Direct Line 2842 4819
Direct Fax
e-mail pauline.ashall@linklaters.com

10 May 2001

Our ref PAA **BY HAND**
Your ref

The Secretary to the Bills Committee
on the Securities and Futures Bill
Legislative Council
8 Jackson Road
Central
Hong Kong

Dear Sirs

Securities and Futures Bill - Part XIII and XIV

The Group of financial institutions for which Linklaters is acting has already provided written submissions on the Bill to the Bills Committee. We note that the Bills Committee is currently considering Parts XIII and XIV of the Bill, relating to Market Misconduct. We have seen a copy of the written Response from the Administration on the public comments made on Parts XIII and XIV, including those comments made by the Group (Paper No.12A/01).

The provisions of the Bill relating to Market Misconduct are of great importance to the operation of the financial markets in Hong Kong. We therefore enclose a further submission for the Bills Committee in respect of these provisions. This highlights some of the more important points made in our previous submission, and also makes some points on the Administration's Response to those comments.

SOLICITORS

Resident Partners

Pauline Ashall, A.J. Carmichael, Steven A. Christopher, David Clark, Marc Harvey, Elaine S.M Kwee, Celia C.L. Lam, Susan G. Lie, Rebecca Lo, Andrew Malcolm, Nick Rees, Zili Shao, Beryl Sze, Peter Treacy, Dominic Tsun, C.J. Walker

Consultants

Alison J. Fidler, Vanessa K.L. Poon, Simon J. Reid-Kay

REGISTERED FOREIGN LAWYERS

Lawrence Vranka, Jr. *(Partner, Linklaters New York, Resident in Hong Kong)*
Richard Lucchese *(Partner, Linklaters New York, Resident in Hong Kong)*

The member firms of Linklaters & Alliance are: De Bandt, van Hecke, Lagae & Loesch; De Brauw Blackstone Westbroek; Gianni, Origoni & Partners; Lagerlöf & Leman; Linklaters (which practises in Germany as Linklaters Oppenhoff & Rädler); with offices in: Alicante Amsterdam Antwerp Bangkok Berlin Bratislava Brussels Bucharest Budapest Cologne Frankfurt The Hague Hong Kong London Luxembourg Madrid Malmö Milan Moscow Munich New York Padua Paris Prague Rome Rotterdam São Paulo Shanghai Singapore Stockholm Tokyo Warsaw Washington DC

We would be grateful if you could arrange to circulate this submission to members of the Bills Committee. We can also arrange to let you have a Chinese translation if this would be helpful.

Yours faithfully

Linklaters

cc: Au King-Chi - Financial Services Bureau
Mark Dickens - Securities & Futures Commission

LINKLATERS ON BEHALF OF A GROUP OF FINANCIAL INSTITUTIONS

Summary of comments on Parts XIII - XIV of the Securities and Futures Bill

Introduction

The Group of financial institutions listed below submitted detailed written comments to the Bills Committee in January, and made a brief presentation at the Bills Committee meeting on 3 February 2001.

Parts XIII and XIV of the Bill relating to market misconduct and misrepresentations (and other provisions of the Bill relating to misrepresentations) are of considerable importance to the operation of the financial markets in Hong Kong. The Group is supportive of Hong Kong having a legal regime that is effective to deter and, where necessary, punish manipulative or abusive market conduct. We do not object in principle to the creation of new criminal offences (for example, criminalisation of insider dealing). Nor do we object to the establishment of the Market Misconduct Tribunal. We also acknowledge that the existing law already gives investors civil rights of action in relation to certain types of manipulation which causes loss, and again we have no objection to this in principle.

Nevertheless, it is of fundamental importance that the categories of "market misconduct" in the Bill are clearly defined, and provide sufficient certainty as to whether particular activities would be regarded as "market misconduct". We also consider that criminal liability should be reserved for wrongdoing committed intentionally or recklessly. Finally, we are concerned about the broad scope of the civil rights of action created under the Bill.

We believe that there is scope for making drafting amendments to the Bill that, while not changing the structure of the market misconduct regime as proposed by the Administration, or reducing the SFC's powers, would alleviate the concerns about:

- legitimate market activities being potentially caught by the new regime,
- criminal liability being imposed for inadvertent errors, and
- market participants being subjected to oppressive civil lawsuits.

The rest of this paper highlights some of the comments already made to the Bills Committee, and also comments on the Administration's Response to public comments made on Parts XIII and XIV (Paper No.12A/01).

Insider dealing

It does not seem that the Administration's response addresses all the issues raised in our previous comments. The starting point is that the existing Hong Kong legislation on insider dealing appears somewhat outdated, and does not include safe harbours for various types of transactions that, while entirely legitimate, may technically fall within the definition of "insider dealing".

An example set out in our previous paper is that of a substantial shareholder wishing to increase its stake in a listed corporation, where the fact that the stake is to be increased may of itself constitute "relevant information", with the result that a purchase of the shares on behalf of the substantial shareholder would constitute insider dealing. The Administration's stance appears to be that the market currently has no difficulty in carrying out such transactions. However, the Securities and Futures Bill creates an opportunity to provide Hong Kong with more modern securities legislation and to remove existing anomalies. We would therefore urge that additional

defences equivalent to those in the U.K. law on insider dealing (and which are also reflected in the laws of other international markets such as Australia and Singapore) be introduced.

