

**Process Review Panel
for the
Securities and Futures Commission**

**Annual Report
to the Financial Secretary**

For 2002

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Chapter 1. General Information

Background and purpose of the Process Review Panel

1.1 The Process Review Panel (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.

1.2 Since its inception, the SFC has been subject to various checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal, judicial review and scrutiny by the Ombudsman and the Independent Commission Against Corruption (ICAC).

1.3 In the course of reforming the regulatory regime for the securities and futures market, the regulatees pointed out to the Administration that these checks and balances could only apply in specific cases. The Administration, in consultation with the SFC, concluded that it would be preferable to improve the transparency of the SFC's internal processes across the board, so that the public would be better able to see for itself that the SFC did indeed act fairly and consistently in the exercise of its powers.

1.4 The SFC's ability to demonstrate that it already operates in this fashion is however constrained by statutory secrecy obligations which limit the extent to which the SFC can divulge information to the public regarding what it has or has not done when performing its regulatory functions.

1.5 In order to enhance the transparency and public accountability of the SFC, without comprising its confidentiality, the Administration saw merit in establishing an independent body to review the fairness and reasonableness of the SFC's operational procedures on an on-going basis and monitor whether its procedures are consistently followed and to make recommendations to the SFC in relation to these objectives.

1.6 The establishment of the PRP demonstrates the Administration's resolve to enhance the transparency of the SFC's operations, and the SFC's determination to retain public confidence and trust. The PRP supports the objective to ensure that the SFC exercises its regulatory powers in a fair and consistent manner.

Terms of reference

1.7 The PRP is tasked to review and advise the SFC upon the adequacy of the SFC's internal procedures and operational guidelines governing the action taken and operational decisions made by the SFC and its staff in the performance of its regulatory functions, including, for instance, the receipt and handling of complaints, licensing and inspection of intermediaries, and disciplinary action.

1.8 To carry out its work, the PRP receives and considers periodic reports from the SFC in respect of the manner in which complaints against the SFC or its staff have been considered and dealt with. In addition, the PRP may call for, and review, the SFC's files to verify that the action taken and decisions made in relation to any specific case or complaint are consistent with the relevant internal procedures and operational guidelines.

1.9 The PRP is required to submit its reports to the Financial Secretary annually or otherwise on a need basis. The Financial Secretary may cause these reports to be published as far as permitted under the law. The PRP's first Annual Report was published in May 2002.

1.10 The terms of reference of the PRP, as approved by the Chief Executive, is at **Annex A**.

Constitution of the PRP and Working Groups

1.11 The PRP 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).

1.12 For better execution, the PRP has set up two working groups. The Working Group on Licensing, Intermediaries Supervision and Investment Products focuses on cases involving application for registration, approval of investment products and inspection of intermediaries. The Working Group on Corporate Finance and Enforcement focuses on cases concerning investigation and disciplinary actions, takeover and merger transactions and prospectus-related matters.

1.13 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 from 1 November 2002 to 31 October 2004.

1.14 The membership of the PRP and the two Working Groups is at **Annex B**.

Chapter 2. Work of the PRP in 2002

Highlights of the work

2.1 This report covers the work of the PRP from 1 January 2002 to 31 December 2002.

2.2 In 2002, the PRP conducted the review of SFC procedures, through the study of completed cases, in 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 and the Securities (Disclosure of Interests) Ordinance;
- (e) approval of prospectuses; and
- (f) handling of takeover and merger transactions and complaints by the Corporate Finance Division.

2.3 The PRP also examined the SFC's procedures in respect of handling of complaints from the public about the conduct of SFC registrants, as well as public consultations, to see if there was any room for streamlining and improvement.

Selection of cases for review

2.4 In accordance with the terms of reference, the PRP may select any completed SFC cases for review. The SFC provided the PRP with monthly reports on all cases completed within that month. The Working Groups then selected individual cases from these monthly reports for review with a view to covering cases of different nature (i.e. corporate finance, intermediaries supervision, licensing, investment products) and length of processing time. Apart from checking the file records against the standard procedures laid down

in the manuals, the Working Group also assessed the adequacy of the manuals from the perspectives of fairness and reasonableness.

2.5 The SFC also provided the PRP with monthly reports on on-going investigation and inquiry cases that had been outstanding for more than one year so that the PRP could monitor the progress of these cases.

Meetings of the PRP and Working Groups

2.6 The PRP met on four occasions in 2002. At the meetings, the PRP discussed specific topics of the SFC’s internal procedures and commented on, and endorsed, Working Group papers containing observations and recommendations from the review of cases.

2.7 Each of the two working groups met twice during the period covered by this report and reviewed a total of 48 cases, which encompassed various areas of the SFC’s work.

Table 1 – Breakdown of cases reviewed by the PRP

	No. of Cases
Licensing	5
Intermediaries supervision	5
Investment products	10
Corporate Finance	28
Total	48

2.8 After the review of each case, the Secretariat prepared a case report

which summarised the findings and observations together with, where applicable, the recommendations for improvements. These reports were discussed at the meetings of the Working Groups where members might give additional comments. The consolidated views of the Working Groups were put to the PRP for comment and endorsement. The observations and recommendations were then conveyed to the SFC for consideration and necessary action. The SFC has been positive in adopting suggestions from the PRP. In cases where the suggestions could not be adopted, the SFC gave detailed reasons.

Engagement with the industry

2.9 The PRP attached great importance to views from all users of the market on issues within its terms of reference. The PRP maintained a dialogue with industry associations and representatives.

2.10 The PRP met various securities industry associations, namely, the Hong Kong Stockbrokers Association, the Institute of Securities Dealers, the Hong Kong Association of Online Brokers and the Hong Kong Securities Professionals Association to listen to their comments on the relevant procedures and processes of the SFC and suggestions for improvement. The PRP exchanged views with these associations on the internal operational procedures of the SFC, in particular the procedures on handling of complaints, public consultations, and the appointment of auditors under Section 160 of the Securities and Futures Ordinance (SFO)¹.

Presentation by the SFC

2.11 The SFC started developing a new processing system in 2002 to administer the new licensing regime to be implemented under the SFO by 1 April 2003. The PRP members attended a presentation by the Licensing Department of the SFC on the proposed new processing system in July 2002. Members noted that the new processing system has the major advantages of providing a complete audit trail on the handling of applications and full and daily backup of all data in the system for the SFC. Members also noted that the SFC would carry out a data conversion exercise to migrate data from the existing system to the new processing system. Members suggested that the SFC

¹ Enacted in March 2002, the SFO is targeted for commencement on 1 April 2003.

should handle the data conversion exercise carefully so as to maintain accuracy of the data and make the exercise as simple as possible if licensed persons are involved.

2.12 The SFC assured the PRP members that adequate resources would be devoted to data conversion planning, testing and implementation with a view to ensuring that all existing useful information on licensed persons would be converted into the new system. According to the SFC, the data conversion would be highly automated, as most of the data in the existing system would be mapped to the new system. Certain data rationalisation work would be unavoidable so as to take care of incomplete or obsolete data that accumulated in the past. Data that would not be converted into the new system, such as those relating to revoked licences, would be frozen as a historical database which could be accessible by the SFC staff through an online enquiry function. New information that would be required from the industry when the SFO commenced, such as information on associated entities, would be captured into the new system as and when the information was received by the SFC.

Chapter 3. Recommendations on the work of the SFC

3.1 From the 48 cases reviewed in the period covered by this report and the review of the SFC's operational procedures, the PRP concluded that there was no serious deficiency in the SFC's operational processes. Yet there were certain areas where the PRP has made recommendations for improvement. The SFC has been positive in adopting the recommendations of the PRP. Where the SFC could not adopt a recommendation, detailed explanations were given. The observations and recommendations are summarised below while the SFC's response to the recommendations are detailed in **Annexes C and D**.

(A) Inspection of intermediaries

Processing time

3.2 The PRP noted that four routine inspections, which were conducted by the SFC from late 2001 to mid-2002, were prolonged² mainly because the inspection teams concerned were occupied with unexpected incidents in the market that required immediate attention, which involved intermediaries within their portfolio. According to the SFC, it was more desirable for an inspection team to handle extra assignments relating to intermediaries within its own portfolio because the inspection team had already built up expertise about the intermediaries through on-going monitoring.

3.3 Nevertheless, the PRP considered that the efficiency of an inspection team might be affected if it was overloaded with extra assignments. The PRP recommended that the SFC shorten the time for conducting inspections and ascertaining the adequacy of staffing resources before commencing a routine inspection. The PRP also recommended that the SFC apply flexibility in the assignment of cases so that, in the case of urgent and unexpected events, resources from other teams could be mobilised to assist the inspection team

² From October 2001 to July 2002, the SFC completed 154 routine inspections on intermediaries. The average processing time of these inspections was about four months. Amongst these 154 cases, the PRP reviewed five cases, which have a longer processing time ranging from eight and a half months to nine months.

concerned. The SFC agreed to these recommendations. The SFC would allocate more resources to handle more complex compliance matters uncovered during an inspection. It would also upgrade the computer system, i.e. the Inspection Activities Management System, to enhancing monitoring of outstanding inspections.

