

Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2002

Executive Summary

Introduction

The second Annual Report of the Process Review Panel (PRP) covers the work of the PRP from 1 January 2002 to 31 December 2002.

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.

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 case adhere to and 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 Hoi Chuen Cheng, JP, 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 her representative). The Chairman and members of the PRP were re-appointed, and a new member was appointed by the Chief Executive in late 2002 for the period 1 November 2002 to 31 October 2004.

Work of the PRP in 2002

5. In 2002, the PRP reviewed SFC cases and/or procedures which covered the following areas –

- (a) routine inspection of intermediaries;
- (b) registration of intermediaries;
- (c) authorisation of collective investment schemes;
- (d) granting of exemptions under the Companies Ordinance (CO) and

the Securities (Disclosure of Interests) Ordinance (SDIO);

- (e) approval of prospectuses;
- (f) handling of takeover and merger transactions and complaints by the Corporate Finance Division (CFD);
- (g) handling of complaints from the public about the conduct of SFC registrants;
- (h) public consultations; and
- (i) appointment of auditors under Section 160 of the Securities and Futures Ordinance (SFO).

6. The PRP concluded that there was no serious deficiency in the SFC's operational processes. The PRP also made a number of recommendations for improvement. The SFC has been positive in adopting recommendations from the PRP. Where the SFC could not adopt a recommendation, detailed explanations were given.

7. The PRP attaches great importance to views from all users of the market on issues within its terms of reference. The PRP maintained a dialogue with the industry to listen to their views on SFC procedures and suggestions for improvement.

Observations and recommendations

8. The observations and recommendations from the PRP are summarised below.

(A) Observations and recommendations accepted by the SFC

Inspection of intermediaries

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(1)	Four routine inspections were prolonged mainly because the inspection teams were occupied with unexpected incidents that required immediate attention.	The SFC should shorten the time for conducting inspections, ascertain the adequacy of staffing resources before commencing a routine inspection, and apply flexibility in the assignment of cases.	The SFC would allocate more resources to handle complex compliance matters uncovered during an inspection. It would also upgrade its computer system to enhance monitoring of outstanding inspections.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(2)	In five routine inspections, the inspected intermediaries waited seven to nine months before being formally informed of the inspection findings through a Letter of Deficiencies issued by the SFC.	The SFC should issue an interim reply to an inspected intermediary on the initial findings.	The SFC would issue an Interim Management Letter to an intermediary when an inspection was not completed after five months from the inspection fieldwork.

Registration of intermediaries

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(3)	A case officer of the SFC granted in-principle approval to an application for registration and asked the applicant to accept conditions for registration before seeking clearance from a Director on the case.	To avoid the undesirable situation where the application is rejected after the applicant has accepted the conditions for registration, the SFC should complete the internal clearance procedures before asking an applicant to accept the conditions.	The SFC agreed to the recommendation.

Authorisation of collective investment schemes

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(4)	An application for authorisation of a collective investment scheme was prolonged because the applicant discontinued submitting essential information to the Investment Products Department (IPD) of the SFC while he was being investigated by the Enforcement Division of the SFC.	The IPD should continue processing the application even when the Enforcement Division is conducting an investigation and should withhold the granting of authorisation pending the completion of the investigation and any disciplinary action.	The SFC agreed to the recommendation.
(5)	An applicant's request to withhold his application for authorisation of a collective investment scheme was not documented in the case file.	The SFC should record in the case file properly any request from an applicant to withhold an application.	The SFC agreed to the recommendation.

Approval of prospectuses

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(6)	The SFC followed the standard procedures in vetting and approving prospectuses.	The PRP conveyed the observation to the SFC.	The SFC noted the observation.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(7)	Some of the requirements on the contents of prospectuses as set out under the Companies Ordinance (CO) might not be totally applicable to debt securities, or to financial products issued by government entities.	The SFC should consider if and how rationalisation of the requirements on the contents of prospectuses could be achieved and whether it would be feasible to grant class exemptions in relation to debt securities and products issued by government entities from certain requirements on the contents of a prospectus.	The SFC had issued guidelines on the offering of equity and debt securities and was finalising two new class exemptions for listed and unlisted debt offerings respectively. The SFC was also working on an advanced draft of a Companies (Amendment) Bill which sought to entrench into the law matters dealt with in the guidelines; and would commence a reform of the prospectus regime.

Granting of exemptions under the Companies Ordinance

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(8)	The SFC followed the procedures in granting exemptions from the contents requirements of prospectuses as set out in the CO.	The PRP conveyed the observation to the SFC.	The SFC noted the observation.
(9)	When granting exemption from the contents requirements of prospectuses, the SFC did not state in the letter of exemption issued to the applicants the requirement of including a statement in the prospectus describing the exemption granted.	The SFC should set out in the letter of exemption the requirement of including such a statement in the prospectus.	The SFC agreed to the recommendation.
(10)	Upon receiving an application for exemption from the contents requirements of a prospectus, the SFC received a recommendation from the Stock Exchange of Hong Kong Limited (SEHK) on the application. The applicant then submitted a new application to replace the original one. The SFC processed the new application based on the SEHK's recommendation on the original application.	The SFC should seek confirmation from the SEHK on the continuing validity of the latter's recommendation whenever a revised application is received.	The SFC agreed to the recommendation.

