Process Review Panel
for the
Securities and Futures Commission

Annual Report
to the Financial Secretary

For 2004

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Chapter 1 General Information

Background and purpose of the Process Review Panel

1.1 The Process Review Panel for the Securities and Futures Commission ("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.

1.3 In the course of reforming the regulatory regime for the securities and futures market in 1999, the regulatees pointed out to the Administration that the checks and balances set out in paragraph 1.2 above 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 compromising 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 to 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 strengthen 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.

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

Constitution of the PRP and Working Groups

1.11 As at 31 December 2004, 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 action, takeovers and mergers transactions and prospectus-related matters.

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

Chapter 2 Work of the PRP in 2004

Highlights of work

2.1 This report covers the work of the PRP from 1 January 2004 to 31 December 2004.

2.2 In 2004, the PRP reviewed 47 completed cases to verify that the action taken and decisions made are consistent with the relevant internal procedures and operational guidelines. The case review included the following areas –

(a) licensing of intermediaries;

(b) inspection of and prudential visit to intermediaries;

(c) authorisation of collective investment schemes;

(d) handling of complaints;

(e) investigation and disciplinary action; and

(f) processing of listing applications under the Dual Filing regime.

2.3 The PRP also examined the SFC's procedures in respect of the following areas to see if there was any room for streamlining and improvement –

(a) hearing and appellate process relating to the issue of warning letters;

(b) settlement of disciplinary action; and

(c) verbal request for information concerning the clients of securities firms.

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 a month. The Working Groups then selected individual cases from these monthly reports for review with a view to covering cases of different nature and length of processing time. Apart from checking the file records against the standard procedures laid down in the operational manuals,

the Working Groups 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 twice in 2004. At the meetings, the PRP discussed specific issues relating to the SFC's internal procedures and commented on, and endorsed, reports submitted by the two Working Groups which contained observations and recommendations from the review of cases.

2.7 The two Working Groups reviewed a total of 47 cases, which encompassed various areas of the SFC's work.

Table 1 – Breakdown of cases reviewed by the PRP

	No. of Cases
Licensing	7
Intermediaries supervision *(6 inspections; 3 prudential visits)*	9
Investment products	7
Complaints *(7 against intermediaries; 3 against listed companies)*	10
Enforcement	7
Corporate finance	7
Total	*47*

Engagement with the industry

2.8 The PRP attaches great importance to views from all users of the market on issues within its terms of reference. The PRP received comments from the relevant industry associations and trade bodies on the internal operational procedures of the SFC, in particular regarding the procedures in relation to the issue of warning letters and settlement of disciplinary action. The PRP also followed up on issues raised by firms which have dealings in the securities and futures industry.

2.9 The PRP welcomes public views on the SFC's operational procedures which fall within the PRP's terms of reference[1]. Suggestions and comments can be referred to the PRP Secretariat by post. (Address: Secretariat of the Process Review Panel for the Securities and Futures Commission, 18th Floor, Tower 1, Admiralty Centre, 18 Harcourt Road, Admiralty, Hong Kong) or by email (Email address: prp@fstb.gov.hk)

[1] The PRP reviews completed or discontinued cases of the SFC in order to assess whether the SFC has followed its internal procedures in handling the cases. Enquiries or complaints relating to non-procedural matters should be made to the SFC. Complaints may be made to the SFC –

By post to : 8th Floor, Chater House, 8 Connaught Road, Central, Hong Kong
By telephone to : (852) 2840 9333
By fax to : (852) 2524 3718
By email to : investor.info@sfc.hk

Chapter 3 Observations and recommendations arising from the review of completed cases

3.1 From the 47 cases reviewed in the period covered by this report, the PRP concluded that the SFC had generally followed its internal procedures in handling those cases. Yet there were certain areas where the PRP had made recommendations to the SFC for improvement. Where the SFC had difficulties in adopting a recommendation, detailed explanations were given. The observations and recommendations are summarised below. Details of the SFC's response to the recommendations accepted are at **Annex C**. Their response to the recommendations that have not been accepted in full is at **Annex D.**

(A) Licensing of intermediaries

3.2 The PRP reviewed seven cases on licensing of intermediaries. The PRP noted that the SFC had generally followed the standard procedures in processing these cases. The longer processing time in certain cases was mainly attributable to the longer time taken by the applicants in providing information and documents to the SFC, or in fulfilling the licensing requirements.

3.3 These cases included two migration applications[2]. The PRP noted that the SFC did not process these two cases immediately upon receipt. The SFC explained that since the licensing status of a migration applicant would be secured as long as the application was submitted within the two-year transitional period from commencement of the Securities and Futures Ordinance ("SFO") on 1 April 2003, the SFC had accorded priority to other more time-critical licensing tasks. Nevertheless, if a migration application involved a change in employer or regulated activities, it would be processed promptly. The SFC had set up a task force in September 2004 to clear the backlog and speed up the processing of migration applications.

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[2] A person or a corporation which was registered with the SFC immediately before commencement of the SFO on 1 April 2003 is deemed to be licensed under the SFO within the two-year transitional period starting from 1 April 2003. If they wish to remain licensed after this period, they are required to submit an application to the SFC for a new licence under the SFO within the two-year transitional period. These applications are known as "migration applications".

(B) Inspection of and prudential visit to intermediaries[3]

3.4 The PRP reviewed six cases on inspection and three cases on prudential visit. The PRP noted that the SFC had generally followed the standard procedures in processing these cases. The long processing time in these cases was attributable to the time taken on the part of the intermediaries concerned to rectify deficiencies identified during the inspections or the visits.

3.5 In one case, the SFC conducted an **inspection** of a subsidiary and in parallel, a **prudential visit** to another subsidiary of the same group of companies. The PRP considered that for small and medium sized firms, subsidiaries of the same group very often share resources. The activities of a subsidiary might have bearing on the operation and risk profile of other companies in the same group. The PRP therefore believed that the SFC should conduct either inspection of or prudential visit to the two related companies in one go. This approach would enable the SFC to form a global view on the operation of the group as a whole.

3.6 The SFC explained that it adopted a risk-based approach in the selection of intermediaries for inspection or prudential visit. Whether inspection and/or prudential visit should be conducted on a single entity or on a group basis depended very much on the risk profile of the group and the specific circumstances of each case. For the case in point, the SFC noticed that the first company had not carried out any advisory activity for a period of time and only provided research support to other companies in the same group. Having regard to the limited market impact, the SFC decided that a **prudential visit** instead of an inspection would be more appropriate for this company. On the other hand, another company in the same group was selected for **inspection** having regard to its active involvement in the securities business. Nevertheless, the SFC would generally take the PRP's recommendation into account in its risk-based approach to the selection of intermediaries for inspection or prudential visit.

(C) Authorisation of collective investment schemes

3.7 The PRP reviewed seven cases on authorisation of collective investment schemes. The PRP noted that the SFC had generally followed the standard procedures in processing these cases. The longer processing time in these cases was attributable to the time taken on the part of the applicants to

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[3] The SFC monitors the financial position of intermediaries and supervises their conduct through inspection of or prudential visits to selected intermediaries. The SFC adopts a risk-based approach in selecting intermediaries for inspections or prudential visits. Generally speaking, prudential visits are more appropriate for firms which are considered to have lower financial risks. Prudential visits allow the SFC to gain an overall understanding of the business outlook and future viability of the companies through meetings with the senior management of the companies. Inspection involves on-site examination of the books and records of the firms and allows the SFC to examine the firm's compliance with legislation and rules, and evaluate the firm's financial position and internal control procedures. Inspection also acts as a deterrent against intermediaries undertaking dubious or illegal practices.

respond to the SFC's enquiries and requests for information. Notwithstanding, it was noted that, in one case, the SFC was heavily involved in the vetting of draft documents submitted by the applicant. This resulted in an unduly long processing time and consumed a significant amount of the SFC's resources. In view of the fact that it was the applicant's responsibility to prepare good quality documents for consideration by the regulator, the PRP invited the SFC to study its procedures to see if they could be further streamlined with a view to alleviating its workload in this area.

3.8 The SFC noted the PRP's comments and had reviewed its procedures. The SFC also pointed out that for this particular case, the applicant was an overseas company and its Hong Kong representative was not very familiar with the SFC's requirements in respect of collective investment schemes. Upon review, the SFC found that the practice of copying correspondences between the SFC and the designated local representative to the overseas applicant in appropriate cases would generally speed up the vetting process. The SFC would formalise this practice and amend its procedural manual accordingly.

(D) Handling of complaints

3.9 The PRP reviewed a total of ten complaint cases, of which seven were against intermediaries and three were against listed companies on listing and takeovers matters. In one of the cases, an investor lodged a verbal complaint against a securities company for the mishandling of transactions. To investigate into the complaint, the subject officer of the SFC tried to contact a director of the company to obtain the relevant information. Despite repeated telephone calls, the SFC officer could not get in touch with the director. The PRP found that as the SFC officer had not resorted to other means of communication, there was no progress made to this complaint for a month. The PRP believed that the SFC should consider making it a standard arrangement that such requests for information from intermediaries should be made in writing as far as possible. The SFC agreed to the suggestion and had reminded its staff that where contact by phone was considered appropriate but the individual concerned could not be reached, the request should be made in writing. Also, the SFC had required its staff to place a complete trail on file to facilitate follow-up action by the subject officer or his successor, in case the officer has been transferred or resigned.