Interim replies to intermediaries

3.4 After completion of an inspection, the SFC would issue a Letter of Deficiencies to the inspected intermediary summarising the findings of the inspection and the improvement work recommended by the SFC. In the five routine inspections selected by the PRP for review, the SFC issued a Letter of Deficiencies to the inspected intermediaries several months (i.e. ranging from seven to nine months) after completion of inspection fieldwork. The PRP considered it undesirable for an intermediary to wait for a long period of time before being formally informed by the SFC of the inspection findings. The PRP recommended that the SFC issue interim replies to an inspected intermediary on the initial findings of the inspection. The PRP also recommended that the SFC consider the feasibility of setting out a performance pledge for conducting routine inspections. The SFC agreed to the proposal of issuing interim replies to complainants. However, the SFC considered that it would be impracticable 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.

Provision of documents by intermediaries

3.5 The PRP noted that in some of the routine inspections, the intermediaries did not submit information/documents to the SFC promptly. In order to expedite the inspection process, the PRP recommended that the SFC consider the need for advising the intermediaries to keep on hand essential information which would be required for inspection. The SFC replied that the inspection teams would send a Document Request List to an intermediary prior to an inspection. Additional documents required during the inspection should have been kept by the intermediary in accordance with the relevant legislation, rules or regulations.

(B) Registration of intermediaries

3.6 The PRP noted that a Senior Manager of the SFC had granted in-principle approval to an application for registration and an associated waiver and had asked the applicant to accept the conditions for registration, before seeking clearance from a Director on the waiver. Both the application for registration and the waiver were subsequently approved. In order to avoid the undesirable situation where the application is rejected after the applicant has already accepted the conditions for registration, the PRP recommended that the SFC complete the internal clearance procedures before asking an applicant to accept conditions for registration. The SFC agreed to the recommendation.

(C) Authorization of collective investment schemes

Processing of applications

3.7 The PRP noted that a Manager of the SFC submitted an application for authorisation of a collective investment scheme to the Senior Director for approval pending provision by the applicant of an Explanatory Memorandum (EM) in Chinese and an executed Trust Deed. Upon receiving the EM in Chinese, the Manager submitted the application to the Senior Director for advance clearance again before receiving the executed Trust Deed. The PRP considered that it might be more desirable for the approving authority to consider an application when all the essential documents were available. The PRP recommended that the SFC consider whether it would be practicable for a subject officer to submit an application to the approving authority only when all the essential documents were available. The SFC welcomed the proposal in principle and considered that in cases where multi-parties or overseas parties were involved, conditional approval or advance clearance would be necessary. The practice of granting conditional approval under such circumstances was welcomed by the market.

3.8 One of the applications for authorisation of collective investment scheme was prolonged (i.e. one year seven months)³ because the applicant

³ The IPD completed 13 cases on authorisation of collective investment schemes in October 2001, including the one described in paragraph 3.8. Amongst the other 12 cases completed in that month, 11 cases were completed within two months and one case was completed in five months.

discontinued submitting essential information to the Investment Products Department (IPD) of the SFC on his application while he was involved in an investigation by the Enforcement Division of the SFC. According to the IPD, the application would have been unlikely to be rejected by the IPD after completion of investigation by the Enforcement Division if the investigation did not result in severe disciplinary actions that affected the applicant's capacity to act as manager to authorised collective investment schemes. In order to expedite the processing of an application by the IPD when the applicant is involved in investigation by the Enforcement Division, the PRP recommended that the SFC consider the feasibility of continuing processing and vetting an application by the IPD when the Enforcement Division was conducting an investigation. The IPD should withhold the granting of authorisation pending the completion of the investigation and of any disciplinary action by the Enforcement Division. The PRP considered that, in this way, the applicant could benefit from savings in time cost, while the SFC's effort in processing the application would be unlikely to be wasted. The PRP also recommended that the SFC set out internal guidelines for the IPD to handle similar cases, which should cover communication with the Enforcement Division on the nature and seriousness of the matter being investigated. The SFC agreed to the recommendations.

3.9 The PRP also noted that an applicant requested the SFC to withhold the processing of one of his applications and accord priority to processing other applications submitted by the same applicant. However, such request was not documented on the case file. The PRP recommended that the request from applicants to withhold an application should be properly documented on the case file. The SFC agreed to the recommendation.

(D) Approval of prospectuses

Compliance with procedures

3.10 The PRP examined procedures for vetting and approving prospectuses by the Corporate Finance Division (CFD) of the SFC and noted from the cases reviewed that the SFC had followed these procedures.

Contents of prospectuses

3.11 The PRP noted that in some of the cases which concerned the issuing of debt securities, provision of certain information in the prospectus as required under the Companies Ordinance (CO) was exempted because such information was considered not relevant to the investors, who were more concerned about the creditworthiness of the issuer and its ability to pay interest and repay capital by the due date. Moreover, the investors relied on the terms and conditions of the debt securities in making an informed decision on whether to invest in the debt securities. In other cases, some of the information required under the CO to be included in the prospectus was exempted because the information was considered irrelevant in the case of debt securities issued by government owned/controlled entities, which were considered less risky. The PRP considered that some of the requirements on the contents of prospectus set out in the CO might not be totally applicable to debt securities as compared with equity, or to financial products issued by government owned/controlled entities.

3.12 The PRP envisaged that the process of issuing a prospectus by the issuer and of vetting prospectuses by the SFC could be streamlined if the requirements on the contents of prospectuses could be rationalised and tailored to suit different types of products, which had different characteristics (such as debt securities), or products issued by government owned/controlled entities, which were less risky. The PRP recommended that the SFC consider if and how rationalisation of 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 financial products issued by government owned/controlled entities from certain requirements on the contents of a prospectus. The SFC agreed to the recommendation. The SFC had issued guidelines on the offering of equity and debt securities, and would grant two more class exemptions in relation to the content requirements of prospectuses for listed and unlisted debt offering respectively. The SFC was working on an advanced draft of a Company (Amendment) Bill which sought to entrench into the law matters dealt with in the guidelines; and would commence a reform of the prospectus regime.

Processing time

3.13 The PRP noted from the cases reviewed that the case with the longest

processing time took four months to complete because it involved a financial product which had not been processed by the SFC before. The SFC had to be cautious in handling the case. The PRP also noted that a large amount of correspondence was exchanged between the SFC and the prospectus issuer in this case because the first draft of the prospectus required further information and clarification from the applicant; frequent and extensive revisions on the documentation were made; and not all the essential information/documents were submitted to the SFC in one lot. To expedite the processing of applications in particular those from new issuers, the PRP recommended that the SFC consider the feasibility of setting out some guidelines on the drafting of prospectuses for reference by issuers. The SFC considered it inappropriate at this stage to put in place guidelines relating to prospectus drafting but would keep the matter under review.

(E) Granting of exemptions under the Companies Ordinance

Compliance with procedures

3.14 Under Sections 38A and 342A of the CO, where a company proposes to offer any shares or debentures to the public by the issue of a prospectus, the company may apply to the SFC for a certificate of exemption from compliance with any or all of the statutory requirements on the contents of the prospectus, if compliance with any or all of those requirements would be either irrelevant or unduly burdensome. The PRP examined the SFC's procedures in processing applications for such exemptions and noted from the cases reviewed that the SFC had followed these procedures in exercising the exemption power.

Transparency in exemptions granted

3.15 There was adequate transparency with respect to the SFC's decisions in the granting of exemption from compliance with the requirements on the contents of prospectuses set out in the CO. A company, in submitting an application for exemptions under the CO, normally submitted a draft prospectus or its relevant extracts to the SFC that included a statement describing the exemption granted/to be granted by the SFC. The inclusion of such statement was to keep the investors informed of the exemption granted and the information omitted from the prospectus so as to facilitate their making of an informed

decision. However, it was not an existing practice of the SFC to state explicitly in the letter of exemption issued by them to the applicant the requirement of including such a statement in the prospectus. In order to ensure that the applicant would include the statement of exemption in the prospectus, the PRP recommended that the SFC set out in the letter of exemption the requirement of including such a statement in the prospectus. The SFC agreed to the recommendation.

Processing of applications

3.16 In one of the cases, a company submitted a new application in addition to the original one because the listing was postponed. The SFC processed the new application based on the recommendation from the Stock Exchange of Hong Kong Limited (SEHK) on the original application. A revised recommendation from the SEHK was not sought because the Manager of the SFC found no substantial change in the new application. In order to protect the interests of the SFC and the applicant, as well as investors, the PRP recommended that the SFC seek confirmation from the SEHK on the continuing validity of the latter's recommendation whenever a revised application was received. The SFC agreed to the recommendation.

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

Compliance with procedures

3.17 The Securities (Disclosure of Interests) Ordinance (SDIO) requires, amongst other things, the disclosure by the directors and chief executive of a listed company of their interests in the securities of listed companies. Disclosure of interests is an important element of an informed market. Under Sections 28 to 31 of the SDIO, the directors and chief executive of a listed company, as well as their spouses and children, are required to inform the listed company and the Exchange Company in writing of their interests in shares in, or debentures of, the listed company or any associated corporation. Moreover, every listed company is required to keep in Hong Kong a register on the interests of the director and chief executive. Section 2A of the SDIO empowers the SFC to exempt a listed company or other person in relation to that company from all or

any of the provisions of the Ordinance.

