Securities and Futures Bill

SECTION A - INSOLVENCY PROVISIONS (PARTS III, X AND XII)

As a foreword to this part of our commentary we would re-iterate the primary purpose of the reform is to create a modern regulatory and legal framework that

- promotes market confidence;
- secures appropriate investor protection;
- reduces market malpractice and financial crime;
- facilitates innovation and competition.

In general, we concur with the aims of this Bill however we believe it should take better account of those investors who may suffer in the event of the collapse of a recognised exchange participant. Given the volatility of the Hong Kong market it is important to promote investor confidence in the market and seek to assuage the fears of investors. Where occurrences within the market put investors at risk, legislation and regulation should seek to maximise the protection available to them.

Although the Securities and Futures Bill ("SFB") seeks to promote market confidence and secures appropriate investor protection, in practice in the event of an exchange participant becoming insolvent, it appears to protect the clearing house in priority to an investor. We note that as a consequence of the provisions of this Bill the clearing house is put in a position similar to that of a secured creditor. If this is the case then investors, creditors and others dealing with the company should be informed of this priority, either through registration in the company's statutory records and/or through client documentation. In addition, we consider that the clearing house and the Commission are better placed to identify a participant who is likely to default and to take precautionary steps to protect their position. Furthermore they have the benefit of recovery procedures afforded by recognised default rules. Consequently we believe the Bill should be amended to give greater protection to investors upon the insolvency of a participant. Where the law of insolvency is inconsistent with the Bill, the law of insolvency should prevail as this has been designed to protect the interests of all parties involved in the event of an insolvency.

Regrettably in the past we have seen failures of Exchange participants, some high profile, with dire consequences for those investors who invested funds and their trust in those participants. There is a clear need to improve the legislative and regulatory measures that seek to afford protection to the investor.

Commentary on specific sections of the Bill

Clause 45 – Proceedings of a recognised clearing house take precedence over law of insolvency

The commencement of insolvency proceedings, i.e. the making of a winding up order or passing of a special resolution appointing liquidators would, in normal theoretical circumstances immediately terminate all contracts and otherwise legally binding agreements. This occurs either from the law of insolvency or from clauses within those contracts. From the law of insolvency perspective this is a necessary protection for creditors and all affected parties by preventing officers or management of the financially distressed organisation from dissipating the company's assets or incurring unnecessary costs in resolving litigation and thus possibly reducing the return for the company's creditors.

The SFB seeks to enforce the completion of a pending market contract which presumably envisages the time lag in the Hong Kong settlement system of T+2, i.e. the trade could be instigated prior to insolvency proceedings with settlement due to occur after proceedings have commenced. This measure if adopted would contrast sharply with the law of insolvency which seeks to prevent transactions occurring at an undervalue or creating a preference to one counter-party over the interests of all other parties. We would point out that if an office-holder believes such a transaction has occurred his course of remedy is through the Courts. A Court should be qualified to determine the facts of a case and make a reasonable decision. Binding legislation does not seem necessary.

Another risk of allowing such trades to be completed could be that the exchange participant entering into the trade is dealing in stocks to which it may not have clear title. By this we mean that if an exchange participant is financially distressed and attempting to raise cash, it may have done so by trading in clients stocks without the client's instructions. Alternatively, if the participant already has a shortfall of stocks in relation to the client positions that it maintains, it might utilise client A's stock to settle a trade on behalf of client B where client B's stock was already missing.

It would appear that clause 45(1) and (2) serve to protect the operations of the recognised clearing house rather than the individual investors, by allowing the clearing house to complete all outstanding uncompleted contracts at the date of the insolvency proceedings. We question whether this is consistent with the Bill's intention to protect investors.

In view of the significance of these provisions in relation to investors, we suggest that it may be appropriate for these provisions to be brought to the attention of investors either in the account opening documentation or contract notes.

Clause 46 – Supplementary provisions as to default proceedings

Before commenting on this section we feel it would be useful to outline the default rules prevalent in Hong Kong.

Hong Kong Securities Clearing Company Limited ("HKSCC") is the recognised clearing house of Hong Kong. It's default rules are contained within section 37 of the General Rules of CCASS being the clearing system maintained by HKSCC. A review of this section reveals the powers of CCASS to be fairly extensive upon the occurrence of an event of default. Its remedies include the ability to:

- to close out all contracts
- to sell or apply Marks, Collateral, Charged Property and any security furnished by a defaulting Broker Participant
- to exercise set-off pursuant to rule 1207 of the General Rules (basically set-off against any cash in the possession of CCASS)
- to debit Eligible Securities from the Stock Clearing account of a defaulting Broker Participant.

