

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

**Annual Report**  
**to the Financial Secretary**  
**for 2010-11**

**September 2011**

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## **Chapter 1      General Information**

### **Background and purpose of the Process Review Panel for the Securities and Futures Commission**

1.1            The Process Review Panel (“PRP”) for the Securities and Futures Commission (“SFC”) is an independent panel established by the Chief Executive (“CE”) in November 2000 to review the internal operational procedures of SFC and to determine whether SFC has followed its internal procedures, including procedures for ensuring consistency and fairness.

1.2            Since its inception in 1989, SFC has been subject to various checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal against the decisions of SFC, 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 markets in 1999, there were comments that the checks and balances set out in paragraph 1.2 above might only be applicable to specific cases. The Administration, in consultation with SFC, concluded that it would be preferable to improve the transparency of SFC’s internal processes across the board, so that the public would be better able to see for themselves that SFC did act fairly and consistently in exercising its powers.

1.4            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 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 SFC, without compromising its confidentiality, the Administration saw merit in establishing an independent body to review the fairness and reasonableness of SFC’s operational procedures on an ongoing basis, to monitor whether its procedures are consistently followed and to make recommendations to SFC in relation to these objectives.

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

### **Terms of reference**

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

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

1.9 PRP is required to submit its reports to the Financial Secretary ("FS") annually or otherwise on a need basis. FS may cause these reports to be published as far as permitted under the law.

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

### **Constitution of PRP and its Working Groups**

1.11 PRP comprises twelve members, including nine members from the financial sector, academia, and the legal and accountancy professions, and a Legislative Councillor and two ex officio members including the Chairman of SFC and a representative of the Secretary for Justice.

1.12 To facilitate execution of its roles and functions, PRP has set up two working groups –

- (a) the Working Group on Licensing, Intermediaries Supervision and Investment Products which focuses on cases involving licence applications, approval of investment products and inspection of intermediaries; and
- (b) the Working Group on Corporate Finance and Enforcement which focuses on cases concerning investigation and disciplinary action, takeovers and mergers transactions and prospectus-related matters.

1.13 The membership of PRP and its two working groups is at **Annex B**.

## **Chapter 2          Work of PRP in 2010-11**

### **Mode of operation**

2.1            In accordance with its terms of reference, PRP may select any completed and discontinued cases for review to examine if the actions taken and decisions made by SFC are consistent with the relevant internal procedures and operational guidelines. Cases under review cover the following areas –

- (a)    licensing of intermediaries;
- (b)    inspection of 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.

2.2            In practice, SFC provides PRP with monthly reports on all completed and discontinued cases. Members of PRP then select individual cases from these monthly reports for review with a view to examining cases of different areas and having regard to factors including the processing time required, etc.

2.3            SFC also provides PRP with monthly reports on ongoing investigation and inquiry cases that have been outstanding for more than one year. PRP may also select these cases for review upon their completion or closure.

2.4            In addition to reports from SFC, PRP gathers and receives comments from market practitioners as well as the general public on the performance of functions by SFC with a view to identifying areas for review and improvement to the procedures and processes.

## Highlights of work

### *Meetings of PRP in 2010-11*

2.5 PRP conducted two rounds of review in 2010-11<sup>1</sup> and held a total of 13 meetings with SFC's case officers on the 57 cases selected from cases completed/discontinued by SFC during 1 July 2009 to 30 June 2010. In addition to seeking clarifications on selected cases at the review meetings, members also conducted file reviews where necessary to assess if SFC had complied with the standard procedures laid down in the operational manuals. Furthermore, members had taken the opportunity to review the adequacy of the manuals from the perspective of fairness and reasonableness.

2.6 Besides case review meetings, the full PRP had met to consider reports from members on the case reviews, set out observations and recommendations, and discussed specific issues relating to SFC's internal procedures. The distribution of the 57 cases reviewed in 2010-11 is summarised below–

	No. of Cases
Licensing	8
Intermediaries supervision ( <i>inspections</i> )	7
Investment products	7
Complaints	9
Enforcement	24
Corporate finance ( <i>processing of listing applications under the Dual Filing regime</i> )	2
<b>Total</b>	<b>57</b>

### *Meeting with the industry associations*

2.7 In March 2011, PRP held an informal meeting with representatives from the securities industry associations to exchange views on the work of PRP and possible areas for review by PRP.

