SECURITIES AND FUTURES BILL

SUBMISSIONS

of the

Securities Law Committee

of

The Law Society of Hong Kong

CONTENTS

General Overview.. 1
Licensing Regime.. 4
Disclosure Of Interests.. 8
Market Misconduct..17

GENERAL OVERVIEW

As a general matter, reform and updating of Hong Kong's securities, futures and forex legislation is clearly to be welcomed.

The Bill provides a number of helpful changes and additions to the current regime, although it does continue in many respects to retain many out-of-date elements rather than tackling head on those difficulties created by the existing legislation (presumably on the basis that some of the provisions fall under the "better the Devil we know" argument).

In addition, the layout and format is a nightmare to navigate around, particularly in the context of definitions.

There are some definitions which appear in one part of the Bill only but which are also used in other parts. It is not clear whether a definition which appears in one part of the Bill only is of general application or whether a different definition would apply to the same term in other parts. Essentially, all definitions should be grouped in one place and clearly marked as to which sections of the Bill they are relevant to.

As the Bill stands at present, it is not user-friendly legislation, and further thought needs to be given to this aspect of the process.

Section 159 (Business Conduct) gives the SFC considerable flexibility to regulate the market by promulgating "rules" having statutory effect. While the flexibility which this offers is welcome, we have the following concerns:

(i) rules will have statutory backing. Breach of the rules will be a criminal offence. However, many of the current equivalents to what will be in these statutory rules (for example the SFC Code of Conduct) are worded in general, non-statutory, language and are, in places, quite

vague. There will be considerable concern should the SFC introduce statutory rules which are worded in a similar way;

(ii) the rules have not been put forward for public consultation. Given their statutory effect, we would expect this to be done significantly in advance of the legislation coming into force;

(iii) the SFC has stated publicly that it does not propose to give statutory backing to the Listing Rules, the Takeovers Code or the Code on Share Repurchases. However, if one of the rules requires registered or exempt persons to comply with the (non-statutory) Listing Rules or Codes, that will, in effect, give them (indirect) statutory backing. Given the nature of the Listing Rules and the Codes (for example, the Takeovers Code expressly states that it is not to be interpreted as if it were a statute), this would be inappropriate;

(iv) the SFC's power to amend the statutory rules means that the usual lead time for legislative enactments and amendments will not apply. This raises a concern that market participants (and their professional advisers) may not receive adequate advance notice of changes to the rules. For example, at present, many SFC policies and decisions are communicated through the SFC bulletin or posted on the SFC website which, frequently, does not give adequate advance notice. It cannot be taken for granted that market participants and their professional advisers will necessarily always be made aware of the latest developments on a timely basis. It would be appreciated if the SFC would consider introducing practices which would improve the dissemination of amendments to the rules.

Additional specific comments and concerns are spelled out below in relation to the specific areas of the Bill.

LICENSING REGIME

We support the introduction of the corporations-only rule for licensed entities.

We support in principle the concept of "one-stop shopping" under a single licence, since that should allow more efficient structuring of group operations as a result.

However, there are various comments which need to be made as regards the proposed revised single licence regime:

Types of activity

- Clear guidance needs to be provided by the SFC as to how the categories will be applied.

- "Dealing in "futures contracts":

  - Why is there no equivalent in "dealing in futures contracts" of sub-paragraph (b) of the "dealing in securities" definition?

- Leveraged forex trading:

  - Why is there no power for the SFC to categorise instruments as either being or not constituting leveraged forex contracts?

  - The "hedging" exemption remains too narrowly drafted - in particular, it should include contracts or arrangements entered into by **any** body corporate (not just Hong Kong companies).

- "Advising on securities":

  - The "wholly incidental" advice issue in relation to solicitors and accountants has been dealt with in separate discussions.

- "Advising on corporate finance":

- ➢ This appears to be covered in many respects under "advising on securities". To that extent, the definitions of advising on corporate finance and securities should be made mutually exclusive.

- "Providing automated trading services":

  - ➢ The criteria for determining whether a system should have a licence or proceed directly to a section 94 authorisation should be clearly spelled out.

  - ➢ As with many other parts of the Bill, the provisional nature of the section 94 et seq provisions, whilst promoting flexibility, also promotes uncertainty. It is important that the relevant criteria and policies to be established in this regard are published for consultation as soon as possible.

We assume that there would be no additions to the categories of activity without prior public consultation.

"Professionals exemption"

The "professionals exemption" contained in Section 3 of the Securities Ordinance (which provides that a person shall not be regarded as "dealing in securities" if they act by or through another person who is a registered dealer / dealer's representative / exempt dealer / exempt dealer's representative) is reflected in the definition of "dealing in securities" contained in Schedule 6 Part I of the Bill. However, it has not been incorporated into the definitions of other activities which require licensing (for example, securities margin financing and leveraged foreign exchange trading). The results seem illogical. For example, an unlicensed person (perhaps a person in another jurisdiction), will not be able to conduct securities margin financing business in Hong Kong, even if all such business is carried out through a registered dealer in Hong Kong, although it could deal in securities in Hong Kong in these circumstances.

We therefore suggest that the old Section 3 "professionals exemption" be extended to more regulated activities than securities dealing and futures dealing.