3.18 The PRP examined the SFC's procedures in processing applications for such exemptions and noted from the cases reviewed that the SFC had followed these procedures in exercising the exemption power.

Transparency in exemptions granted

3.19 The PRP noted that there was no transparency concern in the exercise of the exemption power by the SFC under the SDIO. Such kind of exemption was granted to those applicant companies which were not listed in Hong Kong but were launching financial products listed or to be listed in Hong Kong. Without the exemption, the directors and chief executive of an applicant company would be required to disclose their interests in the shares of the applicant company when the company launched a financial product in Hong Kong. (They would not be required to disclose their interest in the financial product launched by the company.) Since the potential investors of the financial product are more concerned about the holdings in respect of the financial product rather than the applicant company, the information which was exempted from disclosure is irrelevant to them. In this connection, there was no genuine need for the applicant company to inform the investing public that such an exemption had been obtained.⁴

(G) Handling of takeover and merger transactions and complaints by the Corporate Finance Division

3.20 The PRP noted that one of the takeover and merger transaction cases of the CFD of the SFC were handled by more than one SFC divisions. The persons involved in the transaction were also the subjects of investigation by the Enforcement Division of the SFC and they were interviewed and asked to give statements on similar information by both the CFD and the Enforcement Division. There might not have been any sharing of information among the SFC divisions concerned. The PRP recommended that the SFC consider the feasibility of sharing information amongst divisions. The SFC agreed to the

⁴ Under Section 309(5) of the SFO, the SFC is required to publish, by the use of an on-line medium, such particulars of the exemptions from compliance with the requirements on disclosure of interests granted, suspended or withdrawn by the SFC.

recommendation. An effort has been made to improve communication between the CFD and the Enforcement Division, without undermining the effectiveness of data protection efforts, by providing access to certain members of the Enforcement Division to details of takeover transactions in the CFD's database, and conducting monthly meetings between the two divisions on investigation matters.

3.21 In a complaint case handled by the CFD, the final reply was issued to the complainant almost six months after an interim reply had been issued. During this period, the complainant was not informed of the progress of the case. The PRP considered that although the SFC was precluded from disclosing details of an investigation by the secrecy provisions contained in Section 59 of the Securities and Futures Commission Ordinance (SFCO), there should be scope for more communication with the complainant. The PRP recommended that for complaint cases which could not be concluded within a short period of time, the CFD should give an interim reply to the complainant at regular intervals so that the complainant could be assured that his complaint was being taken care of by the SFC. The time intervals for issuing interim replies should be determined by the SFC. The SFC considered that 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.

Chapter 4. Review of specific areas of SFC procedures

4.1 The PRP examined the existing procedures of the SFC in handling complaints from the public about the conduct of SFC registrants and public consultations. The aim was to identify areas for improvement that could reduce the compliance burden of the industry without compromising the quality and integrity of regulation.

4.2 The PRP attaches great importance to views from the industry on possible areas for improvement on the SFC's procedures. In this context, the PRP met with several industry associations to exchange views on the SFC's procedures, in particular procedures on handling complaints from the public about the conduct of SFC registrants, public consultations, and appointment of auditors under Section 160 of the SFO scheduled for commencement in April 2003.

4.3 The PRP considered the merits of the proposals from the industry having regard to the PRP's terms of reference, and where appropriate, referred the proposals to the SFC for consideration and response. The PRP was pleased to note that the SFC has been positive in considering such proposals. The proposals discussed are summarised below while the SFC's responses to the proposals are detailed in **Annexes C and D**.

(A) Handling of complaints from the public about the conduct of SFC registrants

Processing time

4.4 The industry considered that for some complaint cases, investigation by the SFC had taken a long time. This might have an adverse effect on the parties under investigation and might affect the business of the companies concerned. The industry requested the SFC to complete investigations of a complaint as soon as possible, and inform the concerned parties of the result of the investigation and whether further investigation would be conducted. The

industry also requested the SFC to consider making a performance pledge for handling complaints. The PRP invited the SFC to consider the suggestions. The SFC agreed that a preliminary response would be sent to the complainant within two weeks of receiving the complaint. For cases involving preliminary investigation of brokerages, a reply would be sent to the brokerage within two weeks after the Complaint Control Committee (CCC)⁵ of the SFC decided that no further action was to be taken.

Consistency in complaint handling between the SFC and the HKMA

4.5 As most banks also handle securities trading, the industry considered that the SFC and the Hong Kong Monetary Authority (HKMA) should be consistent in their complaint handling procedures on securities trading. The industry suggested the SFC to work closely with the HKMA for consistency in their complaint handling procedures. The PRP considered that the SFC should be invited to respond to this suggestion. The SFC replied that they worked closely with the HKMA on the consistency in handling complaints on securities trading. Section 8 of the new Memorandum of Understanding (MOU) between the SFC and the HKMA⁶ dealt specifically with complaints.

⁵ The CCC is established in the SFC to ensure that complaints are assessed in a consistent, transparent and accountable manner. Its role includes conducting a preliminary assessment of whether a complaint justifies further action, endorsing action that has been taken by an operational department, assessing whether to advise another regulatory agency of a matter and establishing the procedures for the control of complaints and ensuring compliance with those procedures by all departments of the Commission. The CCC meets weekly and consists senior executives from the Supervision of Markets Division, the Enforcement Division, the Corporate Finance Division, the Intermediaries Supervision Department, the Licensing Department and the Investor Education & Communications Department of the SFC.

⁶ The SFC and the HKMA signed a new MOU on 12 December 2002 as a preparation for the new regulatory regime under the SFO and the Banking (Amendment) Ordinance 2002. The new MOU elaborates on the legal framework and sets out the two regulators' mutual understanding in respect of the regulation and supervision of registered institutions and their relevant staff. Registered institutions are those authorized institutions under the Banking Ordinance which are registered with the SFC to conduct regulated activities as defined in the SFO. The SFC and the HKMA share responsibility for the regulation and supervision of registered institutions. Under the SFO, authorized institutions will be required to seek registration from the SFC in order to carry out the regulated activities concerned. In that regard, the criteria adopted in determining whether authorized institutions are fit and proper for the purpose of registration will be consistent with those adopted in considering applications for the grant of licences to stockbrokers. In addition, the relevant employees of registered institutions will be required to meet the same competence and continuous professional training requirements as for SFC licensed representatives. Under the new regulatory regime, registered institutions and their relevant employees will be formally subject to the various rules, codes of business conduct and guidelines issued by the SFC. They will also be subject to the same disciplinary measures in case of misconduct as those applicable to SFC licensees.

Channel for lodging complaints

4.6 The industry considered that the channel for lodging complaints to the SFC, in particular for complaints against staff and decisions of the SFC was not clear to the industry. 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 suggestion. The SFC briefed an industry forum on 11 December 2002 on, among others, information on how the SFC handled complaints. The SFC would give consideration on how to put forth the suggestion further.

Replies to complainants

4.7 The PRP noted that not all operation divisions/departments of the SFC would proactively update the complainant on the progress of his complaint. The PRP saw merit in keeping the complainant informed of the progress of the complaint and recommended that the SFC consider issuing periodic replies to complainants if the complaint could not be concluded within a reasonable period of time. The PRP also recommended that the SFC examine whether the practice in issuing periodic replies could be standardised amongst operation divisions/departments. The SFC agreed to the recommendations and had adopted a standardised procedure for issuing progress updates to complainants.

4.8 The PRP also noted that not all operation divisions/departments have set a target date for issuing substantive replies to complainants. As a measure to guard against prolonged investigation of complaint, the PRP recommended that the SFC set, for all operation divisions/departments, a target date for the issuing of substantive replies to complainants. The SFC agreed to the recommendation and had set a target date by which all complainants should receive a substantive reply.

Notification to employers of complaint investigation involving employees

4.9 The industry considered that for some complaint cases, the management of the company concerned was not informed of the complaint and was not aware of the fact that their staff was being investigated by the SFC.

The industry suggested that the management of the company should be informed of the complaint and the identity of their staff being investigated so that the management could take immediate remedial action if necessary to avoid further damage to the company by the staff being complained. 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 acknowledged that there might be some benefit, in a limited number of cases, in informing an employer of suspected misconduct by an employee. The internal procedures of the Enforcement Division of the SFC were being revised to allow, in exceptional circumstances, disclosure to be made.

(B) Public consultations

Informal consultations

4.10 At present, the SFC would discuss with members of the industry before issuing a formal consultation paper. The industry considered that small and local broker firms were thinly represented in informal consultations. The industry suggested that the SFC should consider including more small and medium-sized broker firms in informal consultations. The PRP invited the SFC to comment on the suggestion. The SFC responded that small and local broker firms had usually been fairly well consulted before the SFC issued formal consultation papers. There was a monthly meeting with broker associations to brief them of proposed and actual consultation documents and seek their initial view. The SFC would continue to ensure that, in future informal consultations, it will listen to the views of a balanced mix of industry members who were representative of the market.