<sup>1</sup> The first round of review was conducted between June 2010 and March 2011, and the second round between December 2010 and July 2011.



## **Chapter 3            Observations and recommendations on review of individual cases**

### **Overview**

3.1            From the 57 cases reviewed in 2010-11, PRP concluded that SFC had generally followed its internal procedures and complied with operational guidelines in handling those cases. PRP made further observations and recommendations to SFC for enhancement of procedures or guidelines. PRP noted that SFC had given positive response to the observations and recommendations. Details of PRP's observations and SFC's responses made to PRP are at **Annex C**.

#### **(A)    Licensing of intermediaries**

3.2            Having reviewed eight cases on licensing of intermediaries, PRP was satisfied that SFC had generally followed the standard procedures. The relatively long processing time taken in some cases was mainly attributable to the need to seek clarification with the applicants on their proposed activities or changes to their business plans. Time was also required to obtain compliance history or assessment from other regulators concerned.

#### **(B)    Inspection of intermediaries**

3.3            PRP reviewed seven cases relating to inspection of intermediaries. PRP noted that SFC had generally followed the standard procedures in these exercises.

#### ***Process of inspection work***

3.4            PRP invited SFC to elaborate on the process and procedures on its inspection work, in particular on surprise inspections. SFC advised that the internal operating manual of the Intermediaries Supervision Department ("ISD") set out detailed inspection work procedures. The manual was reviewed and revised as and when appropriate. Regarding surprise inspections, SFC would usually give seven-calendar-day advance notice to

the company before conducting an inspection. A shorter notice might however be given where circumstances warranted, for example, where there were serious concerns relating to safeguarding of client assets and misconduct issues. SFC would duly record the reasons for it. PRP noted that these guidelines were generally effective, and provided the necessary flexibility for SFC in its inspection work.

### ***Follow-up mechanism after inspection***

3.5 In one case, a company licensed to deal in and advise on securities had sold authorised funds to clients directly or through banks and independent financial advisors. SFC found in an inspection that the company had not provided proper client agreements, and the basis of recommendations and the risks associated with the products were not clearly explained. In addition, it had not set out any policy or procedures to ensure suitability of the recommendations provided to the clients. Taking into account that there was no reason to suspect mis-selling to clients and given the limited scale of the operation involved, SFC decided that it would suffice to issue a management letter requiring the company to enhance its internal control system.

3.6 PRP suggested that SFC should ensure proper follow-up to forestall recurrence of similar problems, including the establishment of a follow-up mechanism on completion of the inspection.

3.7 SFC advised that the internal operating manual of ISD set out the inspection work procedures including the mechanism in following up the deficiencies identified in inspections. SFC would assess the adequacy of a company's response in addressing the concerns raised, and would request the company to take further action if the remedial measures proposed or taken were not satisfactory. In the case concerned, SFC assured PRP that ISD had duly followed up with the company before concluding the inspection.

### **(C) Authorisation of collective investment schemes**

3.8 PRP reviewed seven cases on authorisation of collective investment schemes and noted that SFC had generally followed the standard

procedures in processing these cases. The relatively long processing time taken in some cases was mainly due to the need for applicants to meet the enhanced disclosure requirements after the Lehman Brothers incident, the inaction on the part of the applicants and the need for them to obtain the Qualified Foreign Institutional Investor (“QFII”) quota from the Mainland authorities.

### ***Authorization of A-Share Equity Fund***

3.9 PRP noted from one application for authorization of A-Share Equity Fund that the long processing time was mainly attributable to the need for the applicant to obtain a QFII quota. PRP suggested that it might be more efficient if applications for authorization of fund would only be accepted and processed by SFC after the applicant had obtained the requisite QFII quota.

3.10 SFC explained that the duration required in obtaining a QFII quota from the relevant Mainland authorities was in general beyond the control of the applicant. It was noted that once the quota was granted, the applicant would be subject to a tight schedule to finalise within six months all the related documentation, marketing campaign, launching of the product and remittance of funds raised to the Mainland, etc. The acceptance of these applications by SFC before a QFII quota was obtained was a measure to facilitate the process. While SFC would have to devote certain resources to keep in view the progress of these cases, SFC noted that only a few of such applications were outstanding, and there were no significant issues of concern in respect of SFC’s processing. SFC would however keep the position in view.