Responsible officers

The main problems with this concept are:

- It takes no account of offshore-incorporated entities which operate outside as well as in Hong Kong and which may have several offshore-based executives. In our view, only persons who are based in Hong Kong should be covered. In addition, the fact that "responsible officers" are required to be licensed as representatives, with all the qualifications requirements and ongoing requirements that entails, makes it more unfeasible that offshore executives should be covered. The possible availability in practice of discretionary waivers appears to us to be insufficient for these purposes - the certainty of a tighter definition is preferable.

The requirement that at least one responsible officer must **always** be in Hong Kong should be modified at the very least to allow for the absence of all the responsible officers if there is a reasonable excuse. It would, however, be preferable to maintain the flexibility of the present system where at least one dealing director should, as a matter of usual business conduct and SFC policy, be present in Hong Kong. Failures to adhere to this for extended periods clearly impact on the fitness and properness of the registered entity and, indeed, of the relevant dealing directors. That seems preferable to creating potential criminal liability, which appears to be disproportionate to the "evil" being addressed.

The personal liability of "responsible officers" seems to us to be excessive and will almost certainly act as a deterrent to persons taking up such responsibilities - issues will undoubtedly arise as regards the ability to staff regulated entities (and, where staff are found, issues will surely arise in respect of insurance and indemnity arrangements). Rather than a "responsible" person, responsible officers appear to be viewed in the market as potential "scapegoats".

Similar comments apply to "executive officers" of exempt persons.

Exempt persons

The widening of the concept of an exempt person from merely covering securities to the other categories under the single licence is welcome.

Executive officers to report to the SFC any obstruction to their duties

This will clearly interfere with the internal management of organisations, potentially increasing, amongst other things, internal bureaucracy and corporate in-fighting. We consider this to be a highly unwelcome provision (the reporting provisions in the present internal control guidelines appear to be sufficient in relation to addressing this issue).

Business conduct

The level of uncertainty created by the principally enabling provisions in the Bill are a matter of concern unless there will be full public consultation in that regard, together with a reasonable lead time built in for implementation.

Temporary / Provisional Licences

The codification of the temporary licence regime is helpful, and the introduction of provisional licences welcome.

DISCLOSURE OF INTERESTS

This paper sets out the Committee's comments on the proposals in the Bill relating to the legislation on disclosure of interests.

1. General observations

We support the reduction in the initial disclosure threshold for substantial shareholdings from 10% to 5% and the shortening of the disclosure period to bring Hong Kong's disclosure threshold in line with international practice.

The proposed legislation is now though much longer and more complex than the Securities (Disclosure of Interests) Ordinance (the "Ordinance"), with a number of new developments which will require a significant increase in disclosure by those involved in the securities market, particularly in relation to equity derivatives. The implications for traders, writers and holders of equity derivatives are very great, especially when compared to the current rules under the Ordinance and the position in other jurisdictions (such as the UK). We are concerned that these new complex and (we believe) relatively unique disclosure requirements for derivatives may be a disincentive for international institutional investors and investment banks to actively participate in the Hong Kong securities markets.

In the Bill, the use of an explanatory schedule is continued. However, the schedule in the Bill is now in itself particularly long and complex and appears to be overlapping within itself and with the sections of the Bill. We would hope that the draft legislation could be considered with a view to seeing whether some sections could be deleted and the schedule incorporated into the main body of the Bill. We believe that legislation such as this which imposes criminal sanctions should be both understandable and straight-forward to comply with. The complexity of the old and new legislation is such that there is a real risk of inadvertent non-compliance which would lead to criminal sanctions.

2. Specific sections

2.1.1 Section 301(1) refers to the duty of disclosure of a notifiable interest in shares comprised in the relevant share capital of a listed corporation. By virtue of sub-Section (2), included in interests in shares is the underlying shares of any equity derivative that a person has or ceases to have, by virtue of (a) the holding, writing or issuing by him of the equity derivatives, (b)

the exercise by him of rights under the equity derivatives, or (c) the assignment by him or the lapsing without exercise of rights under the equity derivatives.

The definitions in Section 298 for these purposes are new and far reaching.

"relevant share capital" now refers not only to the issued share capital of a company but also its unissued shares which, if issued, would carry voting rights at general meetings.

"equity derivatives" is also extremely widely defined and covers most conceivable equity derivative contracts. The definition includes at paragraph (a) rights, options or interests in or in respect of the underlying shares. The definition includes in paragraph (b) contracts under which payments are made wholly or partly by reference to the value or change in price of the underlying shares or any rights, options or interest in the underlying shares. Therefore a person holding or writing a cash settled derivative will now be concerned as to whether he has a notifiable interest. This will create disclosure obligations and sanctions for equity derivatives which, to our knowledge, are far more extensive than in other comparable jurisdictions. Investment banks who regularly write, buy or trade cash settled equity derivatives (which give no right to shares or to exercise voting rights in relation to the shares) will no doubt wish to comment on this. Our concerns are noted above. In addition, cash settled warrants, an important part of the Hong Kong securities market and which previously were not relevant for discbsure purposes (due to the fact they gave no right to call for delivery of the underlying shares) will now fall in the definition of "equity derivatives".

2.1.2 Our understanding is that derivatives relating to more than one share are not intended to be covered. The words "wholly or partly" in paragraph (b) make this unclear. Please could you clarify as a separate proviso to the definition that derivatives relating to more than one share are not an equity derivative or short position.