The intention of clause 46(1) appears to compel the office-holder to make an application for a release from specific duties where such duties would be compromised by the provisions of the Bill. It is not clear in what circumstances the office-holder should be making an application. There is also the possibility that the estate has minimal funds and the costs of an office-holder making such an application could be prohibitive and would obviously be borne by the estate of the company in liquidation and ultimately the creditors or investors.

Clause 46(3) seeks to give the SFB priority over both the Bankruptcy Ordinance (Cap. 6)("BO") and Companies Ordinance (Cap. 32)("CO") in the event that the legislation is inconsistent. Below we look at the impact of this stance on the relevant sections of those two ordinances as stated in clause 46(3).

<u>Sections 12, 14 and 20 of the Bankruptcy Ordinance and sections 166,181, 183, 186 and 254 of the Companies Ordinance</u>

These sections deal with the commencement of recognised insolvency proceedings for individuals and companies and provide that either actions are automatically stayed or operations are ceased upon those occurrences or that the Court has the power to stay or cease actions. In the case of section 181 of the CO this permits a company, creditor or contributory to apply to court to restrain proceedings. Clause 46(3) of SFB states that the above-named sections do not prevent or interfere with any default proceedings, i.e. the court cannot interfere. We believe on the other hand that the court should be qualified to consider all the prevailing circumstances of a case and make whatever orders may be necessary.

Clause 46(3) of SFB therefore appears to favour heavily the interests of the clearing house as opposed to the interests of the insolvent estate's stakeholders. It differs markedly from the underlying intentions of the law of insolvency and gives the clearing house a distinct and arguably unfair advantage.

One other point we wish to make is that the clearing house should be obliged to notify the office-holder of default proceedings in the event that they are still continuing, irrespective of the date of commencement. Presumably the defaulting party is then entitled to make its own submissions in mitigation of the occurrence giving rise to the default. This does not appear to be permitted under the General Rules of CCASS.

Clause 49 – Disclaimer or property, rescission of contracts etc.

An office-holder will only normally seek to disclaim onerous property either where the value is negligible, or because it cannot be realised into a cash sum or the costs of realisation are greater than the expected cash proceeds

In the event that the asset is of a nature that a swing in market values could give rise to an additional liability to the insolvent estate, then disclaiming such onerous contracts cannot prohibit the clearing house from submitting a claim/proof of debt to the office-holder. Sections 59(5) of the BO and 268(5), CO, afford an aggrieved party protection in the event that a disclaimer has prejudiced his rights. Therefore the Bill should not seek to take precedence over these sections.

Clause 50 – Adjustment of prior transactions

This seeks to protect a recognised clearing house in relation to applying the default procedures from the provisions on fraudulent preference payments on insolvency. This would appear consistent with clauses 45 to 50. However we would note that as a consequence of these provisions, and clauses 52 to 53 following, the protection is similar to that of a secured creditor's position. If this is the case then investors, creditors and others dealing with the company should be informed of this priority, either through registration in the company's statutory records and/or through client documentation.

This clause seeks to prevent the office-holder's remedy for fraudulent transactions and undervalue transactions, yet one of the stated aims of the SFB is to reduce market malpractice and financial crime. Despite the inference of clause 50, clause 51 then purports to allow the office-holder the right to seek the prescribed gain from an undervalue or over-value transaction from the benefiting party

Clause 51 – Right of relevant office-holder to recover certain amounts arising from certain transactions

The partial re-instatement of sanctions against transactions at an under- or over-value is limited here to transactions occurring within the preceding 6 month period whereas under the BO (s51(1)(a)) the relevant period could be up to 5 years in some cases.

Clause 52 – Application of market collateral not affected by certain other interests

This clause does not protect the interests of the investor whose interests are held in trust by the defaulting participant. However, the argument of who should suffer as a result of the breach of fiduciary duty by the participant does not have a clear answer. The proposed treatment of market collateral as dictated by the SFB is consistent with the treatment afforded secured creditors. However in relation to secured creditors there is a requirement for registration of security. Accordingly, further consideration should perhaps be given to requiring the registration of this priority interest.

Clause 87 – Subrogation of recognised investor compensation company to rights, etc. of claimant on payment from compensation fund

The compensation scheme is subrogated to all the rights and remedies of the individual claimant to the extent of the payment made in accordance with subsection 1(a). Subsection 1(b) further limits the rights of the claimant in bankruptcy or winding-up or other legal proceedings until the recognised investor compensation company ("ICC") has been reimbursed the full amount of its payment.

This provision gives rise to a number of questions. Are the rights of the individual intended to be restricted only until the payment made to the individual claimant is recovered? If so, the words "to that claimant" or similar, should be added at the end of clause 87(1)(b). The current wording indicates that the individual's rights might be restricted until the ICC has been fully compensated to the extent of all the payments it has made to all claimants. If this is the case, then what obligation does the ICC have to enter into proceedings against the exchange participant (or defaulter) to mitigate the claimants' loss? This approach is similar to that adopted in the UK where employees claims are paid by civil agency, the Department of Employment and Education.

