COMMENTS ON SECURITIES & FUTURES BILL - LINKLATERS ON BEHALF OF A GROUP OF FINANCIAL INSTITUTIONS

Introduction

The financial institutions listed below (the "**Group**") have previously provided detailed written comments to the FSB, SFC and the Sub-Committee of the Legislative Council on the Securities and Futures Bill, on the draft Bill issued for consultation in April 2000 (the "**White Bill**"). Following the presentation to the Legislative Council in November of the Blue Bill, this paper sets out the Group's further comments.

The Group is supportive of the objectives of the new regulatory regime proposed in the Bill which (as stated in the Legislative Council Brief issued by the Financial Services Bureau) are to establish a user-friendly regulatory regime for the development of a fair, orderly and transparent market that is competitive internationally as well as attractive to investors, issuers and intermediaries. However, we had a number of concerns in relation to certain areas of the White Bill, which we believed could undermine the achievement of those objectives.

As discussed later in this paper, a number of changes have been made to the White Bill in the light of our (and others) earlier comments, which we very much welcome. In addition, we have had the opportunity to meet with representatives of the SFC and the FSB since publication of the Blue Bill. Those meetings have been constructive and helpful, and we hope that some, at least, of the points raised with them and set out in this paper, will lead to Committee Stage Amendments being proposed. However, quite a number of our earlier comments were not reflected in the Blue Bill and it is clear that some differences of view remain as between the Group and the SFC/FSB on a number of issues.

Executive summary

Our main issues in relation to the Blue Bill, as discussed in more detail later in this paper, can be summarised as follows:

1 Market misconduct and misrepresentations

Our main concerns are as follows:

- criminal liability for misrepresentations made negligently (i.e. where the defendant did not act knowingly or recklessly)
- the very wide scope of the statutory right of action for compensation for misrepresentations, which may apply to all kinds of statements (not just, for example, company announcements, offering documents and other formal communications) and which does not incorporate common law concepts such as "duty of care" and the reasonableness of relying on the statement
- lack of safe harbours in relation to legitimate transactions that might technically constitute insider dealing
- creation of a significant number of overlapping categories of "market misconduct". In particular, the offences for creating an "artificial" price and for "price rigging" appear unduly broad, and unnecessary in view of the other provisions of the Bill on market misconduct.

2 Disclosure of interests in shares

By extending disclosure to include interests in unissued shares and interests in cash-settled derivatives, and by requiring disclosure of changes in the nature of a person's interest, and of short positions, the Bill creates an immensely complex regime which will be very difficult and expensive to comply with, and which creates substantial risks of inadvertent errors resulting in criminal liability.

We question whether the information to be provided will be of value to listed corporations and to investors. The Bill also includes some exemptions, including a new exemption for stock lending and borrowing for Exchange participants, but as drafted that does not assist a large number of stock lenders and borrowers of Hong Kong stock.

We are also concerned that the extensive powers given to a listed corporation to investigate transactions relating to cash-settled derivatives and short positions in its shares will inhibit the development of the derivatives market in Hong Kong.

3 Licensing

3.1 Scope of "regulated activities"

We have some fairly technical drafting comments, and questions that require clarification, on the definitions of the various activities that will be subject to regulation. We are concerned in particular that the definitions of "dealing in securities" and "providing automated trading services" are overly broad and would, read literally, catch technology vendors and other service providers.

3.2 Individual licensing requirements

In our view, more guidance is needed as to the activities conducted by an employee that would amount to a "regulated function" and therefore would require an individual to be registered.

3.3 Transitional arrangements

It is important that existing registered persons be "grandfathered" so that they can become re-registered under the new legislation within the 2 year transitional period provided for in the Bill, without having to meet new requirements such as (in the case of individuals) examinations.

It is also important that transitional relief is given, or implementation be deferred for a period after the Bill is enacted, where substantive new prudential or conduct of business requirements are being introduced, for example in relation to exempt dealers that are not currently subject to such requirements.

4 Offers of investments

The Bill perpetuates many of the uncertainties of the current law as to the meaning of marketing "to the public", as well as narrowing the definition of "professional investors" in the context of the exemption for marketing investments. It also contains provisions equivalent to the unsatisfactory Section 72 of the Securities Ordinance, which requires a dealer, when communicating an offer relating to securities, to provide very detailed written information. The scope of this provision remains unclear and it may impede legitimate communications between a dealer and its clients.

5 SFC's rule making powers

We remain troubled by the fact that the SFC has extensive power to make rules a breach of which, without reasonable excuse, is a criminal offence punishable by imprisonment and substantial fines. We are also concerned that there is no requirement for those rules to be issued in draft for public consultation.

