
CHAPTER 3

THE THREE-TIERED REGULATORY FRAMEWORK FOR THE SECURITIES AND FUTURES INDUSTRY

INTRODUCTION

3.1 This chapter outlines the three-tiered regulatory framework for the securities and futures industry and describes the roles of the Government, the Hong Kong Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx).

THE THREE-TIERED REGULATORY FRAMEWORK

Origin of the Three-tiered Structure

3.2 The existing regulatory framework for the securities and futures industry is a “three-tiered structure”. Its genesis can be traced back to the recommendations of the “Report of the Securities Review Committee” (the “SRC Report”) published in 1988¹⁴. The three-tiered structure is reflected in the Securities and Futures Commission Ordinance (Cap. 24), the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555), and the recently enacted and substantially recast Securities and Futures Ordinance (Cap. 571) and other related legislation.

3.3 We would note that while this structure is commonly referred to as the “three-tiered regulatory structure”, we do not think that it is an accurate description of the roles and functions of the three constituent bodies. For one thing, the role of the Government cannot, with any regard for the accurate use of language, be described as a regulator in the commonly accepted sense. The SFC is clearly a regulator, but its position is not without its unusual features, some of which we will look at later. Similarly,

¹⁴ Following the stock market crash in October 1987, the then Governor appointed the Securities Review Committee (SRC) headed by Mr Ian Hay Davison to review, among other things, the constitution, powers, management and operation of the government offices responsible for regulating respectively the securities and futures markets at the time; and to recommend changes that were desirable to ensure the integrity of the markets and to protect investors. The SRC published its Report in May 1988 and recommended, among other things, the establishment of a new market regulatory outside the civil service to replace the then Securities Commission, the Commodities Trading Commission and the Office for Securities and Commodities Trading.

the HKEx, although commonly described as the “front-line regulator”, is only a regulator in a limited sense since it possesses no statutory powers of investigation and its powers, such as they are, are conferred by the Listing Agreement entered into by issuers seeking a listing. In other words, the source of the HKEx’s regulatory powers is in contract. There are those who would consider it a straining of language to describe a party with the right to enforce a contract as a regulator even though that contract relates to listing and an issuer’s obligations and duties under it. We note that, on occasions, in material emanating from the HKEx, instead of describing itself as the “front-line regulator”, the HKEx often describes part of its functions as “administering the Listing Rules”.

3.4 The essence of this structure is that the operation of the market should rest with a market operator (i.e. the HKEx) close to the market under the watchful eyes of an independent regulator (i.e. the SFC) staffed with personnel equipped with the requisite expertise and market experience. The Government maintains a broad policy interest and concern in the development of Hong Kong’s financial markets as part of Hong Kong’s economy.

The First Tier – The Government

3.5 At the first tier, the Government has overall responsibility under Article 109 of the Basic Law to provide an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre. Consistent with the spirit of the SRC report and international practices, the Government distances itself from the day-to-day regulatory function. It performs its function by appointing the SFC and making sure that the SFC is, and is seen to be, a credible and independent regulatory body vested with the necessary power and equipped with professional expertise to discharge its duties. The Government’s non-interference in the market place, unless exceptional circumstances obtain, is, in common with the views contained in the submissions to us, a practice we believe ought to be maintained.

3.6 The role of the Government is underscored in the recent debate on the Securities and Futures Ordinance 2002. As the Administration explained to the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000:-

“The Government recognizes that while delegating its regulatory responsibilities to the SFC, it cannot delegate to the SFC all its accountability to the public for a properly regulated securities and futures market. The public expects that the Government has a duty to ensure that the SFC does its job properly, and that the Government will be held ultimately accountable if the SFC falls down on its job. The public also expects that the Government should play an effective role in co-ordinating among the various financial sector regulators as financial institutions become increasingly involved in multi-sector services, and responding to the rapid changes in the financial system. This goes beyond the regulatory remit of the SFC, as its functions and powers cover basically the securities and futures market, and hence may not allow it to address matters which straddle different financial sectors and affect the economy as a whole.”¹⁵

3.7 One of the focal points in the debate in the Legislative Council was whether the Government should have a reserve power¹⁶ which, among other things, would enable the Chief Executive (CE) to give the SFC written directions. The power envisaged would only be exercised after consultation with the Chairman of the SFC, upon being satisfied that it is in the public interest to do so, and in furtherance of any of the SFC’s regulatory objectives or the performance of any of its functions. The provision is viewed as a “tool of last resort” for the Government. As the then Secretary for Financial Services, Mr Stephen Ip, explained:-

“The reserve power can be exercised by the Government only in extraordinary emergencies to safeguard public interest. Probable cases include failure of checks and balances, improper performance of duties by the SFC or fluctuations in the financial market that warrant prompt action by the Government to stabilize the financial

¹⁵ Paper No. 2B/01 presented to the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000 on 4 May 2001.