3.10 In another complaint lodged by a company against a listed company for breaching the Takeovers Code, the SFC considered it necessary to put the matter to the subject of the complaint so as to obtain more information for investigation. To achieve this, the SFC would need to seek the consent from the complainant to copy the complaint letter to the listed company. The PRP noted that the complainant did not reply to the SFC and no progress was made in respect of this complaint for a month. The PRP considered that the processing of the

complaint could have been expedited had the SFC given the complainant a deadline to respond to the SFC's request for consent. The SFC explained that before deciding whether to take a complaint further, it would consider whether it was appropriate to put the matter to the subject of the complaint. The critical factor was whether copying the complaint to the subject of the complaint and inviting the latter's views would enable the SFC to have a better understanding so as to address the complaint more fully and accurately. Depending on the circumstances, the SFC might copy the complaint letter or provide a summary of the complaint to the subject of the complaint. If it appeared that the identity of the complainant would be disclosed as a result, the SFC would seek the consent from the complainant for such disclosure. The SFC agreed to the PRP's suggestion of giving a deadline for the complainant to respond to the SFC's request for consent. If the complainant did not reply by the deadline, it would be taken as a refusal to give the consent. The procedural manual on the handling of complaints has been amended accordingly.

(E) Investigation and disciplinary action

3.11 The PRP reviewed seven cases on investigation and disciplinary action. These included three cases relating to issue of warning letters and two on the settlement of disciplinary action. Details about the PRP's observations and recommendations in relation to the hearing and appellate process applicable to the issue of warning letters and the procedures for entering into settlement agreements can be found in paragraphs 4.4 to 4.30 in Chapter 4.

Warning letters

3.12 In one of the cases reviewed, the PRP noticed that the SFC issued warning letters to two persons and asked them to sign on a copy of the letter for return to the SFC. The two persons did not follow the request and the SFC had not taken any follow-up action. The PRP invited the SFC to consider whether the practice to request for a signed copy of the warning letter should continue in view of the enforcement difficulties. The SFC explained that previous misconduct leading to the issue of a warning letter was an aggravating factor in considering disciplinary action, in particular when the persons concerned had been warned for similar misconduct in the past. Requiring the person to sign and return a duplicate of the warning letter served to prove that the person had notice of the warning. Since most regulatees did co-operate and comply with the request, and that such practice imposed few costs on the industry, the SFC considered that the practice had merit and hence should continue.

Advice letters

3.13 In another two cases, the SFC issued a reminder letter to a licensed person and a letter of advice to a licensed corporation on compliance issues. As reminder letters and letters of advice were not covered in the procedural manual of the SFC, the circumstances leading to the issue of these letters were not clear. The PRP invited the SFC to advise on the nature of reminder letters and letters of advice, and the circumstances that warrant the issue of these letters vis-à-vis warning letters. The PRP also invited the SFC to consider setting out the procedures for the issue of reminder letters and letters of advice in the procedural manual to ensure consistency in application.

3.14 The SFC explained that a reminder letter (more typically called a letter of advice) was issued in less serious circumstances. A warning letter was issued when the SFC believed that there had been conduct that technically could warrant formal disciplinary action, but decided, given the circumstances, that it would not take formal disciplinary action, but would issue a warning letter instead. A letter of advice was issued when the SFC believed that there were no conduct issues that warrant formal disciplinary action, but the SFC believed that a person might need advice (or a reminder) about their regulatory or compliance responsibilities. In the light of the comments from the PRP, the SFC agreed to adopt the following recommendations and the procedural manual has been amended accordingly –

(a) standardise the names of reminder letters and letters of advice by grouping them as "advice letters" to avoid confusion;

(b) remind its staff of the circumstances leading to the issue of an "advice letter" as opposed to a warning letter ;

(c) standardise the authority for issue of an advice letter (and a warning letter) at the rank of Director or above; and

(d) conduct checking on precedent cases before recommending or making a decision on the issue of a warning letter or an advice letter to ensure consistency.

Suspected criminal offence

3.15 The PRP noted that there was inconsistency in the handling of suspected criminal offence in two cases. In one case, a suspected forgery was referred to the Legal Services Division for internal legal advice and then to the Police for follow-up action. In another case, no follow-up action was taken despite a reference to "forged" in the case file. The PRP invited the SFC to

consider setting out rules on the handling of suspected criminal offence in order to achieve consistency in application.

3.16 The SFC clarified that there was in fact no forgery in the second case and the word "forged" which appeared in the case file was not used accurately. Therefore the two cases were different and the question of inconsistency in the handling of suspected criminal offence did not arise. Nevertheless, the SFC accepted that the deliberation and decision on whether an activity should be classified as a suspected criminal offence should be clearly documented, and had reminded its staff that the file record must be accurate.

(F) Processing of listing applications under the Dual Filing regime

3.17 The Securities and Futures (Stock Market Listing) Rules ("the Rules") require a corporation applying for listing of its shares to file copies of its listing application to the SFC after the same is submitted to a recognised exchange company. To facilitate compliance and minimise any additional cost to a listing applicant, the Rules enable the applicant to fulfil this obligation by authorising the exchange company to file the material with the SFC on its behalf. The arrangement is known as "Dual Filing".

3.18 Section 6 of the Rules stipulates that the SFC may, within ten business days of an applicant filing an application for listing or supplying further information, require the applicant to supply further information, or object to the listing under certain circumstances. In 2003, the PRP noted from case reviews that there was delay in the passing of listing applications and related documents from the Hong Kong Exchanges and Clearing Limited ("HKEx") to the SFC and commented that such delay might jeopardise the SFC's ability to follow the ten-day deadline set out in the Rules. In the light of the PRP's comment, the SFC reached agreement with the HKEx in early 2004 that listing applications and related documents should be passed to the SFC within ten business days.

3.19 The PRP reviewed a total of seven cases relating to the processing of listing applications under the Dual Filing regime. The PRP noted that in these cases, the SFC received the listing applications and relevant documents from the HKEx within ten business days. The PRP also noted that the SFC provided its comments on the disclosure aspects of these applications within two weeks upon receipt of the documents from the HKEx. The PRP had not identified any procedural irregularities in these cases.

Chapter 4 Observations and recommendations arising from the review of specific subjects

4.1 The PRP examined specific areas of the SFC's procedures as detailed in this chapter. The aim was to identify areas for improvement with a view to reducing unnecessary compliance burden 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 to the SFC's procedures. Where appropriate, the PRP would refer the industry's proposals to the SFC for consideration and response. The issues that the PRP has discussed are –

(a) the lack of fair hearing prior to the issue of warning letters and the absence of proper appeal channels following the issue of these letters; and

(b) settlement of disciplinary action.

4.3 The PRP's discussions and views on these issues are summarised below. Details of the SFC's response to the recommendations accepted are at **Annex C**. Their response to the recommendations that have not been accepted in full is at **Annex D**.

(A) Hearing and appellate process relating to the issue of warning letters

4.4 The PRP noted that although the issue of a warning letter was not a formal or statutory disciplinary sanction, it could be taken as a stigma and could impose adverse impact on a licensee's career prospect because most employers would make reference to a job applicant's compliance history. Unlike formal disciplinary action for which statutory appeal channels (such as application to the Securities and Futures Appeals Tribunal ("SFAT") for a review of the SFC's decisions) are available, there is at present no proper channel for an aggrieved person to appeal against the SFC's decision to issue a warning letter.

4.5 It transpired from a case that the SFC had not communicated with the regulated person prior to issue of a warning letter. Therefore, the regulated person did not have the opportunity to challenge the factual issues and to comment on the allegations. Upon enquiries with the SFC, the PRP was advised that warning letters might be issued after the completion of formal disciplinary process where it was decided that no statutory sanction would be imposed i.e. where there was

conduct of concern which warranted a warning only. Warning letters might also be issued without the commencement of a formal disciplinary process. In the latter case, the issue of a warning letter was meant to be an alternative to a formal disciplinary process. Its purpose was to advise a regulatee of his compliance failings in an informal manner. This allowed the SFC to give the regulatees a second chance to improve its conduct or compliance and, for a corporation, to improve its management system. Warning letters also enabled the SFC to keep an internal record of the regulatees' compliance history and would probably be used as an aggravating factor in case the person committed the same or similar misconduct in future. The response or representation made by the person concerned would only be kept on file for internal reference.

4.6 The PRP noted that in cases where the warning letters were issued after the completion of the formal disciplinary process, any representation made by the regulated person during the formal disciplinary process would have been considered prior to the issue of the warning letters.

4.7 On the other hand, in cases where the warning letters were issued as an alternative to a formal disciplinary process, the PRP considered that the procedures should be improved to ensure procedural fairness. In this context, the PRP invited the SFC to consider the following recommendations –

(a) the recommendation for issuing a warning letter should be reviewed and endorsed by an officer not involved in investigation to ensure an independent review of the decision, thereby strengthening the checks and balances; and

(b) representation made by the person concerned should be considered and, if justified, the warning letter should be withdrawn.

4.8 On the recommendation in paragraph 4.7(a) above, the SFC considered that there was already segregation of the investigation function and the decision-making function as far as the issue of warning letters was concerned. The decision-making process usually involved at least two levels of officers within or outside the respective units of the Enforcement Division. The Investigation Department and the Surveillance Department issued warning letters for misconduct that did not warrant formal disciplinary process, or for simple factual and technical issues such as late submission of returns on disclosure of interests which provided limited scope for dispute. For these warning letters, the recommendations were made by the case officer and approved by the decision maker who was only remotely involved in the investigation. Having regard to the informal nature of warning letters, the SFC did not consider it appropriate to

complicate the process.

4.9 Regarding the recommendation in paragraph 4.7(b) above, the SFC agreed that in case a response to a warning letter could convince the SFC that the warning letter was not warranted, the SFC would withdraw the warning letter and notify the person concerned of the decision.

4.10 To address the need to provide an avenue for appeal against the SFC's decision to issue warning letters, it was proposed that a standard statement be included in the warning letter to draw the attention of the persons concerned of their right to make representation. The proposed statement is as follow –

> "If you wish to respond to this warning letter, we will keep a copy of your response together with the warning letter on the relevant files, so that your response may be considered together with the warning letter in deciding on any possible future use of the warning letter."