### **(D) Handling of complaints**

3.11 PRP reviewed nine complaint cases and concluded that SFC had generally followed the standard procedures in handling these cases.

### ***Handling of complaint referred by HKEx***

3.12 In one case, PRP noted that trading of securities of a company listed on the Main Board of the Stock Exchange of Hong Kong Limited (“SEHK”) had been suspended for more than five years. The company lodged a complaint to the Hong Kong Exchanges and Clearing Limited (“HKEx”) alleging that the Listing Division of SEHK had mishandled the case, resulting in a prolonged suspension of trading of the company’s securities. To avoid possible conflict of interest, HKEx referred the complaint to SFC. After review, SFC concluded that there were insufficient grounds to substantiate the complaint.

3.13 PRP noted that while there were detailed procedures to deal with complaints addressed to SFC, there were no established procedures on the handling of complaints referred by HKEx. PRP suggested that SFC review the need for drawing up guidelines for timely handling and proper monitoring of such cases.

3.14 SFC explained that HKEx had referred the complaint to SFC due to a possible conflict of interest on the part of HKEx in handling the complaint, and this type of complaints was admittedly rare. The matter involved was rather unique and different from complaints received by SFC. The issues involved whether HKEx had discharged its listing functions in a proper, fair and transparent manner. To facilitate SFC’s oversight of HKEx’s proper discharge of listing functions, relevant procedures were set out in the Memorandum of Understanding Governing Listing Matters between SFC and HKEx (“MOU”). SFC pledged to handle related issues, including complaints referred by HKEx in relation to their discharge of the listing functions, in accordance with the standards and procedures set out in the MOU.

### ***Conclusion of complaint cases***

3.15 In another case reviewed by PRP, a complainant raised with SEHK and copied to SFC a discrepancy of the residential address reported by a Non-Executive Director (“NED”) of a listed company in its listing document. SFC advised that SEHK would follow up the matter. After investigation, SEHK considered that there was nothing further to pursue

under the Listing Rules. On this basis, SFC decided to take no further action on the complaint.

3.16 PRP noted that while the case appeared straightforward, it had only been officially closed after nearly one year. PRP considered that an earlier review could have been conducted by SFC to close the case in a prompt manner.

3.17 SFC explained that due to some internal communication issues, the closing note of the case was only recorded in the system after ten months. PRP noted that this was an isolated incident, and that SFC would strive to complete the review of future cases as soon as practicable.

### **(E) Investigation and disciplinary action**

3.18 In 2010-11, PRP reviewed 24 enforcement cases relating to settlement, reprimand, fining, revocation and suspension of licence, prosecution, civil sanction, referral to other agencies and issuance of compliance advice letter. PRP noted that SFC had generally followed the prescribed procedures in handling these cases. The processing time of some cases was longer due to the following reasons:

- court proceedings and/or appeals;
- the need to seek clarification from other regulators;
- the complexity of the cases with voluminous documents, numerous parties and various divisions in SFC involved;
- the backlog of cases being handled by SFC at the time, including the handling of Lehman Brothers related issues to which SFC had accorded priority and devoted substantial resources; and
- the changes in responsible case officers in SFC during the investigation.

### ***Publicity of court ruling on “unissued shares”***

3.19 Arising from complaints lodged by several investors who had subscribed for shares of a listed company in a grey market, SFC found that the middleman promoting the shares before their listing might have conducted unlicensed activities. The case raised question as to whether

“securities” include “unissued shares”. SFC sought clarification from the Court by making an application for a restraining order and/or declaration under section 213 of the Securities and Futures Ordinance (“SFO”)<sup>2</sup>. Eventually, the High Court issued an order confirming that “carrying on a business of dealing in securities in a grey market without a licence, whether or not those securities have been issued or listed, constitutes a contravention of the SFO”. SFC then issued a press release on the court ruling.

3.20 Having regard to the significance of the court ruling, PRP suggested that SFC consider if further publicity on “unissued shares” which are regarded as “securities” should be made.