¹⁶ The reserve power covers, among other things, the power set out in section 11 of the Securities and Futures Ordinance (Cap. 571).

market with the co-operation of the SFC and other regulators.”¹⁷

3.8 The Government likens the reserve power to “a nuclear deterrent against any malfunctioning on the part of the SFC” and is the only statutory tool available to the Government for the effective application of remedial measures in a critical situation. Quoting William O Douglas, a former Chairman of the US Securities and Exchange Commission, and later an Associate Justice of the United States Supreme Courts, “[government] would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.”¹⁸

3.9 Regarding the public perception of the Government’s role, the then Secretary for Financial Services added that:-

“During the consultation period of two years or so, the market participants and the public did not raise any opposition to [the proposed reserve power], which reflects that the public expects the Government to ensure the stability of the financial market.”

3.10 Dissenting views in the Legislative Council (LegCo) were cogently and vociferously expressed that “an independent regulating authority, free from political interference, is fundamental to a modern regulatory system which commands respect and confidence. The regulatory authority must not only be independent, but clearly seen to be independent.”¹⁹ We see the force of those general sentiments.

¹⁷ Speech by Mr Stephen IP, then Secretary for Financial Services, at the meeting of the Legislative Council on 13 March 2002 to move the resumption of second reading of the Securities and Futures Ordinance and a Consequential amendment to Clause 11 of the Bill.

¹⁸ William O Douglas, “Democracy and Finance”, 1940.

¹⁹ Speech by Dr. the Hon Margaret NG at the meeting of the Legislative Council on 13 March 2002 on the Consequential Amendment to Clause 11 of the Securities and Futures Bill 2000.

3.11 In deliberating on the appropriate distribution of powers between the Government and the regulatory bodies, the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill studied the accountability arrangements for regulators in the UK and the US²⁰. In the UK, the Financial Services and Markets Act 2000 (FSM Act), which went into force in December 2001, established the Financial Services Authority (FSA) as an independent regulator for the financial market. While members of the FSA Board are appointed by, and may be removed by, the Chancellor of the Exchequer, there is no provision in the FSM Act which empowers the Treasury or the executive branch of the government to give directions to the FSA. Instead, the Act stipulates other checks and balances such as empowering the Treasury to commission inquiries into the FSA's regulatory activities of public concern, requiring FSA to give evidence to Parliament periodically, and appointing an independent review on resources management of the FSA.

3.12 Similarly in the US, the securities and futures markets are regulated by the independent Securities and Exchange Commission and the Commodities Futures Trading Commission respectively. Their Commissioners are appointed by the President with the consent of the Senate. They are required to make reports to Congress and to attend hearings regularly. However, Congress has no power to interfere with the work of these bodies. Neither the executive branch nor the legislature has any power of direction over the Commissioners. The report of the delegation of LegCo members noted that legislation in the UK and the US do not confer upon the executive branch of the government any overriding power to direct the activities of the regulators. The checks and balances are ensured, not through reserve power of the government but through the power to appoint and require the bodies to make reports and give evidence to the legislature.

3.13 Recognizing the differences in the constitutional frameworks governing the operation of market regulators in other places, a LegCo majority, on balance, accepted the Administration's proposal to retain

²⁰ In April 2001, the LegCo Panel on Financial Affairs and the Bills Committee on Securities and Futures Bill and the Banking (Amendment) Bill 2000 visited London, Washington DC and New York to study the financial systems of the United Kingdom and the United States of America. Details of the findings are set out in the "Report on the Financial Systems in the United Kingdom and the United States of America" published in June 2001. The Bills Committee's conclusions, having regard to the findings of the study, are included in the Report of the Bills Committee on Securities and Futures and Banking (Amendment) Bill 2000 (LC Paper No. CB(1)1217/01-02) on 5 March 2002.

reserve powers over the SFC in order to perform its roles as the “watchdog to the watchdog”.