2.1.3 We question the need for disclosure to be made in respect of purely cash-settled derivatives. For example, if an investment bank issued a cash-settled derivatives warrant in respect of the shares in a listed company, is there a good policy reason for the listed company to receive notifications from person who holds warrants representing 5% of the issued share capital of the listed company (or where the holding of the warrants, aggregated with other positions in shares in the listed company, triggers the 5% disclosure threshold)? We consider not. There seems no good reason for the issuer of the warrants to make notifications of the position

created by issuing the warrants and/or of changes to that interest as warrants are cancelled or exercised. We believe that what would be more relevant to the listed company is actual positions in its issued share capital, taken by the warrant issuer for hedging purposes. Subject to the disclosure threshold, that information is required to be disclosed to the listed company and the market in any event, and further notifications in respect of the warrants appear unnecessary.

2.1.4 Further, since notifiable interests will be determined by reference to both existing issued share capital and a right to subscribe share capital, convertible bonds will give rise to a disclosable interest. We believe that there is little to achieve by requiring disclosure of interests in convertible debt securities. Upon issuance of the convertible debt securities, both the market and the issuer would be aware of issue as well as the amount of shares which would be issued upon conversion. As the convertibles by practice seldom carry any voting rights, we believe that the identity of the holders of the convertibles would be irrelevant and need not be discbsed. Further, requiring disclosure of interests by holders in Euro convertible bonds may be impracticable given the anonymity of the market (most bonds are in global form and traded through Euroclear/Cedel) and the fact that the market participants may not be "equity investors" and thus unfamiliar with disclosure requirements.

2.1.5 With respect to all these equity derivatives, calculation will be constantly required to deal with changes in the issued share capital of the company and other events which give rise to an adjustment (for example, bonus issues, capital distributions etc.). This will certainly create added expense and burden for investment banks in order to ensure their derivative trading systems can also calculate whether a notifiable interest has arisen.

2.2.1 Under Section 304(3), where a person has a notifiable interest in the shares of a company and subsequently has or ceases to have or changes a short position then this requires disclosure as well. This is, of course, all new. In the definition of "short position" a number of circumstances where a disclosure obligation under the paragraphs (a)(i) to (iv) is required would seem to be already covered by the disclosure obligation by reference to the definition of "equity derivatives". We understand this overlap is intended.

2.2.2 With respect to paragraph (b) of the definition of "short position" is it clear, in practice, when this is intended to work? Most master stock borrowing and lending agreements provide the framework for the stock lending relationship which is then structured by reference to a series

of individual stock lending transactions. Sometimes, even then, a trade will fail if the lender has withheld the stock. Could you please clarify that it is when the borrower and lender have completed an individual transaction that the notification obligation will arise for the purposes of Section 305(1).

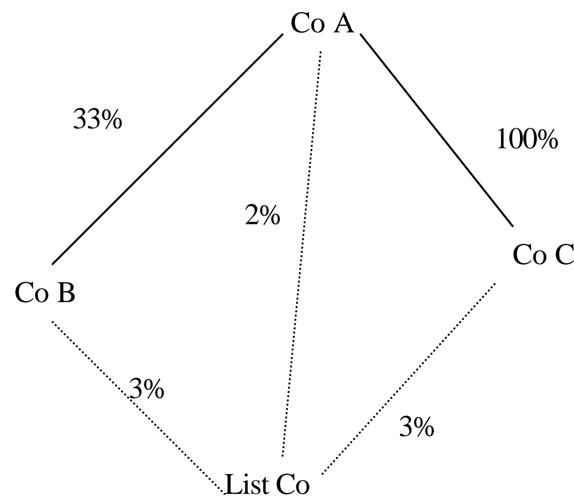
2.2.3 Depending on the specific relevant circumstances (and the detailed wording of the relevant agreements) a borrower can have a temporary disclosable interest in shares during the period of time between when he enters into borrowing agreement (when the right to acquire shares is likely to create a disclosable interest) and his use of the borrowed shares to settle a sale agreement (and vice versa on his acquiring shares, to settle the "return" obligation under the borrowing agreement). We recommend that an exemption is introduced to exclude such temporary interests.

2.3 Some of the disclosure obligations in Section 300 expressly require knowledge or awareness of the relevant facts before a disclosure obligation is triggered, and others do not. Can Sections 302(2) and 303(3) be clarified that a breach of disclosure obligations is only committed when the person becomes aware that he has the relevant level of interest in the shares or relevant short position, as the case may be.

2.4 Provisional allotment letters may also give rise to a disclosable interest. Upon the issue of the provisional allotment letters in a one-for-one rights issue, the shareholder holding 9 % of the shares would be deemed to be interested in 18%, triggering a disclosure obligation. If he were to do nothing and let his rights lapse, then, immediately after the latest time for acceptance, he would be interested in 9% triggering a disclosure obligation. Assuming all rights shares were taken up, immediately before the rights issue shares are issued the shareholder's interest would be deemed to fall to 4.5% (pursuant to clause 305(2)) and immediately after the rights issue shares are issued his interest would be 4.5%. Again this would trigger a disclosure obligation. Because of the ease of omitting a disclosure in such a complex regime, and bearing in mind non-disclosure carries criminal sanctions the issue is raised as to whether the information given is meaningful in that it would really assist the investing public.