3.21 SFC explained that following the press releases, SFC had given further coverage to the Court’s decision in the Enforcement Reporter, which is a bi-monthly publication produced by SFC to highlight the more significant enforcement issues for the attention of market practitioners and investors. PRP was content to note the efforts made by SFC, and that SFC would also include lessons learnt from this case in its ongoing investor education work.

### ***Experience sharing on supervision of junior traders***

3.22 In one case, SFC suspected market manipulation by a company in the constituent stocks of Morgan Stanley Capital International Hong Kong Index during the Closing Auction Session (“CAS”). Among the stocks, the prices of five had increased substantially from the pre-CAS prices. The deviations were caused by high limit bid orders from the company. A junior trader in the company was found responsible for inputting the orders.

3.23 SFC considered that the company might have mishandled the placing of orders. SFC found that there was no clear reporting line in the company and in the absence of his supervisor, the junior trader handled orders of a huge amount by himself and there was no methodology for the junior trader to follow in selecting the price levels. Besides, inputting orders at deviated prices without triggering an alert in the company also exposed the company’s weakness in its compliance surveillance system. In

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<sup>2</sup> Section 213 of SFO provides that the Court of First Instance, on the application of SFC, may make one or more of orders restraining or prohibiting the occurrence or the continued occurrence of any of the matters referred to.

response to SFC's observations, the company submitted a proposal to rectify its internal control weaknesses. As the CAS was suspended on 12 March 2009 and the company had taken remedial actions to address the deficiencies identified, the case was closed by SFC with the issue of a Compliance Advice Letter to the company.

3.24 PRP considered that proper control and supervision of junior traders was an issue that needed to be duly attended to. PRP noted that in response to its suggestion, SFC would consider publicising this case as a case study or an example for experience sharing in the industry.

### ***Raising awareness on corporate governance***

3.25 PRP reviewed a case related to possible market misconduct of a listed company. SFC noted that the company's share price fell sharply following a report that the company had sustained heavy losses in derivatives trading. Trading of the company's shares had been suspended and the company made a loss announcement. After an inquiry, SFC concluded there was insufficient evidence to suggest that insider dealing had taken place.

3.26 PRP noted that in the case, the chairman of the company had not informed other executive directors of the loss in equities and derivatives investment until after one week. PRP considered that the case revealed possible corporate governance concerns which might not be uncommon among listed companies, and suggested that SFC consider raising this with HKEx on further steps to raise awareness of the listed companies on related issues.

3.27 Noting that HKEx is the front line regulator with responsibility for corporate governance issues, SFC would duly raise the issue with HKEx for its consideration.

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

3.28 The Securities and Futures (Stock Market Listing) Rules ("the Rules") require a corporation applying for listing of its securities to file

copies of the application with 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 SFC on its behalf. This arrangement is known as “Dual Filing”.

3.29 PRP reviewed two cases relating to the processing of listing applications under the Dual Filing regime. PRP noted that SFC had followed its established procedures in processing the cases. The relatively long processing time in these two applications was mainly attributable to the incomplete information provided in the application, and the gap between the lapsing of the first submission and the making of the second submission.



## **Chapter 4      Observations on specific areas**

4.1            In the course of reviewing individual cases, PRP would also bring up specific areas of interest for examination. The aim is to identify areas for improvement with a view to enhancing compliance processes and maintaining the quality and integrity of regulation. In 2010-11, PRP deliberated on regulatory issues related to internet trading and high frequency trading. Details of PRP’s observations and SFC’s responses made to PRP are at **Annex C**.

### **(A) Guidelines on regulation of internet trading**

4.2            PRP reviewed a case where trading in the shares of a listed company had exhibited a seeming pattern of “marking the close”<sup>3</sup>. SFC found that a Mainland resident had made use of his sister’s account in Hong Kong and placed orders through the internet. SFC issued compliance advice letters to the Mainland resident and his sister respectively warning them of the risk of being prosecuted for market manipulation and the improper arrangement of letting another person use one’s securities trading account.

4.3            PRP observed that the growing popularity in internet trading might give rise to regulatory concerns. PRP suggested that SFC examine if existing measures were adequate, and whether additional safeguards and investor education efforts should be introduced to prevent unauthorised trading or other illegal transactions on the internet.