3.14 To summarize, the Government should be kept free from the day-to-day regulatory functions. It should focus on the following:–

- (a) It should keep the regulatory framework under constant review and to maintain fair, transparent and orderly markets. Its role is also to promote public confidence in the markets and to secure appropriate degrees of investor protection and to minimize market misconduct. Further, it should facilitate market innovations and competitions and act to enhance Hong Kong’s position as a premier international financial centre²¹;
- (b) It should ensure that there are sufficient checks and balances within the system;
- (c) It should act as co-ordinator of the various regulators of the different financial sectors;
- (d) It has reserved for itself powers in exceptional cases or in emergencies, which should be used only where there are cases of failure of the checks and balances, improper performance by the SFC or fluctuations in the financial markets which warrant prompt action by the Government to stabilize the financial markets and Hong Kong’s economy with the co-operation of the SFC and other regulators; and
- (e) In other words, the Government should be a facilitator and co-ordinator, amongst other things, rather than a regulator. It should provide the sound environment under which Hong Kong’s financial markets can develop and prosper. It should not intervene, save in exceptional circumstances. This, by and large, is also the Government’s view of its role and a view shared by most.

²¹ Speech by Mr Stephen Ip, then Secretary for Financial Services, at the meeting of the Legislative Council on 13 March 2002.

The Second Tier – The SFC

3.15 At the second tier is the SFC, which serves as the watchdog of market operators. Operators include the exchanges and clearing houses (now merged), as well as market intermediaries. Established by the Government in 1989, the SFC was designed in line with the following recommendations of the SRC Report:-

- (a) The SFC should be a statutory body completely outside the civil service and to have adequate staffing and funding. It should be accountable to the Administration. While it is not part of the civil service, it should be part of the wider Government machinery;
- (b) While the Government should continue to provide an overview, all the statutory regulatory powers should be vested in the SFC in order to ensure its independence;
- (c) To avoid undermining the SFC's independence, the Government should not be represented on its board or advisory committees; and
- (d) The role of Government should be to ensure that the SFC does its job properly. Only if the SFC fails should the Government be free to reach an independent view as to what is the right course of action.

3.16 In line with the SRC recommendations, the Government introduced the following safeguards:-

- (a) The Chief Executive of the HKSAR (CE) appoints the Chairman and other directors of the SFC board and has the power to dismiss them;
- (b) The CE is able to give the SFC directions in exceptional circumstances;
- (c) The SFC has to present an annual report and its statement of accounts to the CE who would lay them before the Legislative Council;

-
- (d) The SFC Advisory Committee should be appointed by the SFC with the approval of the CE; and
 - (e) The SFC should develop and submit its annual budget to the Legislative Council.

3.17 In addition, the Government introduced the following checks and balances:-

- (a) Fees and charges levied by the SFC are required to be set out in subsidiary legislation and subject to negative vetting by the Legislative Council;
- (b) The more important decisions of the SFC have to be made by the full board of the SFC, and are not delegable unless with the approval of the Legislative Council;
- (c) An independent Securities and Futures Appeals Panel (SFAP) is established to hear appeals from parties aggrieved by certain decisions made by the SFC. Under the newly enacted legislation, the SFAP is upgraded to a Securities and Futures Appeal Tribunal, which will be chaired by a judge and operated on a full-time basis with an expanded remit;
- (d) Judicial review by the Court of First Instance of the SFC decisions is available;
- (e) Complaints against the actions of the SFC or any of its staff may be lodged with the Office of the Ombudsman; and
- (f) A Process Review Panel (PRP) was appointed in November 2000 to review internal procedures of the SFC to ensure that they are fair and reasonable. The PRP has to submit its report to the Financial Secretary with a view to its publication subject to the SFC's statutory secrecy obligations.

3.18 In practice, the SFC is the principal regulator of the securities and futures market. It acts independently in performing its regulatory functions, and is not required to be answerable to the Government on its day-to-day exercise of regulatory powers. The slightly unsatisfactory feature is

the relative inability of the SFC to regulate listed issuers with which it has no contractual relationship. The situation has been improved somewhat with the implementation earlier this year of the dual filing system so that at least the SFC has some basis for monitoring listed issuers. Otherwise, it is only when, sometimes fortuitously, the Takeovers Code provisions are triggered that the SFC has the jurisdiction to intervene in corporate irregularities of listed issuers.

