

# **Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2001**

## **Executive Summary**

### Introduction

The first annual report of the Process Review Panel (PRP) covers the work of the PRP from its establishment on 1 November 2000 to 31 December 2001.

### 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. The PRP is tasked to review and advise the SFC upon the adequacy of the SFC's internal procedures and operational guidelines, which govern the performance of the SFC's regulatory functions. 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. Cheng Hoi Chuen, Vincent, 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).

## Work of the PRP in 2001

5. In the past year, the PRP focused on a review of cases and SFC procedures in the following areas –

- (a) inspection of intermediaries;
- (b) investigation, disciplinary and enforcement action;
- (c) licensing procedures; and
- (d) handling of corporate finance matters including those in relation to listing and takeovers matters.

6. In accordance with its Terms of Reference, the PRP may review files of the SFC relating to any completed cases. The PRP selected a cross section of cases of different nature and length of completion for review in the past year. The PRP members personally reviewed the case files to ascertain whether the standard procedures as set out in the SFC's internal operational manuals had been followed, and assessed the adequacy of the manuals from the perspectives of fairness and reasonableness.

7. From the 43 cases reviewed in the past year, the PRP came to the view that there was no serious deficiency in the SFC's adherence to its operational processes. Yet there were certain areas where the PRP had identified room for improvement. The SFC has been positive in adopting suggestions from the PRP and where the SFC could not adopt a recommendation, detailed explanations were given to the satisfaction of the PRP.

8. The PRP also dedicated considerable time to identify proposals on the streamlining of procedures, in particular licensing procedures, with a view to encouraging compliance, facilitating enforcement, and lowering the industry's operational costs. The PRP also established a dialogue with four stock brokerage industry associations so as to gauge their views on SFC procedures and to hear their suggestions for improvement.

## Recommendations

9. The recommendations from the PRP are summarised below.

(A) Recommendations accepted by the SFC

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(1)	The reason for selecting a particular firm for inspection was not documented and the selection criteria lacked transparency.	The SFC should prepare a standard form to record the considerations and reasons for selecting a particular inspection target.	The SFC would enhance the computerised Inspection Activities Management System to enable reasons for inspection to be documented.
(2)	Some registrants were informed just a few days before inspection. The late response of intermediaries to questions raised by the SFC prolonged certain inspections.	The SFC should give notice of inspection well in advance, record the date of giving notice and set a reasonable time frame when requesting information from intermediaries.	The SFC would give at least a seven-day advance notice for routine inspection and would set a response deadline for the intermediaries.
(3)	A risk of complacency could develop as the inspection teams became familiar with the firms they routinely inspected.	The SFC should formalise a system for periodic rotation of staff.	The SFC would ensure that inspection staff was regularly rotated.
(4)	Sometimes inspection fieldwork was carried out only by one authorised person.	To prevent favouritism, all fieldwork should be performed strictly by not less than two authorised persons.	The SFC would ensure that the internal guidelines of having at least two authorised persons when performing fieldwork are adhered to.
(5)	The SFC had little communication with an inspection target after receiving its response on proposed remedial action.	The SFC should write to the registrant to conclude the inspection, to express appreciation of its co-operation and to remind it of the possibility of disciplinary action if it failed to carry out the proposed remedial work.	After receiving the registrant's response, the SFC would issue a reply to the registrant to conclude the inspection or advise it to take further actions, and to express appreciation of its co-operation.
(6)	There was no clear guideline to assess the independence of an auditor proposed for appointment by a registrant.	The SFC should formulate objective guidelines for assessing the independence of auditor.	The SFC included relevant guidelines in the Operational Manual.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(7)	Employers should be informed when their staff was under investigation by the SFC, so that they could protect the integrity of their business.	The SFC should balance the employer's right to know against the right of the employee who might turn out to be innocent, and provide guidance to its staff.	The SFC agreed to consider this issue and would report progress to the PRP.
(8)	The SFC had neither consulted its Legal Services Division (LSD) on a prima facie case of theft nor referred the case to the Police.	The SFC should always consult LSD on theft cases, refer such cases to the Police, and set out appropriate guidelines.	The SFC would always consult LSD on theft cases and, subject to LSD's advice, refer such cases to the Police. Guidelines would be included in the Operational Manual
(9)	The processing of licensing applications in 2001 was prolonged due to an upsurge in the number of applications in March 2001.	The SFC should consider taking additional measures to minimise impact when it encountered similar cases in future.	The SFC had employed additional resources and reallocated existing ones to minimize the impact and would continue to do so in future.
(10)	The SFC had not responded to a complaint within a reasonable timeframe and not all SFC Departments had set out complaint handling procedures.	The SFC should provide a reply to the complainant as far as possible and review its complaint handling procedures.	The SFC was reviewing its complaint handling procedures.
(11)	The SFC should reduce the licence fees and provide fee concessions to holders of more than one licence.	The SFC should respond to the recommendation.	Under the new licensing regime as provided for in the Securities and Futures Ordinance, only a single licence would be issued to the licensee covering all relevant regulated activities. The SFC has set out its proposal for fee reduction in a consultation paper published on 8 March 2002.
(12)	The SFC should allow online access, completion and submission of application forms for registration.	The PRP supported the recommendation.	Online access, completion and submission of application forms were proposed under the new licensing system.
(13)	The SFC should promptly notify applicants of the appointment and change of personnel responsible for processing their applications.	The suggestion is reasonable.	The SFC had established a licensing hotline to direct callers to the appropriate licensing officers. The SFC would notify all licensed firms of changes in their respective SFC licensing officers via the FinNet.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(14)	The grace period for applicants to obtain the necessary qualification for registration through professional examinations should be extended from three months to six months.	The PRP supported the suggestion.	The grace period has been extended to six months.
(15)	The SFC and SEHK should standardise the intermediaries /exchange participant approval procedures so as to reduce compliance costs.	The SFC should respond to the recommendation.	The SFC would work with SEHK to take forward the proposals. The SFC has formed a working group comprising of industry participants to design simplified application forms.
(16)	The SFC should expedite the processing of initial applications for registration, give a firm reply to applicants within one month and give an explanation in case of rejection.	The SFC should respond to the recommendation.	The SFC might not be able to complete the processing of an application within one month because the time required to complete the vetting process was outside the control of the SFC. Under the new licensing regime, the SFC could issue provisional licence to natural person applicants within a matter of days. It has been the SFC's practice to give reasons when rejecting an application.
(17)	The SFC should set out the time required for processing various applications.	The PRP shared the view.	The SFC was reviewing its existing performance pledges. Detailed performance pledges would be published upon implementation of the new licensing regime.
(18)	The SFC should simplify the procedures and shorten the processing time for change of accreditation.	The SFC should respond to the suggestions.	The SFC was reviewing its approval process for change of accreditation with a view to reducing the time for processing application from dealer's representatives to around five working days.
(19)	The SFC should allow registrants to retain their registrations for one year after leaving their job.	On balance, the PRP recommended that the period should be extended to six months to provide greater flexibility.	The SFC had proposed that the grace period by which a person may retain his licence pending finding of new employment be extended from 60 days at present to 6 months.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(20)	The SFC should simplify the application procedures for change of accreditation in respect of dealing directors/ investment advisers so as to tally with those for representatives.	The SFC should respond to the suggestions.	Under the Securities and Futures Ordinance, all natural persons are subject to the same set of standard procedures.