Consultation period

4.11 The industry expressed concern on the large number of consultation exercises to be rolled out within a relatively short period of time ahead of the enactment of subsidiary legislation of the SFO. The industry would need time and staff resources to study the consultation documents before offering any constructive comments. The industry suggested that the SFC simplify the consultation procedures and speed up the consultation exercise as far as possible. The PRP considered that the SFC should be invited to respond to the suggestion.

The SFC responded that the bulk of consultations on the SFO and its subsidiary legislation had been completed. The SFC had made the consultation documents and consultation conclusions easily available through a number of channels (e.g. in the SFC's reception area in hard copy and on SFC website in soft copy) and had arranged for comments to be received from respondents through various means, including email and facsimile.

Division of responsibility within the SFC

4.12 The PRP noted that it was the responsibility of an operation division of the SFC to initiate a public consultation exercise on a certain proposal while the Commission had the authority to decide whether and how such public consultation exercise was to be conducted. However, this division of responsibility was not clearly specified in the internal procedures on public consultation for SFC staff. The PRP recommended that the SFC 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.

Consulting the Advisory Committee

4.13 The PRP also noted that 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 PRP recommended that the SFC consider the feasibility and desirability of consulting the AC on public consultation exercises. The SFC replied that it might seek the AC's view on concepts before drafting a proposal on a certain issue. It might also submit consultation papers, bring up issues/proposals in the consultation process, and submit consultation conclusions to the AC as far as practicable.

(C) Appointment of auditors under Section 160 of SFO

Checks and balances

4.14 Under Section 160 of the SFO, the SFC can, upon application by a client of a licensed corporation, appoint an auditor to examine and audit the accounts and records of the licensed corporation. The industry expressed

concern on the possibility of abuse by clients. They considered that the SFC should exercise the power to appoint an auditor with great care and the decision in appointing an auditor should be subject to adequate checks and balances. They suggested that the SFC should consider setting out objective criteria and internal procedures for exercising the power to appoint auditors. The licensed corporation concerned should be given 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 SFC replied that, upon commencement of the SFO, the applicable internal procedures would be documented in the procedural manuals of the Intermediaries Supervision Department, which would include criteria for exercising the power to appoint an auditor under Section 160 of the SFO. Moreover, the SFO had already provided sufficient safeguards⁷ to minimise the possibility of unjustified appointment of auditors and abuse by citizens.

Selection of auditors

4.15 Under Section 160(8) of the SFO, the SFC may require the licensed corporation concerned to bear, wholly or partly, the costs and expenses incurred for an audit. The industry expressed concern that the SFC might give preference to large and international accounting firms in the selection of auditors, thus imposing a heavy financial burden on the licensed corporation concerned. The industry suggested that the SFC should consider the suitability of the auditor nominated by the licensed corporation based on the nominee's experience, capabilities and available resources. Local or smaller accounting firms should be considered on a par with the large and international firms, so 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. The SFC provided statistics of past cases of appointment of accountants for circularisation of client accounts and review of internal control

⁷ The major safeguards include –

- (a) the SFC is required to give the concerned licensed corporation a reasonable opportunity of being heard before appointment of auditors;
- (b) the SFC will only appoint an auditor where it is satisfied that the person making the application has a good reason and the appointment will be in the interest of the concerned parties or investing public;
- (c) the SFC may order the person making the application to bear the cost of the examination and audit; and
- (d) decisions of the SFC on both the appointment of auditors and apportionment of audit costs are subject to appeal to the Securities and Futures Appeals Tribunal.

procedures showing that it 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.

Scope of audit

4.16 The industry considered it essential to define clearly the scope of audit, which should be made known to the licensed corporation concerned so as to facilitate the corporation's assessment on the reasonableness of cost estimates provided by the audit firm. The industry suggested that the SFC should hold discussions with the licensed corporation concerned in determining the scope of audit. The PRP invited the SFC to comment on the suggestion. The SFC responded that the licensed corporation would be given a reasonable opportunity to comment on the objectives and scope of an audit.

(D) Communication with the industry

4.17 The industry noted that there were a lot of new practices and requirements arising from the implementation of the SFO. The SFC had been conducting seminars on these new activities and requirements. Nevertheless, the industry saw the need for improving education for industry participants on these new practices and requirements and suggested that the SFC should consider how this could be done. The PRP considered that the SFC should be invited to respond to the suggestion. The SFC agreed to the suggestion. Seminars, Q&A sessions and workshops on the new provisions under the SFO were conducted in December 2002 and early 2003.

4.18 Under the new licensing regime to be implemented under the SFO, there are different competence requirements for the performance of different regulated activities. The industry pointed out that it was not clear as to what specific qualifications and experiences were required for a person to be qualified for licensing for the regulated activities. The industry suggested that the SFC should consider promulgating clearly the qualification requirements for each regulated activity for the reference of industry participants. The PRP invited the SFC to comment on the suggestion. The SFC replied that a revised Guidelines on Competence, which set out for licensing purposes the qualifications and

experience requirements in respect of responsible officers and representatives, was released in March 2003. The Guidelines included competence requirements for each regulated activity.

4.19 The PRP and the industry opined that there should be closer communication between the SFC and the industry and a mechanism for regular exchange of views between them on market and regulatory issues. The PRP invited the SFC to comment on the suggestion. The SFC responded by organising a monthly discussion forum with the industry that had started from November 2002.

Chapter 5. Way forward

5.1 In 2002, the PRP performed its functions through the review of completed cases and selected topics of the SFC's operational procedures and made relevant recommendations to the SFC. The PRP also maintained a dialogue with the industry with a view to gauging the industry's view on procedural matters.

5.2 For 2003, the PRP intends to focus on examining the new procedures formulated for implementing the regulatory regime enshrined in the SFO. The PRP will also examine the mechanism for internal communication between SFC divisions/departments on 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 performing the dual filing function, to see if proper procedures are in place.

5.3 The PRP will follow up a number of the recommendations. These include the revision of SFC performance pledges, rationalisation of the SFC registration procedures with those of the SEHK, notification of employer on an investigation involving its employees, and appointment of auditors under Section 160 of the SFO.

5.4 The PRP will continue its work on review of completed cases to ensure that the SFC followed its internal procedures consistently and will further cultivate its dialogue with market participants affected by the SFC regulatory processes and procedures.

Chapter 6. Acknowledgement

6.1 The PRP would like to express its gratitude to the Chairman of the SFC and his staff for their assistance in facilitating the review work and co-operation in responding to the PRP's enquiries and recommendations in the past year. The PRP is also grateful to members of the industry who have rendered their views to the PRP for improvements to the SFC's internal procedures and processes.

**Process Review Panel for the
Securities and Futures Commission**

Terms of reference

1. To review and advise the Commission upon the adequacy of the Commission's internal procedures and operational guidelines governing the action taken and operational decisions made by the Commission and its staff in the performance of the Commission's regulatory functions in relation to the following areas-
 - (a) receipt and handling of complaints;
 - (b) licensing of intermediaries and associated matters;
 - (c) inspection of licensed intermediaries;
 - (d) taking of disciplinary action;
 - (e) authorisation of unit trusts and mutual funds and advertisements relating to investment arrangements and agreements;
 - (f) exercise of statutory powers of investigation, inquiry and prosecution;
 - (g) suspension of dealings in listed securities;
 - (h) administration of the Hong Kong Codes on Takeovers and Mergers and Share Repurchases;
 - (i) administration of non-statutory listing rules;
 - (j) authorisation of prospectuses for registration and associated matters;
and
 - (k) granting of exemption from statutory disclosure requirements in respect of interests in listed securities.

2. To receive and consider periodic reports from the Commission on all completed or discontinued cases in the above-mentioned areas, including reports on the results of prosecutions of offences within the Commission's jurisdiction and of any subsequent appeals.
3. To receive and consider periodic reports from the Commission in respect of the manner in which complaints against the Commission or its staff have been considered and dealt with.
4. To call for and review the Commission's files relating to any case or complaint referred to in the periodic reports mentioned in paragraphs 2 and 3 above for the purpose of verifying that the action taken and decisions made in relation to that case or complaint adhered to and are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly.
5. To receive and consider periodic reports from the Commission on all investigations and inquiries lasting more than one year.
6. To advise the Commission on such other matters as the Commission may refer to the Panel or on which the Panel may wish to advise.
7. To submit annual reports and, if appropriate, special reports (including reports on problems encountered by the Panel) to the Financial Secretary which, subject to applicable statutory secrecy provisions and other confidentiality requirements, should be published.
8. The above terms of reference do not apply to committees, panels or other bodies set up under the Commission the majority of which members are independent of the Commission.