6 Unsolicited calls

We agree that there should be restrictions on high-pressure sales techniques through phone calls or personal visits. However, Clause 169 appears to extend the existing law to communications such as mailshots and advertisements posted on a website. Restricting those communications seems impractical and out of line with international practice, as well as being impractical.

7 Investor compensation

The approach to funding the compensation scheme, and the scope of the claims that can be made against it are of fundamental importance to intermediaries and investors in Hong Kong, yet are not set out in the Bill. We are concerned in particular about the risk of moral hazard and cross-subsidisation between different sectors of the industry.

1 Market Misconduct and Misrepresentations

1.1 General

We acknowledge that a number of helpful changes have been made to these areas of the Bill, including a reduction in the number of offences of strict liability, some streamlining in the drafting of Parts XIII and XIV, and changes relating to the criminal liability of a corporation for the acts of an employee or agent, and to the liability of senior management for "market misconduct" by a corporation.

Nevertheless, the overall approach of the proposed regime in the Bill in respect of market misconduct and misrepresentations remains intact. We continue to have some issues on the approach taken in a number of respects, in particular:

- serious criminal sanctions applying to negligent misrepresentations; and
- the scope of the proposed civil right of action, particularly in respect of negligent misrepresentations.

Without repeating all our previous comments (or our proposals for redrafting these provisions, as submitted to the FSB/SFC in August 2000), we set out below some of the main points, together with some further points of a technical or drafting nature.

We also consider that, unless Parts XIII and XIV of the Bill are changed, clear guidelines from the SFC on some of the provisions, confirming that they do not prohibit legitimate activities such as arbitrage even where the transactions affect market prices, will be essential.

1.2 Burden of proof

We note that there has been extensive press coverage on the changes made in the Blue Bill on market misconduct, asserting that the onus of proof in the Blue Bill has been shifted from the defence to the prosecution. The view has been expressed that this will result in the Bill being out of line with U.S. law and giving inadequate protection to investors. We disagree with this view and would note the following:

- The drafting of the market misconduct provisions is very complex, and achieving the right balance between protecting investors against malpractice, without creating undue risks for legitimate activities of market participants, does not depend solely on where the burden of proof lies but also on the way in which the elements of the offence are defined. In any event, it is only in a few cases that the burden of proof has changed from the position in the White Bill.
- In the cases of "false trading" and "price rigging", we understand that it has always been the Government's intention to prohibit only conduct that the prosecution can show was committed with the intention of, or reckless as to whether it would, manipulate the market. A minor drafting change has been made in the Blue Bill to clarify this although in our view the drafting of the Bill still does not achieve clarification.
- In the case of stock market manipulation it is necessary, as under the Australian Corporations Law on which this provision is based, for the prosecution to prove intention, and no change has been made in the Blue Bill.
- In relation to "disclosure of information about prohibited transactions" and "falsely representing dealings in futures contracts", the offences remain ones of strict liability,

with the prosecution not having to prove any particular intention. In these contexts we have not objected to strict liability (although in the latter case we propose a defence for a defendant who could show that he had made a mistake).

- In relation to "misrepresentations relating to securities or futures contracts", the prosecution is now required to prove negligence (rather than a defence being available to the defendant). The shift in the burden of proof is welcomed, but we remain concerned about serious criminal liability arising for negligence, so the change does not of itself meet our concerns.

The press coverage has stated that the U.S. places the burden of proof in respect of market misconduct on the defendant. As a general proposition, this is simply not correct. U.S. counsel has confirmed that, in relation to market manipulation, as that term is understood in the U.S., the burden of proof is clearly on the prosecution, whether that be the U.S. Department of Justice in a criminal prosecution or the Securities and Exchange Commission if administrative proceedings are commenced instead. In both cases it must be proved by the prosecution that the defendant acted for the purpose of creating a particular result. See in particular Section 9(a)(2) of the Securities Exchange Act 1934, 15 U.S.C by which it is unlawful "to effect … a series of transactions in any security… creating actual or apparent active trading in such security or raising or depressing the price of such security **for the purpose of inducing the purchase or sale of such security by others**." The onus of establishing these matters falls on the prosecution.

This has been interpreted by the U.S. courts to mean that the prosecution must establish "scienter" (intent, or recklessness) in order to prove a market manipulation offence under the Securities Exchange Act 1934.

