

Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2004

Executive Summary

Introduction

The fourth Annual Report of the Process Review Panel for the Securities and Futures Commission (“PRP”) covers the work of the PRP from 1 January 2004 to 31 December 2004.

Background and Terms of Reference of the PRP

2. The PRP is an independent, non-statutory panel established by the Chief Executive in November 2000 to review the internal operational procedures of the Securities and Futures Commission (“SFC”) and to determine whether the SFC has followed its internal procedures.

3. Under its Terms of Reference, the PRP may review files of the SFC to verify that the action taken and decisions made in relation to any specific completed case adhere to and are consistent with the relevant internal procedures and operational guidelines. The PRP is required to submit its reports to the Financial Secretary annually or otherwise on a need basis.

Constitution of the PRP

4. The PRP, chaired by Mr. Vincent Hoi Chuen Cheng, currently comprises twelve members, including nine members from the financial services 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 a representative of the Secretary for Justice.

Work of the PRP in 2004

5. In 2004, the PRP reviewed completed cases and/or procedures of the SFC in 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;
- (g) hearing and appellate process relating to the issue of warning letters;
- (h) settlement of disciplinary action;
- (i) verbal request for information concerning the clients of the securities firms.

6. The PRP concluded that the SFC had generally followed its internal procedures in handling cases. The PRP also made a number of recommendations for improvement covering a wide range of the SFC's regulatory activities for improving the transparency, efficiency, consistency and checks and balances of the SFC's processes. Where the SFC has difficulties to adopt a recommendation, detailed explanations were given.

Engagement with the industry

7. 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.

Observations and recommendations

8. The observations and recommendations made by the PRP are summarised below.

(1) Observations and recommendations that are accepted

(A) Inspection of and prudential visit to intermediaries

Item (1)

Case findings/market views

The SFC conducted an inspection of a subsidiary and in parallel, a prudential visit to another subsidiary of the same group of companies

PRP recommendation/observation

The SFC should conduct either inspection of or prudential visit to related companies in one go so as to form a global view of the operation of the group as a whole. (Para. 3.5 of the Report)

SFC's response

The SFC will generally take the PRP's recommendation into account in its risk-based approach to the selection of intermediaries for inspection or prudential visit.

(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 for the issue of financial products submitted by an overseas company through its Hong Kong representative. 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 responsibility of the applicant to prepare good quality documents for consideration by the regulator, the PRP recommended that the SFC should 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 the Report)

SFC's response

The SFC noted the PRP's comments and has reviewed its procedures. The SFC found that the practice of copying correspondences between the SFC and the local representative to the overseas applicant 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 by phone 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 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 the Report)

SFC's response

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. 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.

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 the Report)

SFC's response

The SFC agreed to the recommendation. The procedural manual on the handling of complaints has been amended accordingly.

(D) Investigation and disciplinary action**Item (5) (4 recommendations)**Case findings/market views

In 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 SFC should 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 the Report)

SFC's response

The SFC agreed to adopt the following recommendations and the procedural manual has been amended accordingly –

- (i) standardise the names of reminder letters and letters of advice by grouping them as "advice letters" to avoid confusion;
- (ii) remind its staff of the circumstances leading to the issue of an advice letter as opposed to a warning letter;
- (iii) standardise the authority for issue of an advice letter (and a warning letter) at the rank of Director or above; and
- (iv) 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.

Item (6)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 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.
<p><u>PRP recommendation/observation</u></p> <p>The SFC should consider setting out rules on the handling of suspected criminal offence in order to achieve consistency in application. (Para. 3.15 of the Report)</p>
<p><u>SFC's response</u></p> <p>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. The SFC accepted that the deliberation of 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.</p>

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

Item (7)
<p><u>Case findings/market views</u></p> <p>Unlike formal disciplinary action for which statutory appeal channels 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 as an alternative to formal disciplinary process. 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.</p>
<p><u>PRP recommendation/observation</u></p> <p>In cases where the warning letters were issued as an alternative to a formal disciplinary process, the SFC should ensure that the representation made by a recipient of warning letter would be considered and, if justified, the warning letter should be withdrawn. (Para. 4.7 of the Report)</p>
<p><u>SFC's response</u></p> <p>In case a response to a warning letter could convince the SFC that a warning letter was not warranted, the SFC would withdraw the warning letter and notify the person concerned of the decision.</p>

(F) Settlement of disciplinary action

Item (8)
<p><u>Case findings/market views</u></p> <p>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.</p>
<p><u>PRP recommendation/observation</u></p> <p>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 the Report)</p>
<p><u>SFC's response</u></p> <p>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.</p>

Item (9)Case findings/market views

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.