2.5 With respect to Section 306, could not, for ease of reading, the percentage level be drafted into an earlier section (say Section 305) so that one does not have to cross over to Section 306?

2.6 In the following example, Section 309(6) appears to deem Co B and Co C "interested" in shares of List Co in which Co A has an interest (including shares in which Co A is interested by attribution). This will give rise to an unnecessary and misleading disclosure obligation on Co B. There will also be circularity since Co A is, in turn, treated as interested in all the List Co shares in which B is interested.



Co A has aggregate interest of 8%. Co B and Co C are deemed by Section 309(6) to have an 8% interest (resulting in Co A having an 18% interest, and so on ...).

2.7 Section 310(1)(b) (loans by controlling persons) is a significant extension to the concept of aggregating disclosure than is currently the case in Hong Kong and, for example, the UK. However, what is of concern is the new definition of "controlling person" which includes a person who has the ability to appoint one or more directors to the board of the company. This will capture a shareholder who has less than 35 per cent. of the voting rights but has negotiated a right to have a director on the board. For example, a strategic investor. This definition is a marked extension from the definition of "control" under the Takeovers Code and the provisions of the Companies Ordinance in relation to subsidiaries. It is not the sort of definition that one would expect to apply to a controlling person and we would suggest, for the sake of having some consistency in the Hong Kong rules and legislation, that the concept as to controlling the composition of the board should apply.

In addition, the exemption in Section 310(6) should apply not just to Hong Kong-licensed lenders or dealers but to anyone who lends the money in the ordinary course of his business anywhere in the world. If the change is to be made, presumably other forms of financial

assistance should be covered. We also suggest that exclusions for de minimis loans or loans to group employees would be appropriate.

2.8 Section 349 allows for an order to be made that a transfer of shares is void or the exercise of rights under equity derivatives are void if they are subject to an order imposing restrictions.

However, as drafted, this section would appear to apply to both parties to the equity derivative contract. Therefore, the exercise by the innocent counterparty of his rights under an equity derivative contract would be void. The possibility of having an unenforceable contract just because the other party has not complied with his obligations under the disclosure of interests legislation will be very alarming to banks and financial institutions. It is not something that a financial institution would be able to police. Accordingly, we suggest that it is an offence for the person in breach of the legislation to seek to exercise his rights under the contract but any exercise of rights either by that person or the counterparty is still valid. Similarly, the fact that the exercise of rights under an equity derivative which is the subject of an order constitutes a criminal offence will be of concern to financial institutions. Some of these institutions are dealing with many of these sorts of contracts throughout the day and may (even if they had been given some notice of the order) inadvertently exercise rights under such contract.

2.9 Section 377 requires the disclosure notification to be lodged in prescribed forms. Under the existing regime, use of the SFC's standard disclosure forms is encouraged but not compulsory. In our experience, the existing regime is a sensible approach as, in the case of very complicated disclosures, the current standard forms are not adequate and separate "tailored" disclosure forms have to be used. We strongly recommend that this flexibility is retained.

2.10 Schedule 9 is very long and, in order to make what is already complex legislation more understandable by lawyer and non-lawyer alike, we would suggest that further consideration is given to avoiding overlap. For example, the parts of the Schedule relating to notifiable interests for persons other than directors and the parts of the Schedule relating to notifiable interests of directors are generally the same. Could the section on notifications by directors be merged with the earlier parts of the Schedule and then stating at the end what the differences are? Also we would suggest that consideration is given to building into the relevant sections of the statute itself the relevant provisions of Schedule 9 so that Schedule 9 can be removed.

2.10.1 We are concerned that the requirement for disclosure of the identity of settlors of discretionary trusts may have significant adverse effects for Hong Kong's position as an international financial centre, as maintaining strict confidentiality in relation to the financial interests is a fundamental concern to many Asian investors who set up trusts for asset protection or tax planning purposes. We believe that "settlor" interests are not generally required to be disclosed in major international jurisdictions. In addition, whether or not the trustee is accustomed or would be expected to act in accordance with the wishes of the settlor may be difficult to determine.

2.10.2 Schedule 9 Section 11(b) provides that a person is regarded as ceasing to be interested in shares if another person fails to deliver the shares to him in breach of a contractual obligation. It should be clarified that this does not apply simply because of a delay in delivery of shares. It would not make sense if a purchaser, having acquired an "interest" at the time of agreeing to purchase, had to notify that his interest had ceased (and then notify that his interest had revived) if the seller was late in settling the purchase.

2.10.3 Schedule 9 Section 18 creates an exemption for holders in, and trustees and custodians of, collective investment schemes authorised by the SFC. There seems no justification for restricting this exemption to authorised schemes - foreign schemes which invest in Hong Kong shares should also be entitled to the exemption.

2.10.4 With respect to Section 22 (ceasing to be an exempt security interest) please could you clarify whether (a) should have the word "or" after it so that it is "(a) or (b)".

2.10.5 Under Section 27, a private company has to disclose the name and address of any person in accordance with whose directions it or its directors are accustomed to act. We question the need for this when one takes into account the corporate interest provisions of Section 309(2).

2.10.6 Section 28 also requires disclosure of the agreement itself or a memorandum of its terms where the agreement is one to which Section 310 applies. We question whether this level of disclosure is really necessary. Will the Company secretary really want the paperwork? It may be that the relevant agreement contains information which is private and does not need disclosure. For example, if a loan has to be disclosed, are the terms of the loan really of interest to the public?