4.11 After thorough consideration, the PRP concluded that inclusion of the proposed statement in warning letters could not adequately address the concern of the industry for a proper appellate process, and might even give the wrong impression that the SFC issued the warning letters without thorough deliberation. The SFC explained that warning letters were issued after lengthy and thorough investigations in which explanations were often sought during investigatory interviews from the recipient of a future warning letter about their conduct or, alternatively, warning letters were issued if the conduct in question was open and shut since the facts of the breach speak for themselves, such as late submission of a disclosure of interests in a listed company return. The SFC would therefore not agree that the inclusion of the statement might give the wrong impression that warning letters are issued without sufficient deliberation. Any due process in relation to a regulatory action must be proportionate to the impact of the action and warnings are private[4] and have no immediate effect, so the SFC believed an after the event ability to respond was sufficient.

4.12 The PRP, however, maintained the view that the industry's concern should be addressed by providing an opportunity for the person to give a response **prior to** the issue of the warning letter. On this basis, the PRP recommended that, for warnings to be issued without going through formal disciplinary procedures, the SFC should –

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[4] For background, reader may wish to note that section 194(1)(b)(iii) of the SFO provides that the SFC may impose a range of statutory sanctions on regulated persons, including **public** reprimand or **private** reprimand. The SFC's decisions to impose these sanctions are appeallable to the SFAT.

(a) inform the person concerned of the intention to issue a warning letter before the letter is actually issued. The notice should cover –

   (i) the factual issues upon which the SFC relied on for the issue of the warning letter;

   (ii) a deadline for a response or representation, e.g. a 14-day period which is in line with the practices of other professional organisations and was considered reasonable; and

   (iii) a statement that the SFC might, upon consideration of responses of the person concerned, confirm or set aside the decision for the issue of a warning letter, or substitute it with other disciplinary action. This was to prevent possible abuse by the person concerned who might give a response as a matter of course. This proposed arrangement should to a certain extent address the problem associated with the potential burden on the SFC brought about by this proposal.

(b) make it a standard requirement that the representation/response made should be reviewed by a senior officer who was not involved in the investigation and in making the decision regarding the issue of the warning letter. This requirement could provide a check and balance on the SFC's decisions to issue warning letters, thereby ensuring the fairness of the process.

4.13 The SFC had difficulties with the above recommendations since it would impose substantial burden on the SFC, having regard to the large number of warning letters issued in a year which amounted to 273 in the fiscal year 2004-05, compared with the nearly 200 disciplinary action and criminal prosecutions during the same period. The SFC believed that due process measures should be proportionate to the outcome of an action in order to balance regulatory effectiveness with due process. The proposed measures were disproportionate to a warning that had no immediate consequences and was private. The SFC advised that they issued warning letters only if they believed that there were grounds for formal disciplinary procedures or action. A warning was issued to send a message to the regulatee that they should change their behaviour or they might face disciplinary action in future, and that the disciplinary action would be more severe as they should know the consequences

of their action. The alternative to the issue of warning letters would be formal disciplinary process which in many cases could lead to reprimands and/or fines. These sanctions could be much more damaging to the regulatees, both in terms of the outcome and the time spent in the process. The beneficiaries of a warning system were the recipients of the warning letters, who benefited from a private warning to change their behaviour to avoid possible future enforcement action and also avoided harsher public punishment, and the public, who would gain indirectly from the more efficient use of public resources. The SFC considered that the procedures recommended by the PRP were akin to the formal disciplinary process and noted that, in its experience, the measure proposed in paragraph 4.12(a)(iii) was unlikely to deter unmeritorious dispute of a warning letter. The SFC considered their implementation would reduce the cost/benefit differences between the issue of warning letters and formal disciplinary process, and would as a result weaken the justification for the issue of warning letters in some cases. It was likely that the SFC would contemplate more formal disciplinary process for cases which could have been dealt with by issuing warning letters. This meant that either those who would have received a warning letter would face formal disciplinary action and public sanctions, or that some cases would have to be written off due to lack of resources to pursue them.

4.14 The PRP noted the response from the SFC and will continue to discuss with the SFC to see if the existing procedures could be improved to provide a regulatee with an opportunity of being heard before the issue of a warning letter, and a channel for an aggrieved person to appeal against the SFC's decision to issue a warning letter.

(B) Settlement of disciplinary action

4.15 The PRP noted a comment from the industry that licensees who were subjects of disciplinary action could in effect "buy" themselves out from liability if they could afford to make a payment. In response to the industry's concern, the PRP reviewed two cases on settlement.

4.16 In one case, following formal disciplinary process, the SFC decided to suspend a person's licence for six months. The licensee filed an application to the SFAT and was granted leave to apply for judicial review against the SFC's decision. In parallel, the licensee offered to settle with the SFC by way of payment. The SFC subsequently entered into a settlement agreement with the licensee who, on a "no admission" basis, made a payment to the SFC and in return, withdrew his application to the SFAT and the application for judicial review. The payment had to be paid by the licensee himself without recourse to others under the settlement terms.

4.17 In another case, the SFC decided to suspend the licences of a supervisor and his subordinate for six months and three months respectively. The SFC subsequently entered into a settlement agreement with the supervisor and accepted payment in lieu of the suspension. The level of payment was determined on the basis of the economic effect on the person had there been a suspension of licence. No settlement agreement was made with the subordinate whose licence was suspended for three months. That person did not approach the SFC for settlement.

4.18 Upon enquiries from the PRP, the SFC explained that –

(a) The SFC considered that settlement was an integral part of the regulatory process. The SFAT and judicial review proceedings, if proceeded with, would invariably consume a considerable amount of time and resources of the SFC, which would otherwise have expended on pursuing other SFC investigations and enforcement action. By entering into a settlement agreement, the regulator might apply its resources more efficiently. It could relieve the regulator of the uncertainties inherent in the outcome of any litigation. From the industry's angle, a settlement expedited the conclusion of the enforcement process and the management could then concentrate its efforts on moving ahead with its business.

(b) Settlement by payment in lieu of suspension was in line with the purpose of introducing fines as a disciplinary option under the SFO that took effect on 1 April 2003. The purpose of introducing fines was to bridge the gap where a reprimand was too light a penalty and a suspension might be too harsh in the circumstances.

(c) On the reasons why settlement was made with the supervisor but not the subordinate in the second case, the SFC explained that the subordinate did not approach the SFC for settlement. The SFC considered it a cardinal principle of settlement that settlement negotiations should be initiated by the person proposed to be disciplined unless the circumstances were exceptional. It was not appropriate for a regulator to actively solicit settlement as it would call into question the credibility of the regulator and any payment it sought.

(d) Payment in lieu of disciplinary penalty was not appropriate in cases where –

(i) the misconduct involved dishonesty;

(ii) there was real likelihood that the individual concerned would repeat the similar misconduct; and

(iii) the misconduct was so serious that an immediate removal of the individual from the industry was necessary because his existence would endanger investor interest and market integrity.

4.19 In response to the SFC's advice set out above, the PRP has made several observations and recommendations to the SFC. They are summarised in the following paragraphs –

<u>Recommendations that are accepted</u>

4.20 The PRP considered that a payment in lieu of a suspension of licence meant that the person could stay in the industry without interruption despite his wrongdoing. In drawing up the terms of the settlement, the SFC should consider requiring the licensee or the company to carry out improvement measures as one of the terms of the settlement in order to uphold the industry standards and to protect investor interest. The SFC agreed to adopt the recommendation and clarified that there were cases where the firm was required under the terms of the settlement to undergo a compliance review by independent accountants and to implement the changes recommended by the accountants.

4.21 The PRP considered that since a settlement could be made on a "no admission" basis, the compliance record of the licensee would remain intact. This would prevent the Licensing Department of the SFC from taking into consideration the factual issues that led to the original decision to impose disciplinary sanctions when processing the licensee's future application for registration as a responsible officer. The SFC agreed that the Enforcement Division should consult other divisions where a proposed settlement would have apparent effects on the operation of the relevant divisions. The SFC also noted that the Enforcement Division had consulted the Licensing Department in the case under review.

4.22 The PRP noted that the deliberation of and rationale for going into a settlement were not documented in one of the cases reviewed. In response, the SFC agreed and undertook to remind its staff to ensure that the reasons for entering into settlement agreements would be recorded sufficiently. However, given that settlement was essentially a pragmatic compromise in the circumstances of a particular case, the details given on the file would often be

relatively brief, except perhaps in complex or sensitive cases when there might be a number of relevant considerations.

4.23 The PRP considered that while it was the SFC's policy to consider settlement only if they were approached, the SFC should introduce measures to ensure that the stakeholders were aware of this avenue. People interested in entering into settlement agreements might have missed the chance simply because they were not aware of this possibility. The SFC advised that it agreed with the recommendation and had already taken measures to inform stakeholders of this possibility. The Enforcement Division issued a pamphlet explaining the disciplinary process, including the possibility of settlement. The pamphlet was distributed with each Letter of Mindedness or Notice of Proposed Disciplinary Action, and was available from the SFC office and its website. The SFC's press releases and monthly Enforcement Reporter distributed to all corporate licensees repeatedly mentioned settlement. The Enforcement Division met each of the key industry body representing licensees in 2004. At each of these meetings, the subject of settlement was discussed. In addition to the above measures, the SFC was willing to issue a circular to corporate licensees to draw to their attention again the pamphlet on the SFC's disciplinary process which explained the possibility of settlement with the SFC. However, the SFC would like to emphasise that the pamphlet was constantly available. For example, the SFC issued the pamphlet in the same envelope with every letter of mindedness or notice of proposed disciplinary action which started formal discipline so everyone whom the SFC proposed to discipline knew, if they read the pamphlet, that the SFC was willing to consider settlement in appropriate circumstances. The SFC had a series of upcoming meetings with industry associations and would mention again the pamphlet and the possibility of settlement for them. The PRP noted the SFC's response and would further discuss with the SFC on the implementation of this recommendation.