False trading

Clause 265(1) and (2) (creating a false or misleading appearance) require that the person acted "intentionally or recklessly". However we are concerned that, if a person intentionally does something that, in the view of the Tribunal or Court, has the result of misleading the market, he would be guilty of "false trading", even though he did not intend, and was not reckless as to whether, his conduct created a false or misleading appearance. In our previous comments, we urged the Government to clarify the position by a minor drafting amendments to make clear that the intention or recklessness must relate to all the elements of the offence. The Administration's response does not address this issue.

Clause 265(5) deems certain types of transactions to constitute "false trading", subject to the possibility of the person who engaged in the activity establishing a defence that his purpose was not to create a false or misleading appearance in the market. We understand that Clause 265(5) is intended to prohibit "wash trades" and "matched orders", and we agree that these are abusive transactions that should be prohibited. However, Clause 265(5) would also appear to be drafted widely enough to catch many legitimate transactions:

- by Clause 242(7), a sale or purchase is treated as not involving a change in beneficial ownership if one person had an interest in the securities before the sale or purchase, and an associate of that person has an interest after the sale or purchase.
- Read literally, the clause would prohibit off-market transfers of securities from a company to an associated company, which occur very regularly and have no market impact whatsoever.
- Even in relation to market transactions, it may be very likely that one company will be selling securities (for example, for the purposes of an index arbitrage transaction, and an associated company, or a different division of the same company, (for example, a fund manager acting for its clients) will be purchasing the securities in the market). As a result of Chinese Walls, each party will be unaware of the other's involvement in the market.

In summary, we do not agree with the Administration's comment that the only types of transactions falling within Clause 265(5) are "common blatantly manipulative forms of conduct which have few legitimate excuses". Nor do we believe that it would make it unduly difficult to prosecute blatantly abusive conduct if the onus of proof was on the prosecution. Furthermore, we consider that Clause 265(5) should be more narrowly drafted so as not to deem transactions between associated companies to be illegal.

Price rigging

We remain of the view that a separate market misconduct category of price rigging is unnecessary. The Administration in its response does not explain why, in view of the considerable duplication between Clauses 265 and 266, both are included in the Bill.

The Administration states in its comments that it would be circular, confusing and unnecessary to expand the defence in Clause 266(4) to all the various categories of offence set out in Clause 266. If it were clear that the offences in Clause 266(1)(b) and (2)(b) require proof of intention or recklessness as to all the elements of the offence (including artificiality) we would agree with this. However, we consider that as drafted, these categories do not necessarily require proof of wrongdoing. Our preferred solution would be to repeal or redraft Clause 266(1)(b) and (2)(b).

However, if this is not done, we consider that a defence should be available for a person whose purpose was not to rig the market.

False or misleading information

We note the Administration's comments on Clause 290, but remain unconvinced that it is appropriate for the Bill to criminalise the negligent dissemination of false or misleading information. The offence is a very serious one, carrying a maximum penalty of 10 years imprisonment and a fine of HK$10 million. Also, Clauses 268 and 290 are very widely drafted, and may apply to anyone who is "concerned in" the dissemination of false or misleading information if that information is regarded as "likely" to affect market prices or induce transactions.

This raises the potential for multiple liability, and for civil lawsuits to be brought not just against the person with direct responsibility for the mis-statement. For example, where a listed company has issued an announcement, actions might be brought against all the professional advisers to the company who were in any way involved. Furthermore, these provisions may apply not just to formal documents such company circulars, but also to informal comments or correspondence. For example, an off-the-cuff remark to the press by a director of a listed company may be likely to affect market prices, and it seems very harsh that the director would be exposed to the risk of criminal and civil liability if the remark was, through carelessness, inaccurate.

In summary, we believe that criminal liability should be limited to mis-statements made knowingly or recklessly. While we do not object in principle to statutory rights of action for negligent misrepresentations, we consider that the scope of the right of action should be further qualified, so that the action should only arise in favour of persons to whom the relevant representation was addressed, and where it was reasonable for the person to rely on the representation, and where the loss was within the reasonable contemplation of the parties at the time when the misrepresentation was made.

For completeness, the same concerns arise in relation to clause 208 of the Bill (civil liability for public communications) which in our view is far too widely drafted.

Fraudulent or deceptive devices

We proposed that Clause 292, which applies to fraudulent or deceptive devices, be amended to delete references to practices which are "deceptive", because of concerns that this may impose a purely objective standard. On the basis that the Administration conclude that "deception" imputes the need to prove a blame worthy mental element, we question whether "deceptive" adds anything to "fraudulent" in any event.

Falsely representing dealings in futures contracts

We had proposed a minor amendment to ensure that, if a futures contract was being executed on a futures exchange, and the broker mistakenly confirmed that the order had already been executed when it had not, he would have the ability to establish a defence. This has been rejected by the Administration. This means that the offence is one of strict liability, and could criminalize mistakes made by legitimate futures brokers who are not "bucket shops".

List of submitting group members

Credit Suisse First Boston (Hong Kong) Limited

Deutsche Bank AG

Dresner Kleinwort Wasserstein

Goldman Sachs (Asia) L.L.C.

Merrill Lynch (Asia Pacific) Limited

JP Morgan

Morgan Stanley Dean Witter Asia Limited

Salomon Smith Barney Hong Kong Limited

UBS Warburg