4.4            SFC took note of PRP’s comments on the regulation of internet trading. The prevailing requirements set out in SFC’s codes and guidelines are principle-based and apply to intermediaries who provide trading services to clients, via the internet or otherwise. In addition to the codes and guidelines, SFC issued a circular to licensed corporations in March 2010 specifically on information technology management. SFC assured PRP that it would review the need to update its codes and guidelines regularly, taking into account market developments and views from stakeholders. In terms of investor education,

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<sup>3</sup> Placing orders at or near market close to fix or influence an artificial closing price is commonly called “marking the close”. It is a type of market manipulation and is illegal under the SFO.

SFC pledged that it had and would continue to remind investors of the issues that they should note when conducting on-line trading.

## **(B) Regulation of high frequency trading**

4.5 PRP noted the incident of computer trading error in the United States in 2010 which had caused a market plunge, and asked SFC if programme trading could be an area of concern in regulation.

4.6 SFC confirmed that it had been keeping a close watch on market developments globally, and would adopt measured and appropriate regulations for the Hong Kong market. In fact, as part of this ongoing effort, a cross-divisional team had been set up to consider appropriate updates of internet trading policy, taking into account direct market access, algorithmic trading and high frequency trading issues. In considering regulatory proposals, SFC would consult both the stakeholders and the public before they were adopted. In relation to high frequency trading, SFC noted that other leading markets were still in the process of studying this matter. In addition, the International Organisation of Securities Commissions (“IOSCO”) had recently commenced a study on potential regulatory issues arising from high frequency trading. SFC had been participating in the IOSCO discussions on this aspect.



## **Chapter 6      Acknowledgement**

6.1            PRP would like to express its gratitude to SFC and its staff for their assistance in facilitating the review work, and their co-operation in responding to PRP's enquiries and recommendations in the past year.

**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 actions 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 actions taken and decisions made in relation to that case or complaint adhered to and are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly.
5. To receive and consider periodic reports from the Commission on all investigations and inquiries lasting more than one year.
6. To advise the Commission on such other matters as the Commission may refer to the Panel or on which the Panel may wish to advise.
7. To submit annual reports and, if appropriate, special reports (including reports on problems encountered by the Panel) to the Financial Secretary which, subject to applicable statutory secrecy provisions and other confidentiality requirements, should be published.
8. The above terms of reference do not apply to committees, panels or other bodies set up under the Commission the majority of which members are independent of the Commission.

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

- Chairman: Mr CHOW Wing-kin, Anthony, SBS, JP
- Members: Prof CHAN Yuk-shee, BBS, JP (*up to 31 October 2010*)
- Mr CHIU Chi-cheong, Clifton
- Ms CHOW Yuen-yee (*since 1 November 2010*)
- Mr FUNG Hau-chung, Andrew, JP
- Prof HO Yan-ki, Richard (*since 1 November 2010*)
- Dr LAM Kit-lan, Cynthia (*since 1 November 2010*)
- Mr LEE Jor-hung, Dannis, BBS
- Dr the Honourable LEUNG Mei-fun, Priscilla, JP
- Mr LIU Che-ning
- Mr SUN Tak-kei, David, BBS, JP
- Ex officio members: Chairman, Securities and Futures Commission  
(Dr FONG Ching, Eddy, GBS, JP)
- Representative of Secretary for Justice  
(Mr LAI Ying-sie, Benedict, SBS, JP)

## **Membership of Working Groups**

### **Working Group on Corporate Finance and Enforcement**

Prof CHAN Yuk-shee, BBS, JP (*up to 31 October 2010*)

Mr CHOW Wing-kin, Anthony, SBS, JP

Dr FONG Ching, Eddy, GBS, JP

Prof HO Yan-ki, Richard (*since 1 November 2010*)

Dr LAM Kit-lan, Cynthia (*since 1 November 2010*)

Mr LEE Jor-hung, Dannis, BBS

Mr LIU Che-ning

### **Working Group on Licensing, Intermediaries Supervision and Investment Products**

Mr CHIU Chi-cheong, Clifton

Ms CHOW Yuen-yee (*since 1 November 2010*)