4.24 The PRP noted that the amount of a payment was determined solely on the basis of the economic effect of the intended suspension on the person concerned, regardless of the nature or gravity of the suspected misconduct. In other words, the level of payment in different cases could be substantially different even if the nature of the misconduct was the same. It was necessary to introduce more objective benchmarks such as seriousness or gravity of the misconduct in assessing the amount of the payment. Such rules should be formalised and set out in the procedural manual to ensure consistency in application. The SFC advised that it has already accepted and applied the principle that objective benchmarks such as seriousness or gravity of the misconduct should be considered in assessing the amount of the payment. The SFC would like to brief and discuss with the PRP on how that application is formalised. The PRP noted the SFC's response and would further discuss with the

SFC on this issue.

Recommendations that have not been accepted in full

4.25 The PRP has the following observations and suggestions –

(a) There was a fine distinction between a settlement and a fine. A settlement was exercised at the authority's discretion, with mutual agreement from parties concerned and could be made on a "**no admission**" basis. On the other hand, a fine was a **sanction** for a breach of certain licensing requirements or a misconduct, and the findings leading to the penalty would be recorded in the person's compliance history.

(b) There were circumstances where a settlement was not applicable (4.18(d) above). It was advisable for the SFC to elaborate on the details in order to ensure consistency in interpretation and application. It would be useful to include in the guidelines –

(i) examples of misconduct involving dishonesty; and

(ii) elaboration on the difference between a "suspension of licence" and "immediate removal from the industry".

(c) Disciplinary action carried a notion of disapproval of the conduct. Such disapproval was not demonstrated when the sanction was settled by way of a payment.

(d) It transpired from a case reviewed that the Executive Director of Enforcement Division led the negotiation and made the decision on the terms of the settlement, including the level of the payment. The PRP believed that it would be advisable if the decision maker was not involved in the negotiation process to ensure proper checks and balances.

4.26 In response to the observations in paragraph 4.25(a) concerning the distinction between a settlement and a fine, the SFC advised that whether to insist on an outcome with findings of fault or with no admission amounted to a pragmatic compromise in the circumstances which balanced what was offered on settlement with what might be achieved on appeal. It also took into account the resources savings achieved by settling so other cases could be focused on. The SFC was acutely conscious that accepting a without admission settlement was

sometimes a worthwhile compromise. Sometimes it was not. The public could draw their own conclusions from the willingness of the subject of the disciplinary action to pay sometimes substantial amounts of money or agree to other terms. Even if no finding was entered into their compliance record, a cost was imposed on the regulatee's improper conduct and others in the industry who might be tempted to engage in such conduct could see that it had costs. So the regulatory aims of punishment and deterrence were substantially met.

4.27 Regarding the PRP's suggestion that there should be elaboration on the circumstances under which a settlement was not applicable (paragraph 4.25(b) above), the SFC replied that the considerations relevant to whether to settle were broad or very case specific. The SFC did not agree that more specific articulation of the considerations would help because guidelines could only usefully state the most general considerations which were rather obvious. Detailed rules would be too mechanical and inappropriate in this area. Further, specific articulation of such considerations risked turning what was meant to be a procedural manual into a manual for merit based decision making which was not the manual's function. Decisions to settle were made at senior levels in the SFC and often involved discussion among several staff members after considering precedent cases. An element of discretion had to be accommodated and the staff members were sufficiently experienced to be trusted with such discretion. Even if there was only one decision maker, there were often multiple staff members involved in a recommendation.

4.28 Regarding the specific points suggested for elaboration in the guidelines, the SFC's response is as follows –

(i) Examples of misconduct involving dishonesty

Offences under the SFO and the general criminal law varied in nature. Some were very serious (e.g. criminal market misconduct or fraud and deception) and so obviously involved an element of serious criminal intent or dishonesty. Others were directly based on dishonesty (e.g. lying in an SFC interview or to the HKEx in a filing). Others were regulatory and more technical in nature and might involve carelessness more than dishonesty or serious criminal intent. Some offences might vary in character depending on the precise intent of the person committing them. These matters were more easily determined by looking at the conduct in context and with due consideration to previous like cases. The SFC did not agree that guidelines would assist in this regard.

(ii) Difference between a suspension of licence and immediate removal from the industry

The SFC stated that the use of the word "immediate" in its response was perhaps inappropriate. The only point the SFC wished to make was that settling with a payment in lieu of a suspension was not appropriate if a fine would not serve one of the purposes of a suspension i.e. to remove the person in question from the market so as to protect the investing public from the person's misconduct as a licensed intermediary. Suspension under the previous legislation and the SFO serves several purposes: punitive, deterrent and protective (i.e. removing the person from a position where they could cause further damage to the investing public). Under the previous legislation when fines were not available, suspension often had to be imposed in circumstances where a reprimand did not have sufficient punitive or deterrent effect, but there was no need to remove the person from the industry to prevent a chance of further damage to the investing public. Therefore, in some cases it was not necessary to persist with a suspension if a person was willing to settle in appropriate circumstances where the protective purpose was not warranted and the payment proposed bore a substantially equivalent punitive and deterrent effect to the initially proposed suspension.

4.29 Regarding the PRP's observation that the notion of disapproval was not demonstrated when the sanction was settled by way of a payment (paragraph 4.25(c) above), the SFC advised that even if a settlement was without admission, the SFC would issue a press release that publicised its allegations. As such, the SFC's concerns would be made public. The industry and public would know what conduct the SFC disapproved of. The SFC believed that the public could and did draw its own conclusions from the willingness of a person to meet the settlement terms, which could sometimes be quite tough. The SFC would not insist on a person who was the subject of disciplinary action agreeing to settlement terms if it did not disapprove of the conduct. To do otherwise would not be in the public interest and would be an abuse of process. The SFC believed that the public and industry were aware of this and would draw appropriate conclusions that the SFC disapproved of the conduct in relation to which it settled. Whether to settle with or without admission was an element of what amounted to a pragmatic compromise. The SFC considered a range of factors in deciding whether it would be in the public interest to enter into a settlement.

4.30 On the PRP's suggestion that the decision maker for settlement should not be involved in the negotiation process to ensure proper checks and balance (paragraph 4.25(d) above), the SFC advised that the Executive Director of the Enforcement Division was usually the decision maker in disciplinary action. The person who was the statutory decision maker for the disciplinary action had to act as the decision maker in a settlement where that settlement imposed another statutory sanction other than those initially proposed. In other cases, the decision to compromise a disciplinary action with non-statutory sanctions under section 201[5] of the SFO should be made by the same person. Ultimately, a settlement negotiator had to report his/her negotiation to the decision maker on the settlement who would decide whether, and if so, on what terms the case should be settled. The person to be disciplined and their lawyers often wanted to deal directly with the decision maker to speed up negotiation. The SFC considered this sensible and it suggested efficiencies in having the decision maker also negotiate on a settlement. A segregation of duties therefore could not be meaningful and would likely be inefficient.

4.31 The PRP noted the response from the SFC and will continue to discuss with the SFC to see how the existing process could be improved to strengthen the checks and balances on its decisions relating to settlement agreements and to ensure consistency and fairness in application.

(C) Verbal request for information concerning the clients of the securities firms

4.32 The PRP received a comment from a securities firm about the SFC's practice of making verbal requests for information without citing the relevant statutory provision under which the SFC might obtain such information. The information requested was usually related to the background of the firm's clients and the transactions conducted by the clients. The firm believed that the SFC should make it clear that provision of such information would be on a voluntary basis, as the firm must observe the obligations of confidentiality and the requirements under the Personal Data (Privacy) Ordinance in providing the requested information. In the light of these comments, the PRP suggested that the SFC should include in its letter a prominent warning message citing the legal risks involved in providing such information on a voluntary basis. That apart, in view of the extensive investigative powers vested with the SFC under the SFO, there were questions whether the SFC required voluntary provision of information.

[5] Section 201(3) of the SFO provides that where at any time the Commission is contemplating exercising any power in respect of a person under section 194(1) or (2), 195(1)(a), (b) or (c), (2) or (7), 196(1) or (2) or 197(1)(a) or (b) or (2), it may, where it considers it appropriate to do so in the interest of the investing public or in the public interest, by agreement with the person, exercise any power the Commission may exercise in respect of the person under Part IX of the SFO (whether or not the same as the power the exercise of which has been contemplated) and take such additional action as it considers appropriate in the circumstances of the case.

4.33 The SFC advised that the situations related to occasions when the Surveillance Department of the SFC sought assistance in order to make an evaluation regarding certain market conduct. The SFC only exercised its investigative powers under the SFO when it had a reasonable cause to believe that it was necessary to do so. In order to ascertain whether a reasonable cause exists, it was necessary to collect basic information. The SFC might collect such information under section 181[6] of the SFO. The SFC assured the PRP that whenever information was requested pursuant to section 181, it would cite that provision clearly its letter of request.

4.34 On the need for voluntary provision of information from securities firms, the SFC explained that the information that it was entitled to demand pursuant to section 181 of the SFO was limited and often insufficient to allow the SFC to form a view. Accordingly, there were occasions where it was necessary for the SFC to request the voluntary provision of information following a formal request made under section 181 of the SFO. It was not unreasonable that a regulator should be entitled to make enquiries in such circumstances as the answers provided usually allayed the regulator's concerns and obviated the need to escalate the enquiry to a full blown investigation. Both the regulator and regulatee would benefit from this approach because a full investigation would require time and resources from both parties.

4.35 The SFC accepted that the provision of such further information would be made on a voluntary basis. The SFC undertook to make this clear, whether such requests were made in writing or verbally. The SFC explained that whenever a matter has been escalated to a formal investigation (e.g. under section 182[7] of the SFO), a demand for information would never be made without quoting the relevant provisions.