3. Other issues to be considered

3.1 Investigation by listed corporation in relation to any interest in shares

Section 317 extends the subject of investigation by the company from anything which is an "interest in shares" for the purposes of the substantial shareholder notification requirements, to cover interests in equity derivatives, where the underlying shares of those equity derivatives are shares comprised in the issued share capital. The burden of complying with the notice in giving particulars relating to the interest in the shares and equity derivatives would be very considerable, and most of the information provided would be unlikely to be of interest to the listed company, since such notices are usually issued where a listed company is concerned about stake building and/or potential takeover bids. We recommend that Section 317 be restricted to interests in issued equity share capital only.

3.2 Personal Data (Privacy) Ordinance ("Privacy Ordinance")

Under the Privacy Ordinance, personal data should not, without the consent of the data subject, be used for any purpose other than the purpose for which the data was to be used at the time of its collection or for a purpose directly related thereto. Prima facie, to the extent disclosure of information pursuant to Section 317 of the Bill would reveal "personal data" (i.e. data relating directly or indirectly to a living individual and from which it is practical for the identity of the individual to be directly or indirectly ascertained), such disclosure is prohibited under the Privacy Ordinance, unless an individual to which the data relates consents otherwise. It is conceivable that the Privacy Ordinance could be used as a basis for refusing to make disclosure on the ground that it might constitute a breach of the Privacy Ordinance. This would render Section 317 ineffective to the extent it relates to disclosure of "personal data". This clearly creates a gap in the legislation and we recommend that the SFC reviews this matter urgently with a view to arranging appropriate amendments to the Privacy Ordinance for exemptions permitting such disclosure under Section 317 which may otherwise breach certain data protection principles under the Privacy Ordinance.

3.3 Definition of "listed corporation"

The Definition of “listed corporation” includes a company which only has warrants or debt securities listed on the Exchange. In practice, exemptions are often given by the SFC in respect of shareholdings in such companies, but the exemption needs to be applied for and a fee paid. The definition should be confined to companies with share capital listed on the Exchange, and disclosure only required in respect of share capital which is listed.

MARKET MISCONDUCT

This paper sets out the Committee's comments on the proposals in the Bill for criminal liability for "market misconduct", the jurisdiction of the Market Misconduct Tribunal, and the civil right of action which may arise in respect of "market misconduct" and certain other activities.

1. Overview

Parts XIII and XIV of the Bill apply in respect of "market misconduct", which is defined as encompassing 10 categories of activities in respect of securities and futures contracts.

Contrary to the proposals in the July 1999 Consultation Papers, any form of "market misconduct" will be a criminal offence, carrying a maximum penalty of 10 years imprisonment and a fine of HK$10 million.

All types of "market misconduct" will also be within the jurisdiction of the proposed Market Misconduct Tribunal, which will consider alleged cases on a civil standard of proof. Where the Market Misconduct Tribunal makes a determination that a person has engaged in "market misconduct", it may make a range of different orders.

The Tribunal will not (as had been proposed in the July 1999 Consultation Papers) have power to impose fines or penalties based on a multiple of the profit made or loss avoided, because of concerns that it could contravene the Basic Law and Hong Kong Bill of Rights for a tribunal to impose these sanctions without the safeguards of the criminal process. Presumably, however, the same conduct, if committed by a regulated person, could instead lead to SFC disciplinary proceedings under Part IX of the Bill, and the SFC can impose such sanctions.

Under Sections 268 and 295 of the Bill, anyone who suffers pecuniary loss as a result of market misconduct has a right to compensation by way of damages against the person or persons who engaged in the market misconduct.

2. Summary of comments

In summary, the main issues with which the Committee is concerned are as follows:

- **Overlapping criminal/civil/regulatory jurisdiction**

  The Bill creates a series of widely defined categories of "market misconduct", each of which could constitute a criminal offence or result in a case being brought before the Market Misconduct Tribunal. In addition, in the case of a regulated person, disciplinary action (including fines and pecuniary penalties) could be brought by the SFC. Any adverse finding by the Tribunal or conviction of a criminal offence, would be likely to lead to investors exercising the new statutory right of action for compensation. Although action cannot be brought against the same person for the same conduct by both the criminal courts and the Tribunal, there may still be considerable scope for a single incident to lead to multiple criminal, civil and disciplinary actions against the same person or group of persons in a manner which could be oppressive. Nor is there any clear guidance as to how a decision would be taken on whether to prosecute or to bring a case before the Tribunal.

- **Scope of criminal liability**

  Part XIV of the Bill creates 12 broadly defined offences, the scope of some of which seems somewhat unclear. As regards false or misleading information, the offence is one of strict liability, subject to a defence for a person who can prove that he could not reasonably have been expected to know that the information was false or misleading. This will be a difficult matter to prove. Other offences (eg "false trading") are also offences of strict liability subject to certain limited defences.

  If criminal liability is to be imposed, the scope of the offences should be more clearly and narrowly defined, and criminal sanctions should only apply in the case of intentional misconduct and/or knowing or reckless misstatements.

- **Liability of companies and their management**

  Under Section 368 of the Bill, if any employee does a wrongful act, his conduct is treated as that of the company. Hence the company could be prosecuted for market misconduct, as could any officers who are regarded as contributing to the wrongdoing through their "neglect" (Section 367(3)). It seems inappropriate to impose serious criminal penalties on

companies and their senior management in the absence of proof of deliberate misconduct at senior management level.