**Membership
of the Process Review Panel**

Chairman

Mr. CHENG Hoi Chuen, Vincent, JP

Members

The Honourable Bernard Charnwut CHAN, JP

Mr. CHEONG Ying Chew, Henry

Mr. FONG Hup

Mr. KOTEWALL, Robert George, SBS, SC

Mr. KWAN Pak Chung, Edward

Professor LIU Pak Wai, SBS

Mr. PANG Yuk Wing, Joseph, JP

Mr. Alan Howard SMITH, JP

Ex-officio members

Chairman, Securities and Futures Commission
(Mr. Andrew L T SHENG, SBS, JP)

Non-Executive Director, Securities and Futures Commission
(Mr. FAN Hung Ling, Henry, SBS, JP)

Secretary for Justice
or representative (Mr. Ian G M WINGFIELD, GBS, JP)

**Membership of the
Working Group on Corporate Finance and Enforcement**

Chairman

Mr. KWAN Pak Chung, Edward

Members

The Honourable Bernard Charnwut CHAN, JP

Mr. CHENG Hoi Chuen, Vincent, JP

Mr. KOTEWALL, Robert George, SBS, SC

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**Membership of the
Working Group on Licensing, Intermediaries Supervision
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Chairman

Mr. FONG Hup

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Mr. CHEONG Ying Chew, Henry

Mr. FAN Hung Ling, Henry, SBS, JP

Professor LIU Pak Wai, SBS

Mr. PANG Yuk Wing, Joseph, JP

Mr. Andrew L T SHENG, SBS, JP

**Observations and recommendations that
have been accepted by the SFC**

(A) Inspection of intermediaries

Item 1	Case findings/ market views	<p>The PRP noted that four routine inspections, which were conducted by the SFC from late 2001 to mid-2002, were prolonged mainly because the inspection team concerned were occupied with unexpected incidents in the market that required immediate attention, such as suspected fault, misappropriation by and financial instability of certain broker firms, which involved intermediaries under the inspection team's portfolio. According to the SFC, it was more desirable for an inspection team to handle extra assignments relating to intermediaries within its own portfolio because the inspection team had already built up expertise about the intermediaries through on-going monitoring. Nevertheless, the PRP considered that the efficiency of a team might be affected if it was overloaded with extra assignments.</p>
	PRP recommendations /observations	<p>The PRP recommended that the SFC shorten the time for conducting inspections and ascertaining the adequacy of staffing resources before commencing a routine inspection. The PRP also recommended that the SFC apply flexibility in the assignment of cases so that, in the case of urgent and unexpected events, resources from other teams could be mobilised to assist the inspection team concerned.</p>
	Response from SFC	<p>The period during which the inspections concerned were conducted was an exceptionally demanding period for the Intermediaries Supervision Department of the SFC. Several unexpected and significant events took place during the period: (i) collapse of some brokers; (ii) finalizing of the subsidiary legislation of the Securities and Futures Ordinance; and (iii) close monitoring of financially high-risk intermediaries, had stretched staff resources to the limit. As a result, completion of some inspections were delayed as engaging staffs had to attend to those more urgent matters.</p> <p>The SFC agreed with the PRP's suggestion to find ways to shorten the time for conducting inspections, and proposed the following for possible implementation:</p> <p>(a) If complex compliance matters were uncovered during an inspection, more resources would be allocated to work on the inspection in a more flexible manner (if necessary, by redeploying staff from other inspection teams) with a view to completing the inspection within a reasonable time frame. Currently, the SFC was considering introducing a mechanism of reallocation of staff to handle outstanding inspection cases.</p> <p>(b) Upgrading the computer system, i.e. the Inspection Activities Management System, to enhance its function of generating exception reports and statistical summaries on outstanding inspection cases.</p>

Item 2	Case findings/ market views	In the five routine inspections selected by the PRP for review, the SFC issued a Letter of Deficiencies to the inspected intermediaries several months (i.e. ranging from seven to nine months) after completion of inspection fieldwork. The PRP considered it undesirable for an inspected intermediary to wait for a long period of time before being formally informed by the SFC of the inspection findings.
	PRP recommendations /observations	The PRP recommended that the SFC issue interim replies to an inspected intermediary on the initial findings of the inspection.
	Response from SFC	<p>The SFC agreed to the proposal by instigating a procedure of issuing an Interim Management Letter to the inspected intermediaries. The new arrangement started in late October 2002. The Interim Management Letter, prepared by the case officer in charge of the fieldwork of the inspection, summarised the areas of concern noted from the inspection fieldwork. Where possible, it highlighted the outstanding information to be received/work to be performed before the inspection might be completed. Such Interim Management Letter would be issued to an inspected intermediary when an inspection was not completed after five months from the inspection fieldwork.</p> <p>In addition, it is a common practice for the inspection teams to discuss the preliminary findings with a subject intermediary at the conclusion of the inspection fieldwork. This common practice, coupled with the newly implemented procedure of issuing Interim Management Letters, should serve to give sufficient indication to the intermediary of the preliminary findings as a result of the inspection.</p>

(B) Registration of intermediaries

Item 3	Case findings/ market views	The PRP noted that a Senior Manager of the SFC had granted in-principle approval to an application for registration and an associated waiver and had asked the applicant to accept the conditions for registration, before seeking clearance from a Director on the waiver. Both the application for registration and the waiver were subsequently approved.
	PRP recommendations /observations	In order to avoid the undesirable situation that the application was rejected after the applicant had already accepted the conditions for registration, the PRP recommended that the SFC complete the internal clearance procedures before asking an applicant to accept conditions for registration.
	Response from SFC	The SFC agreed to the recommendation.

(C) Authorization of collective investment schemes

Item 4	Case findings/ market views	One of the cases on authorisation of collective investment schemes was prolonged (i.e. one year seven months) because the applicant had discontinued submitting essential information on his application to the IPD when he was being investigated by the Enforcement Division. According to the IPD, the application would have been unlikely to be rejected by the IPD after completion of investigation by the Enforcement Division if the investigation did not result in severe disciplinary actions that affected the applicant's capacity to act as manager to authorised collective investment schemes (e.g. revocation or suspension of licence of the company or key investment personnel).
	PRP recommendations /observations	In order to expedite the processing of an application by the IPD when the applicant is involved in investigation by the Enforcement Division, the PRP recommended that the SFC consider the feasibility of continuing processing and vetting the application by the IPD even when the Enforcement Division was conducting an investigation. The IPD should withhold the granting of authorisation pending the completion of the investigation and of any disciplinary actions by the Enforcement Division. The PRP considered that, in this way, the applicant could benefit from savings in time cost while the SFC's effort in processing the application would be unlikely to be wasted. The PRP also recommended that the SFC set out internal guidelines for the IPD to handle similar cases, which should cover communication with the Enforcement Division on the nature and seriousness of the matter being investigated.
	Response from SFC	The SFC agreed with the PRP's comments and recommendation.
Item 5	Case findings/ market views	An applicant requested the SFC to withhold the processing of one of his applications and accord priority to processing other applications submitted by the same applicant. However, such request was not documented on the case file.
	PRP recommendations /observations	The PRP recommended that the request from an applicant to withhold an application should be properly documented on the case file.
	Response from SFC	The SFC agreed with the PRP's comments and recommendation.

(D) Approval of prospectuses

Item 6	Case findings/ market views	The PRP examined the SFC's procedures for vetting and approving prospectuses and noted from the cases reviewed that the CFD of the SFC had followed these procedures.
	PRP recommendations /observations	The PRP conveyed the observation to the SFC.
	Response from SFC	The SFC noted the observation.
Item 7	Case findings/ market views	In some of the cases which concerned the issuing of debt securities, provision of certain information in the prospectus as required under the CO was exempted because such information was considered not relevant to the investors, who were more concerned about the creditworthiness of the issuer and its ability to pay interest and repay capital by the due date. Moreover, the investors relied on the terms and conditions of the debt securities in making an informed decision on whether to invest in the debt securities. In other cases, some of the information required under the CO to be included in the prospectus was exempted because the information was considered irrelevant in the case of debt securities issued by government owned/controlled entities, which were considered less risky.
	PRP recommendations /observations	<p>The PRP considered that some of the requirements on the contents of prospectus set out in the CO might not be totally applicable to debt securities as compared with equity, or to financial products issued by government owned/controlled entities.</p> <p>The PRP envisaged that the process of issuing a prospectus by the issuer and of vetting prospectuses by the SFC could be streamlined if the requirements on the contents of prospectuses could be rationalised and tailored to suit different types of products, which had different characteristics (such as debt securities), or products issued by government owned/controlled entities, which were less risky.</p> <p>The PRP recommended that the SFC consider if and how rationalisation of 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 owned/controlled entities from certain requirements on the contents of a prospectus.</p>
	Response from SFC	The SFC had issued guidelines that relate to the offering of equity and debt securities in early 2003. The Guidelines had been gazetted on 21 February 2003. The SFC was finalising two new class exemptions for listed and unlisted debt offerings respectively. The SFC was also looking into the possibility of issuing a class exemption that applied to government entities specified by the SFC.