Mr FUNG Hau-chung, Andrew, JP

Mr LAI Ying-sie, Benedict, SBS, JP

Dr the Honourable LEUNG Mei-fun, Priscilla, JP

Mr SUN Tak-kei, David, BBS, JP



## Securities and Futures Commission's responses<sup>5</sup> to PRP's observations and recommendations

### (A) Intermediaries supervision (inspections)

Item (1)
<p><u>Case findings</u></p> <p>SFC carried out an inspection on a company dealing in future contracts. Before the inspection, SFC met with the senior management of the company to discuss its business activities and operations. After the meeting, SFC conducted the inspection field work for about a month. SFC then followed up with the company on the issues identified until it was satisfied with the responses and rectification measures.</p>
<p><u>PRP's recommendation/observation</u></p> <p>PRP considered that supervision of intermediaries was an important part of SFC's regulatory function, and SFC was therefore invited to elaborate on the process and procedures on its inspection work, in particular on surprise inspections. (para. 3.4 of Chapter 3)</p>
<p><u>SFC's response</u></p> <p>SFC advised that the internal operating manual of its Intermediaries Supervision Department ("ISD") set out its detailed inspection work procedures. The internal operating manual had been revised as appropriate to incorporate recommendations made by PRP from time to time, arising mostly from their inspection case reviews.</p> <p>On the point about surprise inspections, SFC indicated that the manual had essentially followed PRP's previous recommendations and provided that "the Licensed Corporation or Associated Entity would usually be given seven-calendar-day advance notice before conducting an inspection. Shorter notices might be given where the circumstances justified, in which case the reasons for the shorter notice would be recorded...". Over the past few years, SFC had conducted various surprise inspections with short notices to licensed corporations in urgent circumstances, such as cases with serious concerns over the safeguard of client assets and misconduct issues.</p>
Item (2)
<p><u>Case findings</u></p> <p>In one case, a company licensed to deal in and advise on securities had sold authorised funds to clients directly or through banks and independent financial advisors. SFC found in an inspection that the company had not provided proper client agreements, and</p>

<sup>5</sup> Editorial changes are made mainly to remove case-specific information.

the basis of recommendations and the risks associated with the products were not clearly explained. In addition, it had not set out any policy or procedures to ensure suitability of the recommendations provided to the clients. Taking into account that there was no reason to suspect mis-selling to clients and given the limited scale of the operation involved, SFC decided that it would suffice to issue a management letter requiring the company to enhance its internal control system.

PRP's recommendation/observation

PRP suggested that SFC should ensure proper follow-up to forestall recurrence of similar problems, including the establishment of a follow-up mechanism on completion of the inspection. (para. 3.6 of Chapter 3)

SFC's response

SFC replied that the remedial actions undertaken by the firm in addressing SFC's concerns play an important part for the inspection staff to determine the appropriate regulatory action to be taken. In fact, the internal operating manual of ISD also set out the inspection work procedures including the mechanism in following up the deficiencies identified in an on-site inspection. SFC was required to assess the response of the company to its letter of deficiencies and to ask the company to take further action if the remedial actions were considered insufficient. In this specific case, the responsible case officer had followed the said procedures by following up with the company before concluding the inspection.

## **(B) Authorisation of collective investment schemes**

### **Item (3)**

Case findings

An application was submitted for authorization of several subfunds, including the A-Share Subfund. In addition to the need to enhance the disclosures in response to SFC's circular issued after the collapse of Lehman Brothers and SFC's other requirements, the applicant was only able to obtain the Qualified Foreign Institutional Investor ("QFII") quota after some time. With all outstanding issues related to the A-Share Subfund satisfactorily addressed, a formal authorisation letter was subsequently issued. The case took over 18 months to complete.

PRP's recommendation/observation

PRP noted that the long processing time in the case was mainly attributable to the need for the applicant to obtain a QFII quota. PRP suggested that it might be more efficient if applications for authorization of fund would only be accepted and processed by SFC after the applicant had obtained the requisite QFII quota.