(B) Recommendations not accepted by the SFC

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(1)	The inspection targets were assigned to the inspection teams according to alphabetical order of the company names.	Intermediaries should be categorised according to their scale of business and mode of operation. An inspection team would be assigned specifically to each category of intermediaries.	Implementation of the proposal might delay staff development by limiting their exposure to different variety of firms and practices. Moreover, with regular rotation, staff would not see enough of a broker's operation within a short period to realise the benefit.
(2)	The sampling size and criteria of a client circularisation exercise might not be appropriate.	The SFC should consider reviewing the methodology for conducting client circularisation.	It would be difficult to draw up definite guidelines on the methodology of circularisation exercise since the sampling size and criteria would depend on the risk and internal control assessment in each case. For better transparency, the rationale for selection of sample would be recorded.
(3)	Under the SFC's investigation processes, only those interviewees who were the subject of prosecution or disciplinary action were entitled to a copy of the translation of their statements but the SFC would not take the initiative to inform them of their entitlement.	The SFC should inform an interviewee that he could obtain the translation of his statement if he is entitled to it, and should consider allowing all interviewees to access the translation of their statements.	To date there was nothing to suggest there was any problem with this policy. The resource implications may not be justifiable.

	<i>Case findings/market views</i>	<i>PRP recommendations /observations</i>	<i>Response from SFC</i>
(4)	For sanctions of public reprimand, the SFC would not mention anything concerning right of appeal in the Letter of Mindedness (LOM) and Notice of Decision (NOD).	The SFC should state clearly in both the LOM and the NOD that a sanction was not subject to appeal if that was the case.	The suggestion should only be adopted in a NOD as parties concerned might interpret it as coercion, if the SFC was to notify in a LOM that the proposed reprimand was not subject to appeal. Nevertheless, under the Securities and Futures Ordinance, all disciplinary decisions are subject to appeal.
(5)	The industry was very concerned with the time required for processing applications for registration and change of accreditation.	The SFC should look into the issue.	Some of the cases were prolonged because the time required to complete the security vetting process was outside the control of the SFC.
(6)	The SFC should allow registrants who are waiting for approval for change of accreditation to continue to conduct regulated activities for a certain period of time.	The SFC should respond to the suggestions.	To protect investors, full and rigorous vetting must be conducted before allowing a registrant, who might have committed misconduct under his previous employment, to continue to participate in regulated activities.

### Way forward

10. Looking ahead, the PRP intends to focus on examining the new procedures that have to be formulated for implementing the regulatory regime provided for in the newly enacted Securities and Futures Ordinance. The PRP will also follow up a number of the recommendations made in 2001, review revised or new procedures and further cultivate its dialogue with market participants affected by the SFC regulatory processes and procedures.