3. Scope of market misconduct

The Bill provides for ten different categories of "market misconduct", together with two additional offences in Part XIV of the Bill. Notwithstanding that most of the offences are based on provisions in the Australian Corporations Law, the Committee considers that many of the sections lack clarity, and that it is unnecessary and inappropriate to create such a large number of categories of market misconduct, particularly as each of them is a criminal offence carrying substantial penalties.

We comment below on each of the proposed categories of "market misconduct".

3.1 Insider dealing

The scope of insider dealing under the Bill is similar to (but somewhat wider than) that under the existing Securities (Insider Dealing) Ordinance. In addition to minor consequential changes which reflect the terminology used generally in the Bill, a number of other modifications have been made.

In particular, the definition of "relevant information" (i.e. inside information) is extended to include, not just information about a corporation, but also information about a shareholder or officer of the corporation, or about the listed securities of the corporation or their derivatives. The definition of "listed securities", in respect of which insider dealing may be committed, has been extended to include securities not yet issued, or issued but not yet listed, where it is reasonably foreseeable at the time of the insider dealing that the securities will become listed in the future, and this subsequently happens. Finally, the definition of "substantial shareholder" for insider dealing purposes is amended to include any person with a 5% interest (currently, the threshold is 10%). We have no particular objection to these changes. However, our comments are as follows:

- It is confusing and inconvenient that, within Part XIII of the Bill, "insider dealing" is defined in Section 253, but many of the definitions relevant to insider dealing are set out in the general interpretation section at the beginning of Part XIII, Section 229. Other

definitions are set out in Sections 230-233, making particular definitions somewhat difficult to find. The same comments apply in relation to Part XIV. Generally, having separate sections on each category of market misconduct, and their associated definitions, set out in both Parts XIII and XIV, adds unnecessarily to the length and complexity of the Bill.

- The drafting of the new "defence" in Section 254(7) and 280(7) appears defective. It would make more sense if sub-section (6) of each section was amended so that it applied where a person enters into a transaction or counsels or procures another party to enter a transaction, where the counterparty to the transaction knew, or ought reasonably to have known, that it was transacting with a person connected with the relevant corporation or a related corporation.

3.2 False trading in securities

The existing Section 135 of the Securities Ordinance applies where a person intentionally creates a false market, or acts with the intention of creating a false market. This is consistent with the law in other international markets - for example, in the United Kingdom an offence is only committed if a person engages in manipulative conduct for the purpose of creating a false or misleading impression and of thereby inducing others to deal in securities. However, based on Australian legislation, the new definition would cover a person who acts intentionally or recklessly, or who does anything that is likely to create a false or misleading appearance with respect to the market for securities or futures, or is likely to create or maintain an artificial price. Therefore, if a court or Tribunal concluded that a person had created a false or misleading appearance, or created/maintained an artificial price, he would be guilty of "false trading" even though he did not intend to do so.

The Section should be restricted to persons who had the intention or purpose of creating a false or misleading appearance in the market.

Section 257(6) creates a "defence" if a person can prove that the purposes for which he committed the act did not include the purpose of creating a false or misleading appearance. However it is unsatisfactory, particularly in the context of the criminal offence in Section 283, for the burden of proof to be shifted to the defendant in this way. Also, the defence is

confined to the types of conduct falling within Section 257(5) and does not apply to other conduct alleged to constitute "false" trading.

In the Consultation Paper, the Government seeks to justify the creation of a strict liability offence with a limited defence on the basis that such conduct is "blatantly manipulative." However, the various categories of market misconduct are defined in such wide terms that this may not always be the case. In the case of "blatantly manipulative" conduct, the prosecution should not find it difficult to establish that the defendant had the relevant intention or purpose to have committed the misconduct.

We are also concerned about the territorial scope of "false trading". While Section 269(4)(b) provides that activities which may create a false or misleading appearance with respect to a market outside Hong Kong will not be penalised in Hong Kong unless the conduct in question would have been criminal if carried out in the place where the market is situated, the onus of proof is on the defendant to establish that the conduct would not have been a criminal offence outside Hong Kong. Again, it is not correct to shift the burden of proof in this way, whether in respect of criminal proceedings or proceedings before the Tribunal. Also, if the investments are traded in a number of different markets, the defendant must prove that no offence would have been committed in any such market, which may be onerous.

3.3 Price rigging

This applies to fictitious or artificial transactions or devices, and to transactions not involving a change in the beneficial ownership of securities.

This category is also drafted as a strict liability offence, subject to a limited defence (only applying to certain types of conduct which are alleged to be price-rigging) for a person who can prove he did not have the purpose of creating a false or misleading appearance. Again, it seems inappropriate for the burden of proof to be shifted to the defendant in this way, whether in respect of criminal proceedings or proceedings before the Tribunal.

This category overlaps very significantly with the "false trading" category of misconduct. We recommend that these categories of "price rigging" (Sections 258, 263, 284 and 289) be deleted.