(para. 3.9 of Chapter 3)
<p><u>SFC's response</u></p> <p>SFC noted that the timing for the grant of a QFII quota by the relevant Mainland authorities was in general beyond the control of an applicant and once the quota was granted, the applicant would be subject to a tight deadline to finalise all the fund documentation, marketing campaign, launch of the product and remittance of funds raised to the Mainland within 6 months. The processing of such applications before the granting of QFII quotas was a measure to facilitate the industry. There were only a few of such applications outstanding and SFC was not aware of any significant issue in the processing of these applications. SFC would keep this in view for future consideration.</p>

### (C) Complaints against listed companies

Item (4)
<p><u>Case findings</u></p> <p>PRP noted that trading of securities of a company listed on the Main Board of the Stock Exchange of Hong Kong Limited (“SEHK”) had been suspended for more than five years. The company lodged a complaint to the Hong Kong Exchanges and Clearing Limited (“HKEx”) alleging that the Listing Division of SEHK had mishandled the case, resulting in a prolonged suspension of trading of the company’s securities. To avoid possible conflict of interest, HKEx referred the complaint to SFC. After review, SFC concluded that there were insufficient grounds to substantiate the complaint.</p>
<p><u>PRP's recommendation/observation</u></p> <p>PRP noted that while there were detailed procedures to deal with complaints addressed to SFC, there were no established procedures on the handling of complaints referred by HKEx. PRP suggested that SFC review the need for drawing up guidelines for timely handling and proper monitoring of such cases. (para. 3.13 of Chapter 3)</p>
<p><u>SFC's response</u></p> <p>In the case concerned, HKEx referred the complaint to SFC due to a possible conflict of interest on the part of HKEx in handling the complaint. Such type of complaints was admittedly rare. The matter involved was distinct in nature from complaints generally received by SFC that were handled under the normal complaint procedures. The matter gave rise to issues as to whether HKEx had discharged its listing functions in a proper, fair and transparent manner. To facilitate SFC's oversight of HKEx's proper discharge of listing functions, relevant procedures were set out in the Memorandum of Understanding Governing Listing Matters dated 28 January 2003 entered into between SFC and HKEx (“MOU”). SFC suggested that complaints referred by HKEx in relation to their discharge</p>

of the listing functions should be handled in accordance with the standards and procedures set out in the MOU in relation to the oversight of SEHK's listing functions.

#### **Item (5)**

##### Case findings

A complainant raised with SEHK and copied to SFC a discrepancy of the residential address reported by a Non-Executive Director ("NED") of a listed company in its listing document. SFC advised that SEHK would follow up the matter. After investigation, SEHK considered that there was nothing further to pursue under the Listing Rules. On this basis, SFC decided to take no further action on the complaint.

##### PRP's recommendation/observation

PRP noted that while the case appeared straightforward, it had only been officially closed after nearly one year. PRP considered that an earlier review could have been conducted by SFC to close the case in a prompt manner.  
(para. 3.16 of Chapter 3)

##### SFC's response

SFC explained that due to some internal communication issues, the closing note of the case was recorded in the system after ten months. SFC would strive to complete the review of future cases as soon as practicable.

The case was referred to SFC on 14 May 2009. The Dual Filing Team of SFC examined the case on 19 May 2009 and considered no further actions required as stated in an internal email dated 21 May 2009. However due to staff miscommunication, the closing note was not recorded in the system until 8 April 2010. SFC normally strived to complete their review as soon as practicable and believed the case was an isolated incident.

### **(D) Investigation and disciplinary action**

#### **Item (6)**

##### Case findings

Arising from complaints lodged by several investors who had subscribed for shares of a listed company in a grey market, SFC found that the middleman promoting the shares before their listing might have conducted unlicensed activities. The case raised question as to whether "securities" include "unissued shares". SFC sought clarification from the Court by making an application for a restraining order and/or declaration under section 213 of the Securities and Futures Ordinance ("SFO"). Eventually, the High Court issued

<p>an order confirming that “carrying on a business of dealing in securities in a grey market without a licence, whether or not those securities have been issued or listed, constitutes a contravention of the SFO”. SFC then issued a press release on the court ruling.</p>
<p><u>PRP’s recommendation/observation</u></p> <p>Having regard to the significance of the court ruling, PRP suggested that SFC consider if further publicity on “unissued shares” which are regarded as “securities” should be made. (para. 3.20 of Chapter 3)</p>
<p><u>SFC’s response</u></p> <p>Following the issue of press releases on 31 March 2008 and 26 May 2009, SFC gave further coverage to the Court’s decision in the Enforcement Reporter (issued on 12 August 2009) in which it was explained that carrying on a business of dealing in securities in a grey market without an SFC licence, whether or not those securities have been issued or listed, constitutes a contravention of the SFO. Lessons learnt for investors in this case would be included in SFC’s ongoing investor education work on the risks of IPO investment conducted through various media.</p>