(D) Regulatory oversight of the HKEx's performance of listing functions

4.36 The PRP has followed up on a recommendation in the *Consultation Conclusions on Proposals to Enhance the Regulation of Listing* published by the Administration in March 2004 ("Consultation Conclusions on Listing"). The Consultation Conclusions on Listing recommended, among other things, that the SFC prepare and submit annual reports to the Financial Secretary on its audit

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6 Section 181(1) of the SFO provides that an authorised person of the SFC may, for the purpose of enabling or assisting the SFC to perform a function under any of the relevant provisions, require certain persons specified in this section to furnish to him any of the information specified in section 181(2) within the time and in the form specified by him.

7 Section 182(1) of the SFO provides that where the SFC has reasonable cause to believe or has reason to inquire into any of the circumstances set out in section 182(1), the SFC may in writing, direct one or more of its employees or, with the consent of the Financial Secretary, appoint one or more other persons to investigate any of the matters referred to in section 182(1).

reviews on the HKEx's performance of listing functions. To ensure procedural fairness and reasonableness in conducting the audit reviews, it was further recommended that the SFC's regulatory oversight of the HKEx's performance of listing functions, including the conduct of the annual audits, should be a subject of regular review by the PRP. To take forward the recommendation, the PRP made enquiries with the SFC on the framework and methodology of its audit reviews. The SFC advised that the report for the audit review was expected to be finalised for submission to the Financial Secretary by end June 2005. The SFC's work in this area would then be available for review by the PRP. The SFC explained that the audit review could not commence earlier due to other more pressing policy matters at hand.

4.37 The PRP will further discuss with the SFC and will conduct reviews once such cases are available from the SFC.

Chapter 5 Way forward

5.1 In 2004, 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 views on procedural matters.

5.2 For 2005, the PRP will examine, among other things, the SFC's internal procedures for its regulatory oversight of the HKEx's performance of listing functions and the SFC's administration of the Dual Filing system.

5.3 The PRP will also follow up a number of the recommendations made in 2004. These include the SFC's internal procedures on the issue of warning letters to intermediaries and in entering into settlement agreements with persons on whom disciplinary action has been proposed.

5.4 The PRP will continue its work on the review of completed cases to ensure that the SFC follows its internal procedures consistently, and will maintain dialogue with market players affected by the SFC regulatory processes and procedures.

5.5 The PRP will continue to engage the industry to listen to their concerns about the exercise of powers by the SFC, and welcome views from the general public, especially the users of the securities and futures markets, on the performance of functions by the SFC with a view to identifying any areas of improvement to the procedures and processes.

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 their 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 offered useful comments on the possible areas of improvement to the SFC's internal procedures and processes.

Annex A

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.

Annex B

Membership of the Process Review Panel for the Securities and Futures Commission

Chairman:	Mr. CHENG Hoi Chuen, Vincent, JP
Members:	Professor CHAN Yuk Shee, JP *(with effect from 1 November 2004)*
	Mr. CHEONG Ying Chew, Henry
	Mr CHOW Wing Kin, Anthony, SBS, JP *(with effect from 1 November 2004)*
	The Honourable EU Yuet Mee, Audrey, SC, JP *(with effect from 1 November 2004)*
	Mr. FONG Hup
	Mr KAM Pok Man *(with effect from 1 November 2004)*
	Mr. KOTEWALL, Robert George, SBS, SC *(up to 31 October 2004)*
	Mr. KWAN Pak Chung, Edward
	Professor LIU Pak Wai, SBS *(up to 31 October 2004)*
	Mr. PANG Yuk Wing, Joseph, JP
	Mr. Alan Howard SMITH, JP *(up to 31 October 2004)*
Ex-officio members:	Chairman, Securities and Futures Commission (Mr. Andrew L T SHENG, SBS, JP)
	Non-Executive Director, Securities and Futures Commission (Dr. York LIAO, JP)
	Representative of Secretary for Justice (Mr. Ian G M WINGFIELD, GBS, JP)

Membership of Working Groups
(as at 31 December 2004)

Working Group on Corporate Finance and Enforcement

Chairman: Mr. KWAN Pak Chung, Edward

Members: Mr. CHENG Hoi Chuen, Vincent, JP

Professor CHAN Yuk Shee, JP

Mr CHOW Wing Kin, Anthony, SBS, JP

The Honourable EU Yuet Mee, Audrey, SC, JP

Mr. Ian G M WINGFIELD, GBS, JP

Working Group on Licensing, Intermediaries Supervision and Investment Products

Chairman: Mr. FONG Hup

Members: Mr. CHEONG Ying Chew, Henry

Mr KAM Pok Man

Dr. York LIAO, JP

Mr. PANG Yuk Wing, Joseph, JP

Mr. Andrew L T SHENG, SBS, JP

Annex C

Securities and Futures Commission's responses[8] to the observations and recommendations that are accepted

(A) Inspection of and prudential visit to intermediaries

Item (1)
Case findings/market views In one case, the SFC conducted an inspection of a subsidiary and in parallel, a prudential visit to another subsidiary of the same group of companies. The PRP considered that for small and medium sized firms, subsidiaries of the same group very often share resources. The activities of a subsidiary might have bearing on the operation and risk profile of other companies of the same group.
PRP recommendation/observation The PRP believed that the SFC should conduct either inspection of or prudential visit to the two related companies in one go. This approach would enable the SFC to form a global view on the operation of the group as a whole. (Para. 3.5 of Chapter 3)
SFC's response The SFC adopts a risk-based approach in selecting inspection targets. Therefore, whether inspection/prudential visit should be conducted on a single entity or on a group basis depends very much on the risk profile of the group and the specific circumstances of each case. The fact that the SFC has conducted an inspection and at the same time a prudential visit to two related companies is a good example to illustrate how the SFC flexibly select the target for prudential visit based on the company's risk profile. The SFC noticed that the company had not carried out any advisory activity for a period of time and only provided research support to other group companies. In view of limited market impact, the SFC decided that prudential visit would be more appropriate for the company while another active securities firm under the same group was selected for inspection. Nevertheless, the SFC agrees that the recommendation has merit and will generally take this factor into account in its risk-based approach to the selection of intermediaries for inspection or prudential visit.

[8] Editorial changes are made mainly to remove case specific information.

(B) Authorisation of collective investment schemes

Item (2)

Case findings/market views

In one case, the SFC was heavily involved in the vetting of draft documents submitted by the applicant. This resulted in an unduly long processing time and consumed a significant amount of the SFC's resources.

PRP recommendation/observation

In view of the fact that it was the applicant's responsibility to prepare good quality documents for consideration by the regulator, the PRP invited the SFC to study its procedures to see if they could be further streamlined with a view to alleviating its workload in this area. (Para. 3.7 of Chapter 3)

SFC's response

For this particular case, the applicant was an overseas company and its Hong Kong representative was unfamiliar with the requirements of the SFC on collective investment schemes. In order to facilitate processing of the case and to keep the applicant informed of the development on a timely basis, the SFC has copied its correspondence with the Hong Kong representative to the applicant.

The SFC has reviewed its procedures and found that the practice of copying of correspondence with Hong Kong representatives to the overseas applicants in appropriate cases would generally speed up the vetting process. The SFC agreed to formalise this practice and has amended its procedural manual accordingly.

(C) Handling of complaints

Item (3)

Case findings/market views

In one of the cases, an investor lodged a verbal complaint against a securities company for the mishandling of transactions. To investigate into the complaint, the subject officer of the SFC tried to contact a director of the company to obtain the relevant information. Despite repeated telephone calls, the SFC officer could not get in touch with the director. The PRP found that as the SFC officer had not resorted to other means of communication, there was no progress made to this complaint for a month.

PRP recommendation/observation

The PRP believed that the SFC should consider making it a standard arrangement that such requests for information from intermediaries should be made in writing as far as possible. (Para. 3.9 of Chapter 3)

SFC's response

Depending on circumstances, the SFC may adopt different modes of communication with the firms. Normally, the SFC will issue its request in writing. However, in straight-forward cases or where only a simple follow-up question is required, the SFC may choose to communicate with the

firm by phone. Should the SFC fail to reach the individual concerned by phone, it will consider issuing the request by fax, email or other means. The SFC agrees to the recommendation and has reminded its staff that where contact by phone is considered appropriate but the licensee cannot be reached, the request should be put in writing. A complete trail will be placed on file to facilitate follow-up action by the case officer or his replacement.

Item (4)

Case findings/market views

In another complaint lodged by a company against a listed company for breaching the Takeovers Code, the SFC considered it necessary to put the matter to the subject of the complaint so as to obtain more information for investigation. To achieve this, the SFC would need to seek the consent from the complainant to copy the complaint letter to the listed company. The PRP noted that the complainant did not reply to the SFC and no progress was made in respect of this complaint for a month.

PRP recommendation/observations

The PRP considered that the processing of the complaint could have been expedited had the SFC given the complainant a deadline to respond to the SFC's request for consent. (Para. 3.10 of Chapter 3)

SFC's response

Before deciding to take a complaint further, the SFC will consider whether it is appropriate to put the matter to the subject of the complaint. The determining factor is whether copying the complaint to the subject of the complaint and inviting their views would enable the SFC to have a better understanding and thereby more fully and accurately address the complaint. In some circumstances, a complaint may lead to investigations or disciplinary action against the subject of the complaint. It is important to address natural justice concerns by offering an opportunity to the subject to explain its case before any SFC action is taken.