How does the ICC deal with the situation where a claimant who has received compensation repays that compensation in order to commence (or join in) legal proceedings against the exchange participant (or defaulter)? Will such a repayment be permitted?

Clause 205 – Winding-up orders and bankruptcy orders

This clause gives the Commission the right to petition for winding-up or bankruptcy in the event that it believes the petition to be in the interests of the public. However, as drafted, the provision does not appear to restrict the SFC's power to listed and related companies (cf clause 207) which, on the face of it, would be a conceptual change in the Commission's remit. If so this needs to be specifically justified. In addition to this, should the Commission be obliged to seek to resolve, in communication with the participant, the issues that gave rise to the need for presenting a petition, prior to making that application.

Subsection (3) states that the Commission will seek to inform the exchange company or clearing house. There is a perceived risk here that trading licences of the exchange participant may be suspended immediately and thus prevent him from trading. If the petition for winding up or bankruptcy is not subsequently granted, the defendant will potentially suffer a loss of trade which could detrimentally affect the participant's ability to continue his business. We believe the section should be amended to govern the actions of the exchange company and/or clearing house. There always exists the opportunity for the exchange participant to request voluntary suspension.

Clause 206 – Injunctions and other orders

In subsection (7) it states that where the Commission applies to the Court of First Instance for an interim order under subsection (6), the Commission shall not be required, as a condition of the order being granted, to give an undertaking as to damages. Historically the Supreme Court would not permit an ex-parte application

without the applicant providing an undertaking for damages. In the light of the comments on clause 205 (above) regarding possible suspension from trading, it seems to be inequitable that the Commission would be able to make such applications without bearing responsibility for its actions.

Insolvency practitioners could be appointed under a court order, pursuant to clause 205(2)(d), to administer the property of another person. These provisions are not sufficiently detailed to provide for the powers and duties of appointees. Whilst we note that under clause 206(2)(g) the Court can make any "ancillary order" which it considers necessary in consequence of making any other order, we believe that this leaves too much to the interpretation and discretion of the Court without providing guidance.

The definition of "property", previously defined for the purposes of Part X (in clause 188 of the white bill) and now contained in Schedule 1, should be expanded to include books and records. A provision should also be added to enable an administrator appointed under clause 206(2)(d) to approach the Court for directions.

It should be made clear that appointments may be joint and several.

Clause 207 – Remedies in case of unfair prejudice, etc. to interests of members

Again this section gives the Commission wide-ranging powers. In essence the measure seems acceptable given that the Court will make the final decision. However it may also be appropriate for the Commission to be empowered to make the application only following a complaint from a minority shareholder, given that the section seeks to protect the interests of minority shareholders.

Under clause 207(2)(c), appointments as receivers or managers of (part of) a listed corporation's property or business may be made. As with clause 206, the provisions are not sufficiently self-contained in terms of the powers and duties of appointees. While in practice a list of powers, etc. would probably be drawn up in consultation between the SFC and the appointee, and subsequently included in the draft order, still it is considered that the appointments under clauses 206 and 207 could expose appointees to significant risk. Under the circumstances, the legal framework governing them should be more substantial. It is likely that practitioners would be reluctant to take up this work without adequate indemnities from the Commission

It is noted that clause 207(2) is couched in similar terms to s168A, CO. However, if the SFC is responsible for instigating action against a listed, or previously listed company, it is not clear that the Court would always need to be involved in fixing the remuneration of the receiver or manger. Provision could also be made for remuneration to be agreed between the SFC and the appointee.

The inter-changing of terminology in this clause is confusing. Clause 207(1) refers to "a listed corporation", although clause 207(1)(d) indicates that the company need no longer be listed at the time that the SFC petitions the Court. Clause 207(2) reverts to using, "a listed corporation". Clause 207(5) on the other hand refers to "a company",

possibly to limit the effect of this specific provision to Hong Kong-incorporated companies (see the definitions in Schedule 1).

Clauses 228-236 – Investor compensation

The sections on investor compensation appear to be flawed. If an ICC benefits from a subrogated claim, the distribution may include stocks that were previously held for the benefit of the investor. At present there is no authority for the compensation fund to receive a stock distribution

Clause 234(1)(e) – should include (specifically) that the ICC should be able to authorise payments to third parties (e.g. liquidators/accountants) who have assisted the Commission in the calculation or determination of compensation claims.

Clause 235 – subrogation of the Commission to rights, etc of claimant on payment from compensation fund – comments made in respect of clause 87 above apply.

Clause 236(2)(a) - what rights/remedies does an individual claimant have regarding the Commission's decisions about who is entitled to claim, the manner and the amount of the compensation?