<p><b>Item (7)</b></p>
<p><u>Case findings</u></p> <p>In one case, SFC suspected market manipulation by a company in the constituent stocks of Morgan Stanley Capital International Hong Kong Index during the Closing Auction Session (“CAS”). Among the stocks, the prices of five had increased substantially from the pre-CAS prices. The deviations were caused by high limit bid orders from the company. A junior trader in the company was found responsible for inputting the orders.</p> <p>SFC considered that the company might have mishandled the placing of orders. SFC found that there was no clear reporting line in the company and in the absence of his supervisor, the junior trader handled orders of a huge amount by himself and there was no methodology for the junior trader to follow in selecting the price levels. Besides, inputting orders at deviated prices without triggering an alert in the company also exposed the company’s weakness in its compliance surveillance system. In response to SFC’s observations, the company submitted a proposal to rectify its internal control weaknesses. As the CAS was suspended on 12 March 2009 and the company had taken remedial actions to address the deficiencies identified, the case was closed by SFC with the issue of a Compliance Advice Letter to the company.</p>
<p><u>PRP’s recommendation/observation</u></p> <p>PRP considered that proper control and supervision of junior traders was an issue that</p>

<p>needed to be duly attended to. PRP suggested that SFC consider publicising this case as a case study or an example for experience sharing in the industry. (para. 3.24 of Chapter 3)</p>
<p><u>SFC's response</u></p> <p>SFC would consider the suggestion.</p>

<p><b>Item (8)</b></p>
<p><u>Case findings</u></p> <p>PRP reviewed a case related to possible market misconduct of a listed company. SFC noted that the company's share price fell sharply following a report that the company had sustained heavy losses in derivatives trading. Trading of the company's shares had been suspended and the company made a loss announcement. After an inquiry, SFC concluded there was insufficient evidence to suggest that insider dealing had taken place.</p>
<p><u>PRP's recommendation/observation</u></p> <p>PRP noted that in the case, the chairman of the company had not informed other executive directors of the loss in equities and derivatives investment until after one week. PRP considered that the case revealed possible corporate governance concerns which might not be uncommon among listed companies, and suggested that SFC consider raising this with HKEx on further steps to raise awareness of the listed companies on related issues. (para. 3.26 of Chapter 3)</p>
<p><u>SFC's response</u></p> <p>The HKEx is the front line regulator with responsibility for corporate governance issues and SFC would raise the issue with HKEx for its consideration.</p>

**(E) Guidelines on regulation on internet trading**

<p><b>Item (9)</b></p>
<p><u>Case findings</u></p> <p>PRP reviewed a case where trading in the shares of a listed company had exhibited a seeming pattern of "marking the close". SFC found that a Mainland resident had made use of his sister's account in Hong Kong and placed orders through the internet. SFC issued compliance advice letters to the Mainland resident and his sister respectively warning them of the risk of being prosecuted for market manipulation and the improper arrangement of</p>

letting another person use one's securities trading account.

PRP's recommendation/observation

PRP observed that the growing popularity in internet trading might give rise to regulatory concerns. PRP suggested that SFC examine if existing measures were adequate, and whether additional safeguards and investor education efforts should be introduced to prevent unauthorised trading or other illegal transactions on the internet.  
(para. 4.3 of Chapter 4)

SFC's response

The requirements set out in SFC's codes and guidelines are principle-based and apply to intermediaries who provide trading services to clients, via the internet or otherwise. Below are examples of the requirements that are relevant to intermediaries who provide internet trading service to clients:

- a licensed corporation is required to have internal control procedures and operation capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from, inter alia, theft, fraud, and other dishonest acts.
- the management of a licensed corporation are required to ensure that the firm's operating and information management system meet the firm's need and operate in a secure and adequately controlled environment. That includes the establishment of appropriate security policies and procedures to prevent and detect any unauthorised intrusion into the firm's data processing system.

A circular was issued to licensed corporations on 16 March 2010 concerning information technology management.

In terms of investor education, the SFC had and would continue to remind investors of the issues that they should note when conducting on-line trading.

SFC reviews the need to update its codes and guidelines regularly, taking into account market developments and views from stakeholders.