Depending on the circumstances, the SFC may copy the complaint letter (if the complaint was made in writing) or provide a summary of the complaint to the subject of a complaint. In either scenario, if it appears that the identity of the complainant might be disclosed as a result of the disclosure of the complaint, the SFC will write to the complainant to ask for consent to make such disclosure. The SFC has amended the procedures for the handling of complaints to provide that where consent from the complainant is required before passing on information to the subject of the complaint, the SFC will consider setting a deadline for the complainant to respond. If the complainant does not reply within the deadline, it will be taken to mean that he has refused to give consent.

(D) Investigation and disciplinary action

Item (5)

Case findings/market views

In one of the cases, the SFC issued warning letters to two persons and asked them to sign on a copy of the letter for return to the SFC. The two persons did not follow the request and the SFC had not taken any follow-up action.

PRP recommendation/observation

The PRP invited the SFC to consider whether the practice to request for a signed copy of the warning letter should continue in view of the enforcement difficulties. (Para. 3.12 of Chapter 3)

SFC's response

The purpose of asking the addressee of a warning letter to sign acknowledging receipt is to help prove receipt and notice of a warning. Previous proven bad conduct is an aggravating factor in discipline. However, it is more serious when it is conduct that a person has been warned about , as he should be aware of the propriety of his repeated conduct and its consequences. However, in fairness, a person must be aware of a warning for it to have this effect. For this reason, proof of receipt through having the addressee sign and return a duplicate of the letter is useful. In a corporate entity, requiring the addressee to sign and return a duplicate of the letter also ensures that it is brought to the attention of the right person within the corporate hierarchy.

Most regulated persons do co-operate. The practice has value and does not impose a disproportionate burden. The SFC proposes to continue the practice.

Item (6)

Case findings/market views

In another two cases, the SFC issued a reminder letter to a licensed person and a letter of advice to a licensed corporation on compliance issues. As reminder letters and letters of advice were not covered in the procedural manual of the SFC, the circumstances leading to the issue of these letters were not clear.

PRP recommendation/observation

The PRP invited the SFC to advise on the nature of reminder letters and letters of advice, and the circumstances that warrant the issue of these letters vis-à-vis warning letters. The PRP also invited the SFC to consider setting out the procedures for the issue of reminder letters and letters of advice in the procedural manual to ensure consistency in application. (Para. 3.13 of Chapter 3)

SFC's response

A reminder letter and a letter of advice are the same. The SFC will standardise the names as "advice letter".

An advice letter is issued in less serious circumstances than a warning letter. A warning letter is issued when the SFC believes that there has been conduct that technically could warrant formal

disciplinary action, but decides, given the circumstances, that it will not take formal disciplinary action, but will issue a warning letter instead. An advice letter is issued in circumstances where the SFC believes that there is no conduct that warranted formal disciplinary action, but that the SFC believes that a person may need advice (or a reminder) about his regulatory or compliance responsibilities.

Given the relative informality of the procedure for the issue of advice letters, the SFC does not consider that it would assist to add detailed procedures for them in the procedural manual. However, the SFC would consider adding the following to the procedural manual:

- the distinction between when to issue a warning letter as opposed to an advice letter; and
- the requirement that an advice letter (and a warning letter) might only be issued by an officer at the rank of Director or above (in practice, the issue of such letters is usually approved at such ranks); and

The issue of an advice letter is dependent on the circumstances of a particular case and so must be subject to the discretion of the authorising officer and cannot be subject to mechanistic rules.

In disciplinary cases, consistency in the issue of warning and advice letters is achieved through precedent decision checks which must be carried out before all decision recommendations are made. The final decision depends on the authorising officer's view of the circumstances of the particular case considering previous like decisions. In disclosure of interest cases, consistency in the issue of warning letters is achieved via criteria set out in the procedural manual.

Item (7)

Case findings/market views

The PRP noted that there was inconsistency in the handling of suspected criminal offence in two cases. In one case, a suspected forgery was referred to the Legal Services Division ("LSD") for internal legal advice and then to the Police for follow-up action. In another case, no follow-up action was taken despite a reference to 'forged' in the case file.

PRP recommendation/observation

The PRP invited the SFC to consider setting out rules on the handling of suspected criminal offence in order to achieve consistency in application. (Para. 3.15 of Chapter 3)

SFC's response

There was in fact no forgery in the case where the PRP found no follow-up action on an act described as "forged" in the case file. The word "forged" or "forgery" appearing in the case file was inaccurate. Therefore the two cases reviewed by the PRP were different and the question of inconsistency in the handling of suspected criminal offence did not arise. The SFC considered there is no need for any more written procedures. Nevertheless, the SFC accepts that the deliberation and decision on whether an activity is capable of being viewed as a suspected criminal offence should be recorded on the case files and had reminded its staff of the need to ensure all descriptions in files are accurate as far as possible.

Regarding the practice on seeking internal legal advice from the LSD on suspected criminal offence and referral of such offence to the Police, the SFC advised that it is not appropriate to swamp LSD

with every conceivable possibility in this regard. The Senior Director and Director of the Investigation Department have considerable Police experience and are capable of making a decision on the relatively low threshold of whether there is a prima facie case. This is precisely what they do in deciding whether any matters should be referred to LSD. At present, all cases where the Investigation Department considers prosecution may be justified are referred to LSD. Only if LSD advises that prosecution is appropriate can a case proceed. The decision to refer to LSD is made by the Senior Director of Investigation in consultation with his staff and the Executive Director as necessary. The existing process already ensures a high degree of consistency. The SFC has a duty to report criminal matters to the Police but at the same time it has to be responsible in the way it ties up Police resources. The current arrangements appear to work and are resource efficient, both internally and externally.

(E) Hearing and appellate process relating to the issue of warning letters

Item (8)

Case findings/market views

The PRP noted that although the issue of a warning letter was not a formal or statutory disciplinary sanction, it could be taken as a stigma and could impose adverse impact on a licensee's career prospect because most employers would make reference to a job applicant's compliance history. Unlike formal disciplinary action for which statutory appeal channels (such as application to the SFAT for a review of the SFC's decisions) are available, there is at present no proper channel for an aggrieved person to appeal against the SFC's decision to issue a warning letter.

It transpired from a case that the SFC had not communicated with the regulated person prior to issue of a warning letter. Therefore, the regulated person did not have the opportunity to challenge the factual issues and to comment on the allegations. Upon enquiries with the SFC, the PRP was advised that warnings might be issued without commencement of a formal disciplinary process. Warning letters would probably be used as an aggravating factor in case the person committed the same or similar misconduct in future. The response or representation made by the person concerned would only be kept on file for internal reference.

PRP recommendation/observation

The PRP considered that the procedures for the issue of warning letters should be improved to ensure procedural fairness. The SFC was invited to consider the recommendation that representation made by the person concerned should be considered and, if justified, the warning letter should be withdrawn. (Para. 4.7 of Chapter 4)

SFC's response

In case a response to a warning letter convinced the SFC that a warning letter was not warranted, the SFC will withdraw the warning letter and notify the recipient of the decision.

(F) Settlement of disciplinary action

Item (9)
Case findings/market views The PRP considered that a payment in lieu of a suspension of licence meant that the person could stay in the industry without interruption despite his wrongdoing.
PRP recommendation/observation The PRP recommended that, in drawing up the terms of the settlement, the SFC should consider requiring the licensee or the company to carry out improvement measures as one of the terms of the settlement agreement in order to uphold the industry standards and to protect investor interest. (Para. 4.20 of Chapter 4)
SFC's response The SFC has already done this in appropriate instances. In appropriate cases, we will require a firm to undergo a compliance review by independent accountants and to implement the changes recommended by the accountants. We also note that payment of substantial sums of money and agreement to other settlement terms (e.g. to refrain from business activities) impose a direct and substantial cost on the misconduct in question and give an obvious incentive to avoid a repeat of the regulatory action by changing its behaviour and improving compliance measures, when failure to do so is likely to lead to even tougher sanctions on a repeat occasion.

Item (10)
Case findings/market views Since a settlement could be made on a "no admission" basis, the compliance record of the licensee would remain intact. This would prevent the Licensing Department of the SFC from taking into consideration the factual issues that led to the original decision to impose disciplinary sanctions when processing the licensee's future application for registration as a responsible officer.
PRP recommendation/observation The PRP recommended that the Enforcement Division should consult other divisions where a proposed settlement would impact on the decision of the relevant divisions. (Para. 4.21 of Chapter 4)
SFC's response The Enforcement Division agreed that it should consult other divisions where a proposed settlement would have apparent effects on their operations. It typically does and did in the case the PRP reviewed.

Item (11)

Case findings/market views

The deliberation of and rationale for going into a settlement were not documented in one of the cases reviewed.

PRP recommendation/observation

The PRP recommended that the SFC should set out clearly the deliberation of and rationale for going into settlement in the case file. (Para. 4.22 of Chapter 4)

SFC's response

The SFC agreed to the recommendation and would direct its staff to ensure that reasons for entering into settlement agreements are recorded sufficiently. However, given that settlement is essentially a question of pragmatic compromise, the details will often be relatively brief except perhaps in complex or sensitive cases when there may be a number of relevant considerations.

Item (12)

Case findings/market views

In one case, the SFC decided to suspend the licence of a supervisor and that of his subordinate. The SFC subsequently entered into a settlement agreement with the supervisor and accepted payment in lieu of the suspension. No settlement agreement was made with the subordinate whose licence was suspended for three months. On the reasons why settlement was made with the supervisor but not the subordinate, the SFC explained that the subordinate did not approach the SFC for settlement. The SFC considered it a cardinal principle of settlement that settlement negotiations should be initiated by the person proposed to be disciplined unless the circumstances were exceptional. It was not appropriate for a regulator to actively solicit settlement as it would call into question the credibility of the regulator and any payment it sought.