PRP recommendation/observation

The Enforcement Division should consult other divisions where a proposed settlement would impact on the decision of the relevant divisions. (Para. 4.21 of the Report)

SFC’s response

The SFC agreed that the Enforcement Division should consult other divisions where a proposed settlement would have apparent effects on the operation of relevant divisions. The SFC also noted that the Enforcement Division had consulted the Licensing Department in the case under review.

Item (10)Case findings/market views

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

PRP recommendation/observation

The SFC should ensure that the deliberation of and rationale for going into a settlement agreement are documented in the case files. (Para. 4.22 of the Report)

SFC’s response

The SFC agreed and undertook to remind its staff to ensure that the reasons for entering into a settlement agreement would be recorded sufficiently.

Item (11)Case findings/market views

In one case, the SFC decided to suspend the licence of a supervisor and that of his subordinate and 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 who did not approach the SFC for settlement.

PRP recommendation/observation

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. (Para. 4.23 of the Report)

SFC’s response

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 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. The Executive

Director of the Enforcement Division 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 was 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 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 who 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 re-mention the pamphlet and the possibility of settlement for them to re-emphasise to their members. (PRP Secretariat's remarks: The PRP noted the SFC's response and would further discuss with the SFC on the implementation of this recommendation.)

Item (12)

Case findings/market views

The amount of 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 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 SFC should 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. (Para. 4.24 of the Report)

SFC's response

The SFC advised that it had 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 formalized. (PRP Secretariat's remarks: The PRP noted the SFC's response and would further discuss with the SFC on this issue.)

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

Item (13)

Case findings/market views

A securities firm was concerned about the SFC's practice of making verbal requests for information about its clients without citing the relevant statutory provision under which the SFC might obtain such information. The firm believed that the SFC should make it clear that provision of such information would be on a voluntary basis.

PRP recommendation/observation

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. (Para. 4.32 of the Report)

SFC's response

The SFC accepted that the provision of such information would be made on a voluntary basis. The SFC undertook to make this clear, whether such requests were made verbally or in writing. Where the request is made pursuant to the provisions in the Securities and Futures Ordinance, the SFC should cite the relevant provisions in the letter.

(2) *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

Unlike formal disciplinary action for which statutory appeal channels 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 as an alternative to formal disciplinary process.

PRP recommendation/observation

In cases where the warning letters were issued as an alternative to formal disciplinary process, the PRP considered the procedures should be improved to ensure procedural fairness. 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 the Report)

SFC's response

There was already segregation of the investigation function and the decision-making function as far as the issue of warning letters was concerned. For warning letters issued for misconduct that did not warrant formal disciplinary process, or for simple factual and technical issues which provided limited scope for dispute, 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.

Item (2)

Case findings/market views

The PRP considered that the industry's concern about 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 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

For warning letters to be issued without going through formal disciplinary procedures, the SFC should inform the person concerned of the intention to issue a warning letter before the letter is actually issued, and make it a standard requirement that the representation/response made should be reviewed by a senior officer who is not involved in the investigation and in making the decision regarding the issue of the warning letter. (Para. 4.11 of the Report)

SFC's response

The SFC had difficulties with the recommendation since it would impose substantial burden on the SFC, having regard to the large number of warning letters issued in a year. The procedures recommended by the PRP were akin to the formal disciplinary process. Its 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.

(B) Settlement of disciplinary action

Item (3)

Case findings/market views

In response to the SFC's explanation that settlement by payment in lieu of suspension was in line with the purpose of introducing fines as a disciplinary option under the Securities and Futures Ordinance, the PRP noted that 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.

PRP recommendation/observation

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

SFC's response

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 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.

Item (4)

Case findings/market views

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

PRP recommendation/observation

It was advisable for the SFC to elaborate on the circumstances where a settlement was not applicable in order to ensure consistency in interpretation and application. (Para. 4.25(b) of the Report)

SFC's response

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.

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 the Report)

SFC's response

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. 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.

Item (6)

Case findings/market views

It transpired from a case review 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

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 the Report)

SFC's response

The Executive Director of Enforcement Division was usually the decision maker in disciplinary action. 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.

Way forward

9. Looking ahead, 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. 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.