		The SFC was 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. Public consultation on the provisions of the draft bill was in progress.
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(E) Granting of exemptions under the Companies Ordinance

Item 8	Case findings/ market views	The PRP examined the SFC's procedures in processing applications for exemptions from compliance with the requirements on the contents of prospectus set out in the CO and noted from the cases reviewed that the SFC had followed these procedures in exercising the exemption power.
	PRP recommendations /observations	The PRP conveyed the observation to the SFC.
	Response from SFC	The SFC noted the observation.
Item 9	Case findings/ market views	There was adequate transparency with respect to the SFC's decisions in granting of exemption from compliance with the requirements on the contents of prospectuses set out in the CO. A company, in submitting an application for exemptions under the CO, normally submitted a draft prospectus (or its relevant extracts) to the SFC that included a statement describing the exemption granted/to be granted by the SFC. The inclusion of such statement was to keep the investors informed of the exemption granted, and the information omitted from the prospectus, so as to facilitate their making of an informed decision. However, it was not an existing practice of the SFC to state explicitly in the letter of exemption issued by them to the applicant the requirement of including such a statement in the prospectus.
	PRP recommendations /observations	In order to ensure that the applicant would include the statement of exemption in the prospectus, the PRP recommended that the SFC set out in the letter of exemption the requirement of including such a statement in the prospectus.
	Response from SFC	The SFC agreed to the proposal. In relation to Growth Enterprise Market (GEM) companies, there was a disclosure policy that all waivers and exemptions granted by SEHK and the SFC would be dealt with in a specific section of the prospectus. Thus, exemptions granted by the SFC would be stated in that section. This disclosure policy was, however, not currently adopted for Main Board issuers, and generally the practice of disclosure of exemptions was not consistently applied in these prospectuses. The SFC discussed this discrepancy with SEHK. The SEHK agreed to adopt the disclosure approach used in GEM for the purpose of Main Board issuers. The SFC also proposed adopting a similar approach for unlisted issues.

Item 10	Case findings/ market views	In one of the cases, the company submitted a new application in addition to the original one because the listing was postponed. The SFC processed the new application based on the recommendation from the SEHK on the original application. A revised recommendation from the SEHK was not sought because a Manager of the SFC found no substantial change in the new application.
	PRP recommendations /observations	In order to protect the interests of the SFC and the applicant, as well as investors, the PRP recommended that the SFC seek confirmation from the SEHK on the continuing validity of the latter's recommendation whenever a revised application was received.
	Response from SFC	The SFC accepted the PRP's proposal. If this type of incident happened again, the SFC would seek a new recommendation or confirmation from the Stock Exchange on the continuing validity of its earlier recommendation.

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

Item 11	Case findings/ market views	The PRP examined the SFC's procedures in processing applications for exemption from compliance with the requirements under the Securities (Disclosure of Interests) Ordinance (SDIO) and noted from the cases reviewed that the SFC had followed these procedures in exercising the exemption power.
	PRP recommendations /observations	The PRP conveyed the observation to the SFC.
	Response from SFC	The SFC noted the observations.
Item 12	Case findings/ market views	There was no transparency concern in the exercise of the exemption power by the SFC under the SDIO. Such kind of exemption was granted to those applicant companies which were not listed in Hong Kong but were launching financial products listed or to be listed in Hong Kong. Without the exemption, the directors and chief executive of an applicant company would be required to disclose their interests in the shares of the applicant company when the company launched a financial product in Hong Kong. (They would not be required to disclose their interest in the financial product launched by the company.) Since the potential investors of the financial product were more concerned about the holdings in respect of the financial product rather than the applicant company, the information which was exempted from disclosure is irrelevant to them. In this connection, there was no genuine need for the applicant company to inform the investing public that such an exemption had been obtained.

	PRP recommendations / observations	The PRP invited the SFC to comment on the observation.
	Response from SFC	The SFC noted the observation.

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

Item 13	Case findings/ market views	The PRP noted that one of the takeover and merger transactions cases of the CFD of the SFC were handled by more than one SFC divisions. The persons involved in the transaction were also the subjects of investigation by the Enforcement Division of the SFC and they were interviewed and asked to give statements on similar information by both the CFD and the Enforcement Division. There might not have been any sharing of information among the SFC divisions concerned.
	PRP recommendations / observations	The PRP recommended that the SFC consider the feasibility of sharing information amongst divisions.
	Response from SFC	<p>The CFD appreciated the importance of close liaison with other SFC divisions (in particular Enforcement Division) which were conducting contemporaneous investigations into a person or company that was also being investigated by the CFD in relation to possible breaches of the Takeovers Code. Efforts to improve communication with the Enforcement Division included granting certain members of the Enforcement Division access to details of takeover transactions that were filed in the CFD's database.</p> <p>There were also monthly meetings between CFD case officers who were conducting investigations and their counterparts in the Enforcement Division in order to determine the possible relevance of one division's investigation upon the others. Given the size and complexity of most investigations and manpower considerations, one division had to a large extent to rely on the other division's assessment of the relevance of the information it held.</p> <p>The CFD was also conscious of the natural justice requirement that a party was entitled to know and respond to the case against him. This might include disclosure of some of the information gathered by another division if that information was relevant to the case against the party in question. In such circumstances, if disclosure to the party might prejudice subsequent proceedings (criminal or otherwise) by the Enforcement Division, the CFD might need to delay commencing disciplinary proceedings under the Takeovers Code until the Enforcement Division's proceedings had been dealt with. This would be likely to result in delay to any proceedings under the Takeovers Code.</p>

		The CFD hoped that the above measures would help reducing duplication of interviews and other requests to parties when the underlying matters under investigation were sufficiently similar.
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(H) Handling of complaints from the public about the conduct of SFC registrants

Item 14	Case findings/ market views	The industry considered that for some complaint cases, investigation by the SFC had taken a long time. This might have an adverse effect to the parties under investigation and might affect the business of the companies concerned. The industry requested the SFC to complete investigations of a complaint as soon as possible, and inform the concerned parties of the result of the investigation and whether further investigation would be conducted. The industry also requested the SFC to consider making a performance pledge for handling complaints.
	PRP recommendations /observations	The PRP invited the SFC to consider the suggestions.
	Response from SFC	<p>The SFC's performance pledge for complainants stated that a preliminary response would be sent to the complainant within two weeks of receiving his complaint, advising whether the complaint could be processed any further, e.g. if it fell within the SFC's jurisdiction, or if the SFC needed to ask for additional information. This pledge had been widely publicised, e.g. in the SFC's Annual Report and in a pamphlet for investors.</p> <p>As each complaint case varied in complexity, it would be extremely difficult to establish a time frame for processing or investigating a complaint since each case would be different.</p> <p>In cases involving brokerages, the SFC would consider the complainant's allegations following which the SFC would usually approach the brokerage for an explanation of the matter, i.e., a preliminary investigation would be carried out. After further review by the relevant operating department, a recommendation would be made to the CCC of the SFC to refer the case to one of the SFC's divisions for further action or recommend "no further action" in respect of the brokerage. The SFC agreed that in cases involving preliminary investigations, a reply would be sent to the brokerage within two weeks after the CCC decided, following its review, that "no further action" was to be taken and the case was closed.</p> <p>If the case was referred to the Enforcement Division, final replies were issued to persons under investigation to notify them the investigation results.</p>
Item 15	Case findings/ market views	As most banks also handle securities trading, the association considered that the SFC and the HKMA should be consistent in their complaint handling procedures on securities trading. The industry suggested the SFC to work closely with the HKMA for consistency in their complaint handling procedures.

	PRP recommendations /observations	The PRP considered that the SFC should be invited to respond to the suggestion.
	Response from SFC	<p>The SFC worked closely with the HKMA on complaint issues. Section 8 of the new Memorandum of Understanding between the SFC and the HKMA dealt specifically with complaints. Where the subject matter of the complaint was one that the SFC could investigate under Section 182 of the SFO, then the HKMA would refer such complaints to the SFC for investigation. Furthermore, where the HKMA considered appropriate, the HKMA would refer to the SFC complaints against authorised institutions that appeared to relate to the SFC's functions under the SFO, including those complaints that appeared relevant to any matter about which the SFC could inquire under Section 179 of the SFO.</p> <p>In such circumstances, the SFC would be handling complaints against banks in relation to matters over which the SFC had jurisdiction and the issue of consistency of approach should not arise.</p>
Item 16	Case findings/ market views	The industry considered that the channel for lodging complaints to the SFC, in particular for complaint against staff and decision of the SFC was not clear to the industry. The industry suggested that the SFC should set out the complaint channels and inform the industry accordingly.
	PRP recommendations /observations	The PRP considered that the SFC should be invited to respond to the suggestion.
	Response from SFC	<p>The SFC briefed an industry forum on 11 December 2002, which included information on how the SFC handled complaints against its staff, complaints about the SFC's disciplinary decisions and complaints against market misconduct. Some information on lodging complaints against the SFC was also included in both the 2000-2001 and 2001-2002 Annual Reports.</p> <p>The SFC would give consideration on how to put forth the suggestion further.</p>
Item 17	Case findings/ market views	The PRP noted that not all operation divisions/departments of the SFC would proactively update the complainant of progress of his complaint.
	PRP recommendations /observations	The PRP saw merit in keeping the complainant informed of the progress of the complaint and recommended that the SFC consider issuing periodic replies to complainants if the complaint could not be concluded within a reasonable period of time. The PRP also recommended that the SFC examine whether the practice in issuing periodic replies could be standardised amongst operation divisions/departments.
	Response from SFC	The SFC agreed to the recommendations and had adopted a standardised procedure for issuing progress updates to complainants.