PRP recommendation/observation

The PRP considered that the SFC should introduce measures to ensure that the stakeholders were aware of this avenue. People interested in entering into settlement agreements might have missed the chance because they were not aware of this possibility. (Para. 4.23 of Chapter 4)

SFC's response

The SFC agreed with the recommendation and had already taken measures to inform stakeholders of this possibility. The SFC has issued a pamphlet in 2004 explaining the disciplinary process, including the possibility of settlement. This is distributed with each Letter of Mindedness/Notice of Proposed Disciplinary Action, and available from the SFC office and its website. The SFC's press releases and monthly Enforcement Reporter, distributed to all corporate licensees, widely publicised and available from the SFC's website, repeatedly mentioned settlement. The Enforcement Division has met each of the key industry body representing licensees in 2004 and proposed to meet them at regular intervals. At each of these meetings, settlement was discussed. The organisations told the SFC that they understood the SFC's position much better after these meetings and would pass what was mentioned to them on to their members. Speakers from the Enforcement Division have offered to speak to members of these organisations following these

meetings and have done so. The Executive Director of Enforcement and Director in charge of the Discipline Department regularly spoke at industry and professional education seminars on discipline, including settlement. In addition to the above measures, the SFC is willing to issue a circular to corporate licensees to draw to their attention again the pamphlet on the SFC's disciplinary process which explains the possibility of settlement with the SFC. However, the SFC would like to emphasise that the pamphlet is constantly available. For example, the SFC issues the pamphlet in the same envelope with every letter of mindedness or notice of proposed disciplinary action which starts formal discipline so everyone who the SFC proposes to discipline knows, if they read the pamphlet, that the SFC is willing to consider settlement in appropriate circumstances. The SFC has a series of upcoming meetings with industry associations and would re-mention the pamphlet and the possibility of settlement for them to re-emphasise to their members.

Item (13)

Case findings/market views

The amount of a payment was determined solely on the basis of the economic effect of the intended suspension on the person concerned, regardless of the nature or gravity of the suspected misconduct. In other words, the level of payment in different cases could be substantially different even if the nature of the misconduct was the same.

PRP recommendation/observation

The PRP considered that it was necessary for the SFC to introduce more objective benchmarks, such as seriousness or gravity of the misconduct in assessing the amount of payment. Such rules should be formalised and set out in the procedural manual to ensure consistency in application. (Para. 4.24 of Chapter 4)

SFC's response

The SFC already accepts and applies the principle that objective benchmarks such as seriousness or gravity of the misconduct should be considered in assessing the amount of the payment. The SFC would like to brief and discuss with the PRP on how that application is formalised.

(G) Verbal request for information concerning the clients of the securities firms

Item (14)

Case findings/market views

The PRP received a comment from a securities firm about the SFC's practice of making verbal request for information without citing the relevant statutory provision under which the SFC might obtain such information. The information requested was usually related to the background of the firm's clients and the transactions conducted by the clients. The firm believed that the SFC should make it clear that provision of such information would be on a voluntary basis, as the firm must observe the obligations of confidentiality and the requirements under the Personal Data (Privacy) Ordinance in providing the requested information.

PRP recommendation/observation

The PRP suggested that the SFC should include in its letter seeking provision of such information a prominent warning message citing the legal risks involved in providing such information on a voluntary basis. That apart, in view of the extensive investigative powers vested with the SFC under the SFO, there were questions whether the SFC required voluntary provision of information. (Para. 4.32 of Chapter 4)

SFC's response

The situations related to occasions when the Surveillance Department of the SFC sought assistance in order to make an evaluation as to certain market conduct.

The SFC only exercises its investigative powers under the SFO when it has reasonable cause to believe that it is necessary to do so. In order to have a reasonable cause to believe it is necessary to collect basic information. Section 181 of the SFO provides opportunity for the SFC to collect that basic data. Whenever information was requested pursuant to section 181, that provision was always clearly identified in any letter of request.

However, the information that the SFC is entitled to demand pursuant to section 181 is limited and often is insufficient to allow the SFC to form a view. Accordingly, there will be occasions when requests for additional information will follow a formal request pursuant to section 181. It does not seem unreasonable that a regulator should be entitled to enquire of a regulatee in such circumstances as the answers to such enquiries usually allay the regulator's concerns and obviate the need to escalate the enquiry to a full blown investigation. This approach has advantages for both the regulator and regulatee because a full investigation will necessitate that both parties spend time and resources in handling such matter.

The SFC accepted that the provision of such further information is on a voluntary basis and, on those occasions where such requests are reduced to writing, the SFC undertook to make clear that the provision of such information is on a voluntary basis. Likewise, on those occasions when it is necessary to make requests over the telephone, SFC staff has been instructed to make clear that the provision of such information is on a voluntary basis.

The SFC is confident that whenever a matter has been escalated to a formal investigation (e.g., under section 182 of the SFO), a demand for information will never be made without quoting the relevant provisions pursuant to which the request is made.

Securities and Futures Commission's responses[9] to the observations and recommendations that have not been accepted in full

(A) Hearing and appellate process relating to the issue of warning letters

Item (1)
Case findings/market views The PRP noted that although the issue of a warning letter was not a formal or statutory disciplinary sanction, it could be taken as a stigma and could have an adverse impact on a licensee's career prospect because most employers would make reference to a job applicant's compliance history. Unlike formal disciplinary action for which statutory appeal channels (such as application to the SFAT for a review of the SFC's decisions) are available, there is at present no proper channel for an aggrieved person to appeal against the SFC's decision to issue a warning letter.
PRP recommendation/observation The PRP considered that, in cases where the warning letters were issued as an alternative to a formal disciplinary process, the recommendation for issuing a warning letter should be reviewed and endorsed by an officer not involved in investigation to ensure an independent review of the decision, thereby strengthening the checks and balances. (Para. 4.7(a) of Chapter 4)
SFC's response For warning letters issued by the Discipline Department, the decision to issue a warning is made by staff who are independent of the investigation process conducted by the Investigation Department. Warning letters issued by the Surveillance Department and the Investigation Departments are reviewed and signed by senior staff who are only remotely involved in an investigation and have sufficient experience to judge when they should be issued. Moreover, warning letters issued by the Surveillance Department usually concern late submission of return on disclosure of listed company interest, which is a simple factual matter established by the date of submission of the return. There is little scope for dispute over the issue of these warning letters. Given the informal nature of warning letters, the SFC does not consider it appropriate to overcomplicate the process for issue of warning letters by requiring the decision to issue them to be taken outside of the Investigation Department or the Surveillance Department. Warnings are used to save regulatory resources for more serious cases by tempering a tough enforcement policy with a degree of mercy in less serious cases by not imposing a statutory sanction and issuing a warning instead. If non-sanctions such as warnings are encumbered with excessive restrictions, then this degree of regulatory liberality achieves little or no saving of resources and is difficult to justify – it would be difficult to justify taking a lighter regulatory approach in circumstances that would technically warrant a punishment if the use of public resources is, or is close to, the same and a more sensible, targeted use of resources is not possible as

9 Editorial changes are made mainly to remove case specific information.

a result. The Enforcement Division has in the past year made greater use of warnings in borderline cases reflecting an effort to focus resources on more serious cases, issuing 41 warnings in disciplinary proceedings in calendar year 2004 compared with 31 in calendar year 2003. The Enforcement Division would have to review this trend if changes were made.

Item (2)

Case findings/market views

To address the need to provide an avenue for appeal against the SFC's decision to issue warning letters, it was proposed that a standard statement be included in the warning letter to draw the attention of the persons concerned of their right to make representation. The PRP concluded that inclusion of the proposed statement in warning letters could not adequately address the concern of the industry for a proper appellate process and might even give the wrong impression that the SFC issued the warning letters without thorough deliberation. The PRP maintained the view that the industry's concern should be addressed by providing an opportunity for the person to give a response **prior to** the issue of the warning letter.

PRP recommendation/observation

The PRP recommended that, for warnings to be issued without going through a formal disciplinary process, the SFC should –

(a) inform the person concerned of the intention to issue a warning letter prior to having the letter actually issued. The notice should cover –

   (i) the factual issues upon which the SFC relied on for the issue of the warning letter;

   (ii) a deadline for a response or representation, e.g. a 14-day period which was in line with the practice of other professional organisations and was considered reasonable; and

   (iii) a statement that the SFC might, upon consideration of responses of the person concerned, confirm or set aside the decision for the issue of a warning letter, or substitute it with other disciplinary action. This was to prevent possible abuse by the person concerned who might give a response as a matter of course. This proposed arrangement should, to a certain extent, address the problem associated with the potential burden on the SFC brought about by this proposal.

(b) make it a standard requirement that the representation/response made should be reviewed by a senior officer who was not involved in the investigation and in making the decision regarding the issue of the warning letter. This requirement could provide a check and balance on the SFC's decisions to issue warning letters, thereby ensuring the fairness of the process.

(Para. 4.12 of Chapter 4)

SFC's response

The number of warnings issued by the Discipline Department is 41 in calendar year 2004 and 48 in fiscal year 2004-05. The number of warnings has been rising in an effort to concentrate resources on more serious cases, which involved more resources as they were more complex, but also hopefully achieved more impact in terms of regulatory outcome.

The number of private warnings in fiscal year 2004-05 must be measured against the total number

of disciplinary case finalised, which was about 100. That is, the number of warnings represents another nearly 50% of the total number of cases in which the formal disciplinary procedure is followed.

The steps proposed by the PRP only differs from the formal disciplinary procedure in that the period for defence submissions is shorter and there is no statutory right of appeal to the SFAT, instead, there is an internal right of appeal. With respect, this represents little tangible saving on the process to be followed if these cases were to be subject to the formal disciplinary process.