Can a claimant who has been fully compensated by the fund can repay the fund (with/without interest) and receive the shares being returned by the liquidator (once number of available shares is determined).

How, if a client is only partially compensated by the fund, does the liquidator pay the ICC? For example:

(a) Liquidator pays shares/cash to the ICC to the value of the cash the fund has paid to the claimant, but the balance of the claimant's shares/cash are given directly to the claimant (how to treat non-board lots);

(b) Liquidator pays all the claimant's entitlement to the ICC (even if it exceeds the compensation the claimant has received) and the ICC keeps all assets received for all claimants until all payments made to all claimants are fully reimbursed to the fund (see comments on clause 87 above);

(c) Liquidator pays the full amount of an individual's claim to the ICC but the ICC keeps only the shares/value paid to the individual claimant and then the balance is paid by the ICC to the claimant (as cash or shares).

The Bill should specify or at least give guidance of what is permitted under the proposed framework.

Finally, we would question whether it is appropriate for the SFC to be making rules to govern its own procedures and requirements under clause 236(2)(i).

SECTION B - SECURITIES AND FUTURES APPEALS TRIBUNAL, MARKET MISCONDUCT TRIBUNAL AND INVESTIGATIONS (PARTS XI, XIII, VI, VIII AND XV)

Securities and Futures Appeals Tribunal

It is not clear to us why certain decisions should be deemed to be "excluded decisions" and not be appealable to the Tribunal, although we note that under clause 225 an aggrieved person has a right of appeal against an excluded decision to the Chief Executive in Council.

We would suggest that under clause 221, the Court of Appeal should have the power to vary a decision of the Tribunal, in addition to the power to remit a matter back. In contrast, a power to substitute another order in place of a decision of the Market Misconduct Tribunal is conferred upon the Court of Appeal under clause 258(2)(b).

Market Misconduct Tribunal

Clause 251

We would suggest that the imposition of compound interest under clause 251 should be discretionary rather than mandatory, particularly given that the rate of interest on judgment debts is already relatively high. In normal circumstances, we understand, it is not common for the Court to impose compound interest.

Clauses 257-258

We doubt whether the power of the Court of Appeal to substitute a different order to that of the Market Misconduct Tribunal should be limited to orders made by the Tribunal under clauses 249, 250 and 252. A decision by the Tribunal with regard to contempt, under clause 253, for example, should also be susceptible to variation by the Court, which may for instance wish to vary the sentence imposed by the Tribunal. In a matter before the courts, a decision of the Court of First Instance regarding contempt of court may be appealed to the Court of Appeal.

Clause 272

The meaning of the phrase "directly or indirectly" in clause 272(3)(b)(ii) is unclear. We would suggest that something is either attributable to a person or it is not.

Clause 273

The contents of the "Safe Harbour" Rules will be important. We support the proposal to conduct full public consultation on any such rules before they are formally tabled.

Clauses 156-159 – Appointment of auditors

The reference in clause 156 to an auditor being appointed by the Commission to "examine and audit…the accounts and records of the licensed corporation…" may not be appropriate. The term "audit" in relation to the work of auditors has a specific

technical meaning. It is unclear what is intended in the context of this provision as the juxtaposed terms "examination" and "audit" would ordinarily represent two completely different things. It appears that an auditor appointed under clause 156 will not have been appointed to give an opinion on the financial statements of the company as such, in which case the term "audit" would need to be qualified. Furthermore, we would suggest that the engagement under clause 156(2) should be confined to looking into the specific allegations to which the provision refers, otherwise there would be a danger of its becoming open-ended and creating unnecessary uncertainty.

Given in particular the wide scope of the powers of examination under this clause, we would question why a decision to appoint an auditor should be an excluded decision under Schedule 7, and therefore not susceptible to appeal to the Securities and Futures Appeals Tribunal. We believe that this should not be an excluded decision.

Clauses 175-178 - Investigations

Consideration should be given to excluding under clause 178(1)(b) persons acting bona fide as legal advisers, otherwise an adviser who in good faith advised a client that he was not compelled to comply with a particular request from an investigator could be held liable for the failure to comply if the Court held that such failure was without reasonable excuse. This could deter legal advisers from using their best endeavours to serve the interests of their clients.

Clauses 347-357 - Power to investigate a listed corporation's ownership

We note that clause 341, regarding the production of records and evidence to inspectors, etc. is widely drafted. In particular, the duties imposed on officers and agents of a corporation to attend before an inspector (clause 350(2)(b)) and to give the inspector "all assistance in connection with the investigation which they are reasonably able to give" (clause 350(2)(c)) could be onerous and there is a potential danger that advisers may in effect be pressed into doing the work of the inspectors for them on an unpaid basis. There should be some safeguards to ensure that this does not happen and that any demands placed on advisers are kept within reasonable bounds.

Hong Kong Society of Accountants
18th January 2001.