Item 18	Case findings/ market views	The PRP noted that not all operation divisions/departments of the SFC have set a target date for issuing substantive replies to complainants.
	PRP recommendations /observations	As a measure to guard against prolonged investigation of complaint, the PRP recommended that the SFC set, for all operation divisions/departments, a target date for issuing substantive replies to complainants.
	Response from SFC	The SFC agreed to the recommendation and had set a target date by which all complainants should receive a substantive reply.
Item 19	Case findings/ market views	The industry considered that for some complaint cases, the management of the company concerned was not informed of the complaint and was not aware of the fact that their staff was being investigated by the SFC. The industry suggested that the management of the company should be informed of the complaint and the identity of their staff being investigated so that the management could take immediate remedial action if necessary to avoid further damage to the company by the staff being complained.
	PRP recommendations /observations	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.
	Response from SFC	The SFC acknowledged that there might be some benefit, in a limited number of cases, in informing an employer of suspected misconduct by an employee. However, the SFC recognised that there were considerable potential dangers in adopting this in all cases. Some employers might, for example, be tempted to destroy or tamper with evidence, thereby prejudicing an investigation; others might resort to the summary dismissal of the employee concerned, before a conclusive finding has been made. The Enforcement Division's internal procedures were therefore being revised to allow, in exceptional circumstances, disclosure to be made.

(I) Public consultations

Item 20	Case findings/ market views	At present, the SFC would discuss with members of the industry before issuing a formal consultation paper. The industry considered that small and local broker firms were thinly represented in informal consultations and suggested that the SFC should consider including more small and medium-sized broker firms in informal consultations.
	PRP recommendations /observations	The PRP invited the SFC to comment on the suggestion.

	Response from SFC	Small and local brokers firms had usually been fairly well consulted before the SFC issued formal consultation papers. It was the SFC's general practice to form working groups (consisting of members from various sectors of the practitioners, such as representatives from the broker associations) to exchange ideas on major policy issues prior to issuance of consultation papers. There was also monthly meetings with broker associations to brief them of proposed or actual consultation documents and seek their initial view. The SFC would continue to ensure that, in future informal consultations or forums for exchange of ideas, it would listen to the views of a balanced mix of industry members who were representative of the market.
Item 21	Case findings/ market views	The industry expressed concern on the large number of consultation exercises to be rolled out within a relatively short period of time ahead of the enactment of subsidiary legislation of the SFO. The industry would need time and staff resources to study the consultation documents before offering any constructive comments. The industry suggested that the SFC simplify the consultation procedures and speed up the consultation exercise as far as possible.
	PRP recommendations /observations	The PRP considered that the SFC should be invited to respond to the suggestion.
	Response from SFC	The bulk of the consultations on the SFO and its subsidiary legislation had been completed. The SFC appreciated the amount of time and resources required of brokers before they could offer comments during the consultation process. The SFC had made the consultation documents and consultation conclusions easily available through a number of channels (e.g., in the SFC's reception area in hard copy and on SFC website in soft copy) and had arranged for comments to be received from respondents through various means, including email and facsimile.
Item 22	Case findings/ market views	The PRP noted that it was the responsibility of an operation division of the SFC to initiate a public consultation exercise on a certain proposal while the Commission had the authority to decide whether and how such public consultation exercise was to be conducted. However, this division of responsibility was not clearly specified in the internal procedures on public consultation for SFC staff.
	PRP recommendations /observations	The PRP recommended that the SFC set out the division of responsibility clearly in its internal procedures for public consultation.
	Response from SFC	The SFC agreed to the recommendation and had amended its internal procedures on public consultation to set out more clearly the division of responsibility.

Item 23	Case findings/ market views	The PRP noted that the AC of the SFC, which included representatives from the industry, was set up to give advice to the SFC on policy matters.
	PRP recommendations /observations	The PRP recommended that the SFC consider the feasibility and desirability of consulting the AC on public consultation exercises as far as possible.
	Response from SFC	The function of the AC was to advise the SFC on matters of policy regarding any of its regulatory objectives and functions. The SFC might seek the AC's view in an early stage on concepts before drafting a proposal on a certain issue. The AC's view would help the SFC to frame the proposals or direction in consultation papers. The SFC might submit consultation papers to the AC before they were issued if the timing of the AC meeting fit the consultation timetable. The SFC might also bring up issues/proposals in consultation process for AC members' discussion/comments if the relevant consultation was still going on at the time of the meeting. The consultation conclusion might also be submitted to the AC at various stages. Moreover, the SFC would put AC members on its mailing list so that they would receive all publications including consultation papers and be aware of the topics/issues the Commission was consulting the public.

(J) Appointment of auditors under Section 160 of the SFO

Item 24	Case findings/ market views	Under Section 160 of the SFO, the SFC can, upon application by a client of a licensed corporation, appoint an auditor to examine and audit the accounts and records of the licensed corporation. The industry expressed concern on the possibility of abuse by clients. They considered that the SFC should exercise the power to appoint an auditor with great care and the decision in appointing an auditor should be subject to adequate checks and balances. They suggested that the SFC should consider setting out objective criteria and internal procedures for exercising the power to appoint auditors. The licensed corporation concerned should be given an opportunity to make representations before an auditor is appointed.
	PRP recommendations /observations	The PRP considered that the SFC should be invited to address the concern of the industry.
	Response from SFC	Upon commencement of the SFO, the applicable internal procedures would be documented in the procedural manual of the Intermediaries Supervision Department of SFC, which would include, among others, criteria for exercising the power to appoint an auditor under Section 160 of the SFO. Moreover, the following safeguards had been provided in the SFO to minimise the possibility of unjustified appointment of auditors and abuse by clients — (a) The SFC is required to give the concerned licensed corporation a reasonable opportunity of being heard before appointment of auditors [s160(6) of SFO];

		<p>(b) the SFC will only appoint an auditor where it is satisfied that the person making the application has a good reason and the appointment will be in the interest of the concerned parties or investing public [s160(4) of SFO];</p> <p>(c) the SFC may order the person making the application to bear the cost of the examination and audit [s160(8) of SFO];</p> <p>(d) the person making the application must verify all statements in the application by statutory declaration [s160(3) of SFO] (false declaration is a criminal offence);</p> <p>(e) the coverage of the immunity available to the person making the application covers liabilities arising from the law of defamation only but not all civil liabilities [s160(7) of SFO]; and</p> <p>(f) decisions of the SFC on both the appointment of auditors and apportionment of audit costs are subject to appeal to the Securities and Futures Appeals Tribunal [s216(1) of SFO].</p>
Item 25	Case findings/ market views	Under Section 160(8) of the SFO, the SFC may require the licensed corporation concerned to bear, wholly or partly, the cost and expenses incurred for an audit. The industry expressed concern that the SFC might give preference to large and international accounting firms in the selection of auditor, thus imposing a heavy financial burden on the licensed corporation concerned. The industry suggested that the SFC should consider the suitability of the auditor nominated by the licensed corporation based on the nominee's experience, capabilities and available resources. Local or smaller accounting firms should be considered on a par with the large and international firms, so long as the former were considered independent and capable of handling the job.
	PRP recommendations /observations	The PRP considered that the SFC should be invited to respond to the concern of the industry.
	Response from SFC	30 accounting firms were appointed during the period 1 January 2002 to September 2002, including 29 local accounting firms and only 1 "Big 4" international firm. The scope of assignments mainly involved circularisation of client accounts, review of internal control procedures and assessment on the extent of the misappropriation, potential loss and financial position. The reported fees ranged from HK\$5,000 to \$250,000. Only in one instance the fees charged was about \$500,000 as this assignment involved quantification of losses and assessment of internal control deficiencies.

		As indicated from the analysis, the SFC did not have any preference or bias towards any particular accounting firm. In evaluating whether an accounting firm was acceptable for undertaking any review assignment, the SFC would consider factors such as the independence of accountant, complexity of the engagement, the experiences of the engagement partner and staff, and the track record of the firm in past reviews of a similar nature.
Item 26	Case findings/ market views	The industry considered it essential to define clearly the scope of audit, which should be made known to the licensed corporation concerned so as to facilitate the corporation's assessment on the reasonableness of cost estimates provided by the audit firm. The industry suggested that the SFC should hold discussions with the licensed corporation concerned in determining the scope of audit.
	PRP recommendations /observations	The PRP invited the SFC to comment on the suggestion.
	Response from SFC	Under the standard procedures of the Intermediaries Supervision Department of SFC, the auditor would invariably be required to prepare an engagement letter setting out, among others, the objectives and scope of work and procedures for the engagement. The licensed corporation concerned would be given a reasonable opportunity to comment on the proposed objectives and scope. The amount of particulars given in respect of the detailed review steps depends on the particular circumstances of each case. Where it might jeopardise the investigation, disclosure in the engagement letter would by necessity be kept to a minimum.