3.4 Dissemination of information about prohibited transactions

The reason for including this provision in the legislation, and the circumstances in which it is likely to apply, are unclear. If a person has engaged in "prohibited transactions", this will constitute market misconduct by itself, and a further category of market misconduct in respect of disclosure of information about such transactions seems unnecessary. It seems unsatisfactory to introduce a new provision attracting substantial criminal and civil penalties where the "mischief" at which the provision is addressed is obscure.

3.5 Stock market manipulation

The scope of this category is not restricted to false, misleading or artificial transactions. It would apply to any transaction that is likely to increase, decrease or stabilise the market price of securities, if done with the intention of inducing other persons to buy, sell or refrain from dealing in, as the case may be, those securities or securities of a related corporation.

A person who carries out a substantial transaction in securities or futures will know that the transaction will move the price and, thereby, affect the investment decisions of third parties. It may therefore be arguable that he "intended" his actions to have that consequence. However, if the transaction is a genuine transaction which does not create a false or misleading appearance in the market, the fact that it moves the market and influences dealings by third parties should not mean that it is a criminal offence and/or market misconduct.

Transaction effected for the purpose of inflating or depressing the market price would be artificial transactions already falling within the "false trading" category. We recommend the deletion of this additional category of market misconduct (Sections 260 and 286).

3.6 False or misleading information

This applies to anyone who is concerned in the dissemination of false or misleading information which is likely to induce transactions in securities or futures in Hong Kong, or to influence market prices of securities or futures in Hong Kong. It is not necessary to show that the person concerned was aware that information was false or misleading. Instead, the person would need to prove that he had acted in good faith, did not know and could not in the

circumstances of the case reasonably have known, or reasonably have been expected to know, that the information was false or misleading.

As a result, any statement (written or oral) which may influence the investment decisions of another person would have to be verified to prospectus standards, otherwise there is a risk of committing market misconduct (and a criminal offence punishable with up to 10 years imprisonment) if the statement turns out to be inaccurate. The Committee considers that providing inaccurate information should not be market misconduct unless the person acted knowingly or recklessly.

Insofar as these provisions create civil liability, we note that they overlap with Section 107 of the Bill which, in our view, sets a more appropriate test for civil liability. As regards criminal liability (Sections 287 and 291) these sections could be replaced by a slightly modified version of Section 109, which is another criminal offence for fraudulently or recklessly inducing persons to invest money. Again, we note that there is considerable duplication and inconsistency and the Bill is longer and more complex than necessary.

4. Other Offences

Part XIV of the Bill largely replicates all the categories of "market misconduct", creating criminal offences for each of them. There are, in addition, two further criminal offences, in Sections 292-293 of the Bill, relating to fraudulent or deceptive devices and "bucketing" of futures contracts. Section 292(1)(a) requires "intent to defraud or deceive", however (b) sets a purely objective standard and it would be more appropriate only to impose criminal liability where the person knew, or was reckless as to whether, his conduct would operate as a fraud or deception. Section 292(1)(c), like the market misconduct category of false or misleading information, creates a strict liability offence subject to a narrow defence, the burden of proof of which lies with the defendant. Again, this is an unsatisfactory standard for criminal liability, as well as entirely duplicating other offences in the Bill.

The rationale for introducing the offence in Section 293 is unclear. Does the Government have evidence of "bucketing" taking place in Hong Kong and which could not be dealt with under some other category?

As already mentioned, there is also another criminal offence in Section 109 of the Bill for fraudulently or recklessly inducing persons to invest money, which overlaps with the offences in Part XIV. The drafting approach results in long and complex legislation, and a more streamlined approach to the drafting would have been welcome.

5. Liability to pay compensation

Sections 268 and 294 of the Bill have the effect that a person who has engaged in "market misconduct" is liable to pay compensation by way of damages to any other person who has sustained pecuniary loss as a result, however that loss arose.

It should be noted that Section 107 of the Bill imposes civil liability for inducing others to invest money and Section 200 also imposes civil liability for false or misleading misstatements to the public. Again, overlapping provisions arise in different Parts of the Bill. The effect is that the Bill falls a significant way short of streamlining and consolidating the pre-existing legislation.

Section 200 is a new provision which has not previously been exposed for consultation. It imposes liability equivalent to that for false or misleading statements in prospectuses. We assume that it is intended to apply to announcements issued by a listed company in respect (for example) of movements in its share price.

However, Section 200 is drafted extremely widely. It may apply to anyone who "in any material manner assisted or participated in, or approved the making or issuing" of the statement. If there is to be such a cause of action it would be better to specify (as is done in Section 40 of the Companies Ordinance on prospectuses) the categories of person who may be sued, and in respect of which information they may be sued.

Section 200 appears capable of covering any communication made to the public, in written form or verbally, which concerns securities or futures contracts. This would appear to cover research reports, statements made by analysts during press interviews, and comments made by governmental or regulatory officials or staff of the exchanges. It does not seem appropriate to impose "prospectus liability" on all communications in respect of securities and futures contracts. Section 107 already imposes civil liability for fraudulent, reckless or negligent misrepresentations which induce other persons to invest, where the loss was within the

reasonable contemplation of the person making the misrepresentation at the time the statement was made. In the view of the Committee, Section 107 sets a more appropriate standard for, and scope of, civil liability, and we see no justification for the wider provisions in Section 200. Section 200 (and Sections 261 and 265) could be deleted, and Section 107 amended to include misrepresentations which induce people to deal in futures and/or to refrain from dealing in securities or futures. This would cover any gap that might otherwise be created.