We must be clear that we only issue warning letters if we believe that there are grounds for formal discipline. A warning is issued to send a message to the recipient that they should change their behaviour or they will likely face disciplinary action in future and that action will be more severe as they should know the consequences of their action. The alternative will be formal disciplinary process. This is likely in many cases to be a reprimand and a fine and, as such, be public and much more damaging to the subject, both in terms of outcome and time spent in the process. The beneficiaries of a warning system are the recipients of a warning letter and the public who gain indirectly from efficiencies in the use of public resources. If the cost benefit difference between warnings and formal discipline is insignificant, it is likely that the SFC will discontinue the practice of issuing warnings as the cost of warnings will likely approach or exceed their benefit considering alternative possible action. This means that either those who would have received a warning will face formal discipline and public sanctions or that some cases will have to be written off for lack of resources to pursue them. In the latter case, both the recipient of the warning may be considered to lose out in that they lose an opportunity to be warned of the consequences of their present conduct and the public loses in that there is less behavioural change among those whose conduct is contrary to the public interest.

The total number of warning letters issued by the Enforcement Division in fiscal year 2004-05 is 273, which includes 160 issued by the Surveillance Department (including 154 issued for disclosure of interest failings), and 65 issued by the Investigation Department (13 issued for disclosure of interest failings). We note that, in addition to the disciplinary cases in the 2004-05 fiscal year, there were 82 prosecutions which proceeded to trial (including prosecutions that ended in acquittal, but not those in which summons were withdrawn or no evidence offered). The total number of warning letters issued outnumbers by nearly another 1/3 the total number of disciplinary action and prosecutions. We understand that the PRP proposes that this approach apply to all warning letters. If the process proposed were followed in all of these cases, it would have very significant resource implications which would likely result in a significant backlog of cases as we would struggle to process all cases in a timely fashion in accordance with the procedures suggested. The effect would be to hinder the Enforcement Division in achieving timely results while adding unnecessarily to bureaucracy. And, in the case of warning letters issued for disclosure of interest failings, it would possibly result in more criminal prosecutions which may provoke criticisms of a mechanistic approach to law enforcement.

Warnings are an attempt to effect behavioural change while giving a degree of leniency to the recipient and savings in public resources. It requires that the process used to implement them be proportionate. We believe that the existing process is. The harm is minimal and some benefit accrues both to the recipient (who avoids formal proceedings) and the public (from resource saving and behavioural change). Over-judicialisation of the process jeopardises this regulatory flexibility, producing regulatory rigidity and drives the regulator into a more antagonistic approach as a strict enforcer of the law with a reduced ability to set priorities and exercise sensible discretion. We do not believe this is in anyone's interests. Accordingly, we do not accept the recommendations made.

We do not agree that wording of the nature proposed in para. (a)(iii) of the PRP's recommendation would deter abuse of the procedure to be heard or significantly contribute to meeting the original

purpose behind issuing a private warning. For reasons we have stated, we believe that, to accord almost all of the trappings of a full right to be heard commensurate with proceedings to impose a statutory public sanction, is disproportionate. Further, to correspond or litigate over warning letters after their issue as a matter of routine absent exceptional circumstances also voids the purpose of issuing them. We believe the effect and private nature of a warning letter together with an after issue ability to lodge a response which will appear in their compliance file sufficiently balances the regulatory effect of a warning letter with proportionate due process. We disagree that the proposed wording would deter intermediaries from abusing an opportunity to be heard procedure or of making unmeritorious use of it. In our experience, if an opportunity to provide responses is offered it will be taken. It would only be in the most extreme cases (e.g. deliberate or reckless misrepresentations or lies in submissions) that a case could be made out that the process had been abused warranting a revision of the decision to issue only a private warning or that use of a procedure offered was somehow unmeritorious and propose a public statutory sanction instead. Even then, it would, in many cases, obviate the purpose of the initial decision to issue a private warning (to save resources to focus resources on more serious cases, but still achieve a measure of behavioural change and public protection).

(B) Settlement of disciplinary action

Item (3)

Case findings/market views

The PRP noted that there was a fine distinction between a settlement and a fine. Settlement was exercised at the authority's discretion, with mutual agreement from parties concerned and could be made on a "**no admission**" basis. On the other hand, a fine was a **sanction** for a breach of certain licensing requirements or a misconduct, and the findings leading to the penalty would be recorded in the person's compliance history.

PRP recommendation/observation

The PRP invited the SFC to comment on the above observation. (Para. 4.25(a) of Chapter 4)

SFC's response

Whether to insist on an outcome with findings of fault or with no admission amounts to a pragmatic compromise in the circumstances which balances what is offered on settlement with what might be achieved on appeal and takes into account the resource saving achieved by settling so other cases can be focused on. Sometimes accepting a without admission settlement is a worthwhile compromise. Sometimes it is not. The Enforcement Division is acutely conscious of this. We reiterate that the public can and does draw their own conclusions from the willingness of the subject of disciplinary action to pay sometimes substantial amounts of money or agree to other terms. Even if no finding is entered into their compliance record, a cost is imposed on the subject's improper conduct and others in the industry that might be tempted to engage in such conduct can see that it has costs. So the regulatory aims of punishment and deterrence are substantially met.

Item (4)

Case findings/market views

The PRP was advised that there were circumstances where a settlement was not applicable.

PRP recommendation/observation

The PRP considered it advisable for the SFC to elaborate on the details in order to ensure consistency in interpretation and application. It would be useful to include in the guidelines –

(i) examples of misconduct involving dishonesty; and

(ii) elaboration on the difference between "suspension of licence" and "immediate removal from the industry".

(Para. 4.25(b) of Chapter 4)

SFC's response

The considerations relevant to whether to settle are broad or very fact specific. The SFC does not agree that more specific articulation of them would help. Further, specific articulation of such considerations risks turning what was meant to be a procedural manual into a manual for merit based decision making which is not the manual's function. Decisions to settle are made at senior levels in the SFC and often involved discussion among several staff after considering previous like cases. An element of discretion has to be accommodated and the staff are sufficiently experienced to be trusted with such discretion. Even if there is only one decision maker, there are often multiple staff members involved in a recommendation.

Regarding the specific suggestions on elaboration of the guidelines, the SFC considers that –

- Offences under the SFO and the general criminal law vary in nature. Some are very serious (e.g. criminal market misconduct or fraud and deception) and so obviously involve an element of serious criminal intent or dishonesty. Others are directly based on dishonesty (e.g. lying in an SFC interview or to the HKEx in a filing). Others are regulatory and more technical in nature and may involve carelessness more than dishonesty or serious criminal intent. Some offences may vary in character depending on the precise intent of the person committing them. These matters are more easily determined by looking at the conduct in context and with a view to previous like cases. The SFC does not agree that guidelines would assist in this regard.

- The use of the word "immediate" was perhaps inappropriate. The only point we seek to make is that settling with a payment in lieu of a suspension is not appropriate if a fine will not serve one of the purposes of a suspension to remove the person in question from conduct with the investing public so as to protect the investing public from the person's conduct as a licensed intermediary. Suspensions under the previous legislation and the SFO serve several purposes: punitive, deterrent and protective (i.e. removing the person from a position where they can cause further damage to the investing public). Under the previous legislation, when fines were not available, suspensions often had to be imposed in circumstances where a reprimand did not have sufficient punitive or deterrent effect, but there was no need to remove the person from the industry to prevent a chance of further damage to the investing public. Therefore, in some cases it was not necessary to persist with a suspension if a person was willing to settle in appropriate circumstances where the

protective purpose of a suspension was not warranted and the payment proposed imposed a substantially equivalent punitive and deterrent effect to the initially proposed suspension.

Item (5)

Case findings/market views

The PRP considered that disciplinary action carried a notion of disapproval of the conduct. Such disapproval was not demonstrated when the sanction was settled by way of a payment.

PRP recommendation/observation

The PRP invited the SFC to comment on the above observation. (Para. 4.25(c) of Chapter 4)

SFC's response

Even if a settlement is without admission, the SFC will issue a press release that publicises its allegations. As such, our concerns will be made public. The industry and public will know what conduct the SFC disapproves of. As stated, we believe that the public can and does draw its own conclusions from the willingness of a defendant to meet the settlement terms, which can sometimes be quite tough. The SFC would not insist on a defendant agreeing to settlement terms if it did not disapprove of the conduct. To do otherwise would not be in the public interest and would be an abuse of process. We believe that the public and industry are aware of this and draws appropriate conclusions that the SFC disapproves of the conduct which it settles. Whether to settle with or without admission is an element of what amounts to a pragmatic compromise. The SFC considers a range of factors in deciding whether it would be in the public interest to enter into such a settlement. At the end of the day, the question to settle is one of the merits of case. Such considerations are very case specific and further guidelines are unlikely to assist because they can only usefully state the most general considerations which are rather obvious. We believe we have already done this sufficiently. Detailed rules are too mechanistic and inappropriate in this area.

Item (6)

Case findings/market views

It transpired from a case reviewed that the Executive Director of Enforcement Division led the negotiation and made the decision on the terms of the settlement, including the level of payment.

PRP recommendation/observation

The PRP believed that it would be advisable if the decision maker was not involved in the negotiation process to ensure proper checks and balances. (Para. 4.25(d) of Chapter 4)

SFC's response

The Executive Director of Enforcement is usually the decision maker in disciplinary action (infrequently, the Director of Discipline may act as decision maker) and, under administrative law, the person who is statutory decision maker for the disciplinary action must act as decision maker in a settlement where that settlement imposes another statutory sanction other than those initially proposed. In other cases, the decision to compromise disciplinary action with non-statutory sanctions under section 201(3) and (4) of the SFO should be made by the same person. Ultimately,

a settlement negotiator must report his/her negotiation to the decision maker on the settlement who will still decide whether, and if so, on what terms the case should be settled. Defendants and their lawyers often want to deal directly with the decision maker to speed up negotiation. This is sensible and suggests efficiencies in having the decision maker also negotiate on a settlement. A segregation of duties therefore cannot be meaningful and is likely to be inefficient.