(K) Communication with the industry

Item 27	Case findings/ market views	The industry noted that there were a lot of new practices and requirements arising from the implementation of the SFO. The SFC had been conducting seminars on these new activities and requirements. Nevertheless, the industry saw the need for improving education for industry participants on these new practices and requirements and suggested that the SFC should consider how this could be done. For instance, the SFC might consider uploading the video of the seminars on the SFC website.
	PRP recommendations /observations	The PRP considered that the SFC should be invited to respond to the suggestion.

	Response from SFC	To improve the industry's awareness of the new provisions of the SFO, the SFC jointly held, with three brokers associations and the Hon. Henry Wu's office, two seminars on 23 November and 14 December 2002. In addition, the SFC conducted 2 large-scaled open seminars in January 2003, 6 technical workshops in February and March 2003 and open Q & A sessions on Intermediaries Supervision (IS) and Licensing matters in March and April 2003.
Item 28	Case findings/ market views	Under the new licensing regime to be implemented under the SFO, there are different competence requirements for the performance of different regulated activities. The industry pointed out that it was not clear as to what specific qualifications and experiences were required for a person to be qualified for licensing for the regulated activities. The industry suggested that the SFC should consider promulgating clearly the qualification requirements for each regulated activity for the reference of the industry participants.
	PRP recommendations /observations	The PRP invited the SFC to comment on the suggestion.
	Response from SFC	The Licensing Department of the SFC had released 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. The Guidelines included competence requirements for each regulated activity.
Item 29	Case findings/ market views	The PRP and the industry opined that there should be closer communication between the SFC and the industry and a mechanism for regular exchange of views between them on market and regulatory issues.
	PRP recommendations /observations	The PRP invited the SFC to comment on the suggestion.
	Response from SFC	In response to the request of the industry to enhance communication between the SFC and the industry, in particular, the small and local brokers, the SFC suggested conducting monthly discussion forums with representatives of the industry. The SFC started to organise such forums since November 2002. The forums provided opportunities for the SFC to exchange views on market and regulatory issues with the industry.

Recommendations that have not been accepted by the SFC

(A) Inspection of intermediaries

Item 1	Case findings/ market views	The PRP noted that five routine inspections were prolonged. In these inspections, the SFC issued a Letter of Deficiencies, which summarised the inspection findings, to the inspected intermediaries several months (i.e. ranging from seven to nine months) after completion of inspection fieldwork.
	PRP recommendations /observations	The PRP recommended that the SFC consider the feasibility of setting out a performance pledge for conducting routine inspections.
	Response from SFC	<p>Although the SFC aimed to complete each inspection within as short a time frame as was reasonable in the circumstances, it might not be practicable at this stage to introduce a performance pledge policy on routine inspection as any one or a combination of the uncontrollable factors below could delay the completion of an inspection:</p> <ul style="list-style-type: none"> • The size and the complexity of operations between different intermediaries varied to a high degree. • The degree of co-operation from the registrants affected the inspection process and its completion time. • Greater effort was spent to review poor quality records and books kept by intermediaries. • Any follow-up and/or referral action requiring co-ordination with other parties (e.g. Enforcement Department, ICAC, Police, etc) needed a longer time frame to allow the various parties to work out a co-ordinated action plan.
Item 2	Case findings/ market views	In some of the inspection cases, the intermediary did not submit information/documents to the SFC promptly.
	PRP recommendations /observations	In order to expedite the inspection process, the PRP recommended that the SFC consider the need for advising the intermediaries to keep on hand essential information which would be required for an inspection.
	Response from SFC	Planning usually took place three to four weeks in advance for each inspection. During the planning stage, a Document Request List was prepared and sent to the intermediary not less than seven days in advance in accordance with the standard procedure. Each Document Request List clearly specified the essential information needed by the inspection staff, and each list was prepared after due consideration was given to the inspection target's business focus, size, and the extent of coverage required for the inspection.

		<p>While additional documents or detailed evidence (e.g. deal tickets, daily vouchers) might be required by SFC staff during the course of the inspection to further ascertain or clarify certain issues, such documents or records would have been kept and retained by an intermediary in accordance with the relevant legislation, rules or regulations applicable to the intermediary in the conduct of the business for which it was registered with the SFC. Some intermediaries were less cooperative and failed to provide the requested information on a timely and/or organized manner, despite the SFC's utmost effort in giving prior notice to the intermediaries and the necessary materials/information should be readily available.</p>
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(B) Authorization of collective investment schemes

Item 3	Case findings/ market views	<p>In one of the cases, the Manager of the SFC submitted an application for authorisation of a collective investment scheme to the Senior Director for approval pending provision by the applicant of an Explanatory Memorandum (EM) in Chinese and an executed Trust Deed. Upon receiving the EM in Chinese, the Manager submitted the application to the Senior Director for approval again, pending provision of the executed Trust Deed by the applicant. The PRP considered that it might be more desirable for the approving authority to consider an application when all the essential documents were available.</p>
	PRP recommendations /observations	<p>The PRP recommended that the SFC consider whether it would be practicable for a subject officer to submit an application to the approving authority only when all the essential documents are available.</p>
	Response from SFC	<p>The SFC welcomed the proposal in principle. However, on a practical level, the SFC observed that it would be necessary in cases where multi-parties or overseas parties were involved to allow for conditional approval or advance clearance so as to facilitate the market practitioners to prepare their documentation or to effect Chinese translation. The current practice of granting a conditional approval that subject only to the formality executing the Trust Deed was widely welcomed by the market and their advisers as this would avoid bureaucratic burden.</p> <p>In the particular case reviewed, the second submission to the approving authority was to seek authorisation of the product subject to only one outstanding matter: the execution of the Trust Deed. This step was also considered necessary not to delay the applicant in making the necessary arrangements for launching the product and to avoid administrative hassles.</p>

(C) Approval of prospectuses

Item 4	Case findings/ market views	Amongst the cases on vetting and approving of prospectuses which were reviewed by the PRP, the one with the longest processing time took four months to complete because it involved a financial product which had not been processed by the SFC before. The SFC had to be cautious in handling the case. The PRP also noted that a large amount of correspondence was exchanged between the SFC and the prospectus issuer in this case because the first draft of the prospectus required further information and clarifications from the applicant; frequent and extensive revisions on the documentation were made; and not all the essential information/documents were submitted to the SFC in one lot.
	PRP recommendations /observations	To expedite the processing of applications in particular those from new issuers, the PRP recommended that the SFC consider the feasibility of setting out some guidelines on the drafting of prospectuses for reference by issuers.
	Response from SFC	<p>The SFC had not issued guidelines that related to prospectus drafting for a number of reasons including the following:</p> <ul style="list-style-type: none"> (a) It was a normal practice for issuers' professional advisers, namely, investment bankers or lawyers, to draft prospectuses and for the regulator to comment on them. The advisers had access to numerous precedents as drafting aids. (b) The listing rules and the CO dealt with the persons who had responsibility for the contents of a prospectus. The CO imposed civil and criminal liability on the directors of the issuer and others who had authorised the issue of the document. The SFC considered it not desirable to do anything that might suggest that responsibility for the prospectus and its contents was not in the hands of the issuer and its advisers. (c) Issuers and their advisers appreciated that a prospectus must comply with the contents requirements in the Third Schedule to the CO in particular paragraph 3 of that Schedule. That paragraph required the prospectus to include sufficient information to enable a reasonable person to form a valid and justifiable opinion of the shares or debentures and the financial condition of the company. The SFC as a regulator was neither well placed to make a determination on these matters nor to provide guidance on what any particular prospectus should say. Moreover, every case was different, and given the wide range of companies that might wish to make an offering, and the wide range of prospectuses that might be appropriate, it would not be possible to provide any useful guidance on what prospectuses should contain. (d) When preparing a prospectus, issuers and their advisers were already required to ensure that simple language was used in documents to enable investors to have a clear understanding of what was said.

		In light of the above, the SFC considered it inappropriate at this stage to put in place guidelines relating to prospectus drafting. However, the SFC would keep this matter under review.
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(D) Handling of complaint cases by the Corporate Finance Division

Item 5	Case findings/ market views	In a complaint case handled by the CFD, the final reply was issued to the complainant almost six months after an interim reply had been issued. During this period, the complainant was not informed of the progress of the case. Although the SFC was precluded from disclosing details of an investigation by the secrecy provisions contained in Section 59 of the SFCO, there should be scope for more frequent communication with the complainant as in the present case.
	PRP recommendations /observations	The PRP recommended that for complaint cases which could not be concluded within a short period of time, the CFD should give an interim reply to the complainant at regular intervals so that the complainant could be assured that his complaint was being taken care of by the SFC. The time intervals for issuing interim replies should be determined by the SFC.
	Response from SFC	The CFD was conscious of the highly time consuming nature of complaint driven inquiries and investigations that often involve case officers (who were at the same time working on 'live' transactions) conducting interviews of relevant parties and obtaining and analysing financial data such as bank statements and trading accounts. The CFD was concerned that interim replies, in reality, would disclose very little because of the constraints of the secrecy provisions of Section 59 of the SFCO. Given this, the CFD agreed to issuing a more detailed first response letter to all complainants explaining that investigations tended to take a long time, that Section 59 of the SFCO precluded the CFD from disclosing details of the investigation and that the CFD would communicate with the complainant again once the investigation is completed.