Granting of exemptions under the Securities (Disclosure of Interests) Ordinance

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(11)	The SFC followed the procedures in granting exemptions from the disclosure requirements under the Securities (Disclosure of Interests) Ordinance (SDIO).	The PRP conveyed the observation to the SFC.	The SFC noted the observation.
(12)	The SFC granted exemptions to some companies, which were not listed in Hong Kong but were launching financial products listed or to be listed in Hong Kong, from the disclosure requirements under the SDIO. There was no transparency concern in granting such exemptions because the information which ought to be exempted from disclosure was irrelevant to the potential investors.	The PRP invited the SFC to comment on the observation.	The SFC noted the observation.

Handling of cases on takeover and merger transactions and complaints by the Corporate Finance Division

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(13)	Matters relating to a takeover and merger transaction were investigated by both the CFD and the Enforcement Division. There might not have been any sharing of information among the divisions concerned as the subjects of investigation were interviewed and asked to give statements by both divisions on similar information.	The SFC should consider the feasibility of sharing information amongst divisions.	Certain members of the Enforcement Division were provided access to details of takeover transactions in the CFD's database. Monthly meetings were conducted between the two divisions on investigation matters.

Handling of complaints from the public about the conduct of SFC registrants

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(14)	The industry suggested that the SFC should complete complaint investigations as soon as possible, inform the concerned parties of the result of the investigation, and make a performance pledge for handling complaints.	The PRP invited the SFC to consider the suggestions.	A preliminary response would be issued to a complainant within two weeks of receiving his complaint. In cases involving preliminary investigation of brokerages, the SFC would issue a reply to the brokerage within two weeks after the SFC decided that no further action was to be taken.
(15)	The industry suggested that the SFC should work closely with the Hong Kong Monetary Authority (HKMA) for consistency in their complaint handling procedures on securities trading.	The PRP considered that the SFC should be invited to respond to the suggestion.	The SFC worked closely with the HKMA for consistency in their complaint handling on securities trading. Section 8 of the new Memorandum of Understanding signed between the SFC and the HKMA dealt specifically with complaints.
(16)	The industry suggested that the SFC should set out the complaint channel and inform the industry accordingly.	The PRP considered that the SFC should be invited to respond to the suggestion.	The SFC agreed to the recommendation and briefed an industry forum in December 2002 on how the SFC handled complaints.
(17)	Not all operation divisions/ departments of the SFC would proactively update the complainant on the progress of his complaints.	The SFC should consider making it a standard practice for all divisions/departments to issue progress updates to a complainant if a complaint could not be concluded within a reasonable period of time.	The SFC agreed to the recommendation and had adopted a standardised procedure for issuing progress updates to complainants.
(18)	Not all operation divisions/ departments of the SFC had set a target date for issuing substantive replies to complainants.	The SFC should set, for all operation divisions/ departments, a target date for issuing substantive replies to complainants.	The SFC agreed to the suggestion and had set a target date by which complainants should receive a substantive reply.
(19)	The industry suggested that the management of a company should be informed of any complaint against the company and the identity of its employee(s) under investigation by the SFC.	The PRP noted that the SFC was considering the suggestion, which had been raised by the industry before, and invited the SFC to report on the progress.	The SFC was revising the internal procedures of the Enforcement Division to allow, in exceptional circumstances, disclosure to be made.

Public consultations

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(20)	The industry suggested that the SFC should involve more small and medium-sized broker firms in informal consultations.	The PRP invited the SFC to comment on the suggestion.	Small and local broker firms had usually been fairly well consulted before the SFC issued formal consultation papers. Working groups with representatives from various sectors were formed and monthly meetings with broker associations were held to discuss consultation papers.
(21)	The industry suggested that the SFC should simplify and speed up the consultation exercises relating to the enactment of subsidiary legislation of the SFO.	The PRP considered that the SFC should be invited to respond to the suggestion.	The SFC had made the consultation documents and conclusions readily available through a number of channels and had arranged for comments to be received through various means.
(22)	The division of responsibility within the SFC in initiating a public consultation and in deciding whether and how a public consultation was to be conducted was not specified clearly in the SFC's internal procedures.	The SFC should set out the division of responsibility clearly in its internal procedures on public consultation.	The SFC agreed to the recommendation and had amended its internal procedures on public consultation to set out more clearly the division of responsibility.
(23)	The Advisory Committee (AC) of the SFC, which included representatives from the industry, was set up to give advice to the SFC on policy matters.	The SFC should consider the feasibility and desirability of consulting the AC on public consultations as far as possible.	The SFC might seek the AC's view on concepts before drafting proposals, and submit consultation papers, bring up issues/proposals during the consultation process and submit consultation conclusions to the AC as far as practicable.