3.19 Implicit in the system is the belief and the foundation that the SFC has, or should have, professional expertise, knowledge of local market conditions and international good practices, a sound mechanism to gauge the views of stakeholders, as well as the credibility and vigilance to perform its functions effectively. Should the SFC not possess or be denied any of these attributes, the checks and balances will be undermined. By and large, our inquiries confirm the efficiency of the SFC and the existence of those important attributes in its role as regulator.

The Third Tier – The HKEx

3.20 At the third tier, and closest to the ground, the market operators play a self-regulatory role and perform certain public functions, such as risk management and market surveillance. As we mentioned earlier, the HKEx is not vested with any statutory investigatory powers and has to rely on the terms of the listing agreements entered into by issuers. At present, there is only one exchange in Hong Kong (the HKEx). To increase competitiveness and to meet the challenges of an increasingly globalized market, the Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited demutualised and together with Hong Kong Securities Clearing Company Limited merged under a single holding company, the HKEx. The merger was completed on the 6 March 2000 and the HKEx listed its shares on the Stock Exchange on the 27 June 2000.

3.21 As a self-regulator, the HKEx is responsible for ensuring an orderly and fair market in securities and futures contracts traded on or through the HKEx. It must also ensure that risks are managed prudently.

3.22 The HKEx is subject to checks and balances including the following :-

-
- (a) Under the Merger Ordinance (Cap. 555), the HKEx must act in the interest of the public, having particular regard to the interests of the investing public;
 - (b) The Government has the power to appoint a specified number of members to the Board of the HKEx;
 - (c) The SFC is the statutory regulator of the HKEx including its wholly owned subsidiaries of the Stock Exchange of Hong Kong, the Hong Kong Futures Exchange, and the Hong Kong Securities Clearing Corporation Limited. The SFC is responsible, in general, for supervising and monitoring the activities of the HKEx. The SFC, as the regulator, may serve “restriction notices” and “suspension orders” on the HKEx;
 - (d) The SFC may direct the HKEx to cease to provide or operate specified facilities or services in emergencies; and
 - (e) The SFC is empowered to approve any new or amended listing rules before they can be implemented.

3.23 The SFC and the HKEx have signed four major Memoranda of Understanding (MOU)²² in the past two years, in not dissimilar items, to facilitate a co-operative working relationship between the parties. Under the MOU, in seeking the SFC’s approval for any amendments to the Rules of the HKEx, it must engage the involvement of the relevant SFC staff at a stage of the amendment process which will reasonably enable the SFC to

²² The MOUs are –

- (a) Amended and Restated MOU Governing Listing Matters (6 March 2000), Amended and Restated Addendum to MOU Governing Listing Matters (6 March 2000); and First Supplement to the MOU Governing Listing Matters (21 August 2000);
- (b) MOU for the Listing of Hong Kong Exchanges and Clearing Limited on The Stock Exchange of Hong Kong Limited (19 June 2000);
- (c) MOU on Matters Relating to SFC’s Oversight, Supervision of Exchange Participants and Market Surveillance (20 February 2001); and
- (d) MOU for the Listing of Hong Kong Exchanges and Clearing Limited on The Stock Exchange of Hong Kong Limited (22 August 2001).

have sufficient knowledge of the nature of the proposed amendments and to raise issues of concern²³.

REVIEW AND REFINEMENT

3.24 Since the introduction of the three-tiered regulatory framework in 1989, there has not been any major review of the structure, though refinements have been made especially in the enactment of the Securities and Futures Ordinance 2002.

3.25 Until the sell-off of penny and small-cap stocks on the 26 July 2002 following on from the publication of the HKEx Consultation Paper the day before, there has not been too much unhappiness over the structure, which is based on a solid foundation and has worked reasonably well.

3.26 Clearly, even prior to the 26 July 2002, there are those within the financial services industry who would voice the occasional complaint over, for instance, the lack of engagement by the HKEx of brokers, some of whom claim to be ignored, and the perceived excessive powers of the SFC. This should occasion little surprise. There would be something very wrong with the regulators if all those regulated have nothing but praise for them.

3.27 Our considered view is that the three-tiered regulatory structure itself is sound. We refer later to certain areas in which we have received representations and over which we suggest for consideration some refinements and improvements.

²³ **Annex V** to the MOU on Matters Relating to SFC's Oversight, Supervision of Exchange Participants and Market Surveillance (20 February 2001).