In the Consultation Paper, it is noted that previous submissions argued that the statutory right of action should apply only if the plaintiff had an existing relationship with the defendant. However, any person can bring an action based on "market misconduct" by a third party, even though there was no prior relationship between them. The only limits are that the plaintiff would have to establish that his loss was caused by the defendant's conduct, and the court could determine that it was not "fair, just and reasonable" to require compensation to be paid.

This may create a danger of opening the floodgates for unmeritorious claims from investors. For example, there is a risk that anyone who had seen a research report (whether or not it had been sent to that person) which turned out to be inaccurate would bring an action. Even if frivolous claims are ultimately rejected, or the court exercises its discretion not to award damages, the defendant may have incurred substantial costs. Plaintiffs may be able to win out of court settlements, however unmeritorious their claims, because of the nuisance value of those claims.

6. Market Misconduct Tribunal

If "market misconduct" is alleged, a wide range of actions can be brought against persons involved i.e. criminal prosecution, SFC disciplinary action (in the case of regulated persons) and civil actions pursuant to the statutory right of action, as well as the case being referred to the Market Misconduct Tribunal for a determination. The need for this plethora of sanctions is questionable.

We have the following comments on the proposed scope of the Tribunal's powers.

- although it is no longer proposed that the Tribunal has the power to fine, we note that it may order a person to contribute to the expenses of the SFC and the Government (which

could be very substantial). We consider that if the Tribunal is to have this power it should be subject to strict safeguards, and a "cap" imposed.

- also, the Tribunal would have power to award payment of the amount of profit made or loss avoided, together with compound interest from the date of the market misconduct. An order to pay compound interest is generally viewed as penal in nature, and from the point of view of the defendant is tantamount to a pecuniary penalty, which can be very substantial.

- the Tribunal can make an order that a person shall not, without the leave of the court, deal in any securities, futures or collective investment schemes for a period of up to 5 years. This is described in the Consultation Paper as a "cold shoulder" order, but the drafting goes much wider than the normal concept of such an order. As an example of a "cold shoulder" order, the Takeovers Panel may direct that investment banks in Hong Kong do not provide corporate finance services to a person for a period of time. However, the Tribunal could make an order preventing a person from buying or selling any investments (which could for example prevent him from contributing to an MPF scheme, or continuing to deal with his existing securities portfolio). It would be very expensive and time consuming for a person to have to seek the leave of the court before he could make or unwind any investments held for his personal account. This provision should, at least, be redrafted to exclude assets held for personal savings and investment purposes.

7. Corporate and Senior Management Liability

Under Section 368 of the Bill, any act or omission of an individual acting or purporting to act for a corporation within, or apparently within, the scope of his office or employment is treated as the act or omission of the corporation. In the context of the market misconduct provisions and the criminal offences under the Bill, this substantially expands the normal circumstances in which a corporation can be penalised for the criminal conduct of an individual. Usually, this only arises where the individual was the "directing mind and will" of the company (Tesco v Nattrass) and the Bill should not extend the scope of corporate liability further than this.

Furthermore, where a corporation has committed a criminal offence under the Bill, if that offence was committed with the consent or connivance of, or attributable to any neglect on the part of, any officer of the corporation, that person is also guilty of the offence (Section

367(3)). In view of the extensive potential for criminal liability under the Bill, it does not seem appropriate to create a risk of officers of a corporation being guilty of serious criminal offences, unless they knowingly participated in the relevant conduct. Notwithstanding the similar provision in Section 147 of the Securities Ordinance, "neglect" should not be a sufficient threshold for imposing serious criminal sanctions.

Section 367(3) is drafted somewhat differently from the provisions relating to civil liability of officers for market misconduct, under Section 268 of the Bill. This extends civil liability to an officer of the corporation where the corporation has committed market misconduct which was directly or indirectly attributable to, or occurred with the knowledge, consent or connivance of that officer.

It would be more satisfactory to redraft both Sections 268 and 367(3) so that they only applied where the wrongful conduct had been committed with the knowledge, consent or connivance of an officer.

8. Safe harbours

Scope of power to establish safe harbours

The powers in Sections 269 and 296 for the SFC to create "safe harbours" should extend to the creation of safe harbours in respect of any category of market misconduct - at present insider dealing and certain other categories are excluded. For example, any safe harbour for price stabilising activities should create a defence in respect of insider dealing, as it does in other countries. Even if the SFC cannot at this stage foresee any circumstances in which it would wish to create safe harbours from some of the other categories of market misconduct, it is unhelpful to restrict the scope of the powers in this way.

Stabilisation activities

A safe harbour should be created in respect of stabilisation activities. This would bring Hong Kong in line with other developed securities markets, such as the United States and the UK. In Australia, which does not expressly permit stabilisation in its legislation, both the Australian Stock Exchange and the Australian Securities and Investments Commission have issued "no-action" letters in respect of stabilisation activities.

Chinese Walls

There should also be an express safe harbour, as in the UK, in respect of activities conducted on different sides of a Chinese Wall (Section 48(6) of the Financial Services Act 1986). This is similar to the "Chinese Walls" defence in Section 254(2) of the Bill, which applies in respect of insider dealing. Similar defences or safe harbours should be introduced for the other categories of market misconduct.

The Law Society of Hong Kong
3 August 2000

41098/08/00