuring decisions to open and close investigation cases were well-made and reasoned would be of paramount interest and concern to the SFC. For this reason, it was an area that the SFC was keen to refresh and improve and would add this process to the procedural manual in due course.</p>

(F) Handling of complaint on alleged improper disclosure of price sensitive information

<p>Item (14)</p>
<p><u>Case findings/market views</u></p> <p>There were several complaints about the remarks made by a person who was the chairman of a listed company regarding his plan to inject assets to that company. The complainants alleged that the person might have improperly disclosed price sensitive information.</p>
<p><u>PRP recommendation/observation</u></p> <p>The PRP noted that the SFC’s consideration of the complaint was primarily based on paper review of media reports and company announcements. The PRP commented that it would be useful if the SFC could also conduct interview with the subject of the complaint to obtain clarifications. (Para. 4.7 in Chapter 4)</p>
<p><u>SFC’s response</u></p> <p>The SFC took note of PRP’s suggestion.</p>

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

(A) Authorisation of Collective Investment Schemes

<p>Item (1)</p>
<p><u>Case findings/market views</u></p> <p>In the case of Investment-Linked Assurance Schemes, an applicant was required to fill in a standard compliance checklist. However, there was no such requirement for application for unit trusts and mutual funds.</p>
<p><u>PRP recommendation/observation</u></p> <p>The PRP considered it a good practice to use a standard compliance checklist so that the relevant considerations could be captured in a standard template. (Para. 3.10 of Chapter 3)</p>

SFC's response

The SFC considered that the current practice of requiring annotations on the application documents worked effectively as a compliance checklist and the existing arrangement had been working smoothly. The use of an additional checklist might not be desirable as it would impose additional cost and burden onto the applicants.

Way forward

9. Looking ahead, the PRP will follow up a number of recommendations made in 2006. These include the SFC's internal procedures on the development of a policy on initiating criminal proceedings in lieu of or in addition to disciplinary proceedings, and prescribing in the procedural manual the circumstances in which the SFC may initiate settlement negotiation. The PRP will continue its work on the review of completed cases, maintaining dialogue with market players, and engaging the industry to listen to their concerns. The PRP welcomes views from the general public with a view to identifying any areas of improvement to the SFC's procedures and processes.