Appointment of auditors under Section 160 of the SFO

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(24)	The industry suggested that the SFC should set out objective criteria and internal procedures for the appointment of auditors under Section 160 of the SFO. The SFC should give the licensed corporation concerned an opportunity to make representations before an auditor is appointed.	The PRP considered that the SFC should be invited to address the concern of the industry.	The internal procedures on the appointment of auditors would be set out in the procedural manual of the Intermediaries Supervision Department. Moreover, sufficient safeguards had been provided in the SFO to minimise the possibility of unjustified appointment of auditors and abuse by clients.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(25)	The industry suggested that the SFC should consider the suitability of an auditor nominated based on its experience, capabilities and available resources. Local or smaller audit firms should be considered on a par with the large and international firms, as long as the former were considered independent and capable of handling the job.	The PRP considered that the SFC should be invited to respond to the concern of the industry.	Statistics on past cases showed that the SFC did not have preference or bias towards any particular accounting firm. The SFC would consider, among other factors, the independence and merits of an accounting firm when evaluating whether it was suitable for engagement.
(26)	The industry suggested that the SFC should hold discussions with the licensed corporation concerned to define clearly the scope of an audit.	The PRP invited the SFC to comment on the suggestion.	The SFC would give the licensed corporation concerned a reasonable opportunity to comment on the objectives and scope of an audit.

Communication with the industry

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(27)	The industry suggested that the SFC should improve education for industry participants on the new practices and requirements arising from the implementation of the SFO.	The PRP considered that the SFC should be invited to respond to the suggestion.	Seminars, Q&A sessions and workshops on the new provisions under the SFO were conducted from late November 2002 to March 2003.
(28)	The industry suggested that the SFC should promulgate clearly the qualification requirements for each regulated activity under the new licensing regime to be implemented under the SFO.	The PRP invited the SFC to comment on the suggestion.	The SFC had issued a revised Guidelines on Competence, which set out for licensing purposes the qualifications and experience requirements in respect of responsible officers and representatives, in March 2003.
(29)	The industry suggested that there should be closer communication between the SFC and the industry.	The PRP invited the SFC to comment on the suggestion.	The SFC started organising monthly discussion forums with the industry in November 2002.

(B) Recommendations not accepted by the SFC

Inspection of intermediaries

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(1)	In five routine inspections, the SFC issued a Letter of Deficiencies, which summarised the inspection findings, to the inspected intermediaries seven to nine months after completion of inspection fieldwork.	The SFC should consider setting a performance pledge for conducting routine inspections.	It was not practicable to introduce a performance pledge for conducting routine inspections as the progress of an inspection was affected by a number of factors outside the control of the SFC.
(2)	In some routine inspections, the intermediary did not submit information/documents to the SFC promptly.	The SFC should advise the intermediaries to keep on hand essential information which would be required for an inspection.	The inspection team of the SFC would send a Document Request List to an intermediary prior to an inspection. Any additional documents required during an inspection should have been kept by the intermediary in accordance with the relevant legislation, rules or regulations.

Authorisation of collective investment schemes

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(3)	A Manager of the SFC submitted an application for authorisation of a collective investment scheme to a Senior Director for advance clearance before all the essential documents were provided by the applicant.	The SFC should consider whether it was practicable to submit an application to the approving authority only when all the essential documents are available.	In cases where multi-parties or overseas parties were involved, conditional approval or advance clearance would be necessary so as to facilitate the market practitioners to prepare their documentations or to effect Chinese translation. The granting of conditional approval under such circumstances was welcomed by the market.

Approval of prospectuses

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(4)	In one of the cases on approval of prospectuses, a large amount of correspondence was exchanged between the SFC and the applicant.	To expedite the processing of applications, the SFC should set out guidelines on the drafting of prospectuses for the reference of issuers.	It was inappropriate at this stage to put in place guidelines relating to prospectus drafting. However, the SFC would keep the matter under review.

Handling of complaint cases by the Corporate Finance Division

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(5)	In a complaint case, the CFD issued a final reply to the complainant almost six months after an interim reply was issued. During this period, the complainant was not informed of the progress of the case.	The CFD should give an interim reply to the complainant at regular intervals.	Interim replies would disclose very little because of the constraints of the secrecy provision. Nevertheless, the CFD would issue a more detailed first response letter to all complainants explaining that investigations tended to take a long time, that the secrecy provision precluded the CFD from disclosing details of the investigation and that the CFD would communicate with the complainant again once the investigation was completed.

Way forward

9. Looking ahead, the PRP intends to focus on examining the new procedures formulated for implementing the regulatory regime provided for in the SFO. The PRP will examine the mechanism for internal communication between SFC divisions/departments in operational matters, and the interface between the SFC and the SEHK in the execution of the new Memorandum of Understanding between them for implementing the SFO, and for the performance of the dual filing function, to see if proper procedures are in place.

10. The PRP will also follow up a number of the recommendations made in 2002, continue its review of completed cases and further cultivate its dialogue with the industry.