While there are some contexts in the U.S. where misrepresentations relating to securities offerings give rise to private civil actions by investors unless a defence can be established, this is already the case in Hong Kong in any event (Section 40 of the Companies Ordinance, which creates civil liability for misrepresentations in prospectuses) and does not afford a useful analogy with the market misconduct provisions in the Bill which are drafted in general terms and would, if the onus of proof was on the defendant, mean that a substantial part of legitimate day to day activities in the financial markets would be criminalised unless the person carrying out those activities could prove the contrary.

1.3 Liability for misrepresentations

1.3.1 Criminal liability

Criminal liability arises under:

- Clause 106 (fraudulent or reckless misrepresentations which induce other persons to invest in securities, funds or "regulated investment agreements")
- Clause 290 (disseminating misrepresentations relating to securities or futures contracts, knowing, reckless or negligent as to whether the information is false or misleading)
- Clause 293 (identical to Clause 290, but applying in respect to leveraged foreign exchange trading).

Misrepresentations can also attract criminal liability under Clause 292 (fraud or deception) or Clause 294 (falsely representing dealings in futures contracts).

While we welcome the fact that Clauses 290 and 293 have been amended so that the burden of proving negligence has been shifted to the prosecution, we remain concerned that an offence can be committed through negligence i.e. producing information carelessly, and whether or not the person producing the information intended other persons to invest in reliance on that information. Despite this, the maximum penalty is a fine of HK$10 million and 10 years imprisonment.

We have reservations about serious criminal offences being committed in the event of a person's inadvertent but careless mistake, particularly where the error causes at worst economic loss (rather than physical harm). In most other situations, criminal liability for misrepresentation only arises where the misrepresentation was made knowingly or recklessly, and where the person concerned knew or was reckless as to whether it would be acted upon in a particular way by the recipient of the statement.

In the UK, for example, the Financial Services & Markets Act 2000, s.397 (misleading statements and practices) only imposes criminal liability for false or misleading statements made knowingly or recklessly and made for the purpose of inducing, or reckless as to whether it may induce, another person to invest or refrain from making an investment. In the U.S. also, criminal liability does not arise for mere negligence, i.e. only wilful violations are punishable by fine or imprisonment (Section 24 of the Securities Act of 1933 and Section 32 of the Securities Exchange Act of 1934).

There may be very specific situations where it is very clear that the utmost standard of care is required and where there may be an argument for imposing criminal liability for failing to meet that standard e.g. Section 40A of the Companies Ordinance, on prospectuses. However, in other contexts, civil liability to compensate investors (where appropriate) and/or disciplinary action by the SFC, the Stock Exchange, or the Panel on Takeovers & Mergers, is a more fitting sanction than imposing criminal penalties for careless misstatements.

We note that Section 138 of the Securities Ordinance and Section 64 of the Commodities Trading Ordinance already impose criminal liability for negligent misrepresentations in some circumstances (whereas Section 3 of the Protection of Investors Ordinance requires fraud or recklessness). However:

- the Bill should aim to rationalise the existing laws, which contain many anomalies, and to create an appropriate framework that protects investors without being unduly draconian; and
- the existing offences are narrower than Clauses 290 and 293 because they only apply to statements made <u>for the purpose</u> of inducing a sale of securities, or a purchase or sale of a futures contract.

In our view, Clauses 106, 290 and 293 should be combined into one offence (in Part IV of the Bill) covering:

- fraudulent or reckless misrepresentations;
- likely to induce investment transactions (of any type); and
- made with the intention of inducing, or knowing that they would or reckless as to whether they would be likely to induce, investment transactions.

Alternatively, we propose that Clauses 290 and 293 be amended to introduce a test of knowledge or recklessness and be limited to statements likely to increase, reduce or stabilise the market price of securities or futures contracts, or leveraged foreign exchange contracts as the case may be. This would be more consistent with the other "market misconduct" provisions and would reduce the substantial overlap with Clause 106.

1.3.2 Civil liability (to compensate investors)

This arises under:

- Clause 107 (fraudulent, reckless or negligent misrepresentations which induce other persons to invest in securities, funds or "regulated investment agreements")
- Clause 208 (previously Clause 200) which relates to false or misleading communications to the public
- Clauses 272 and 296, by which false or misleading statements falling within Clause 268 and 290 also create a civil cause of action for investors.

Clause 107

The previous version of Clause 107 made clear that a person was only liable to pay compensation for pecuniary losses that were within the reasonable contemplation of the parties at the time when the misrepresentation was made. We had also proposed restricting compensation to cases where it was reasonable for the person to whom a misrepresentation was made to have relied on it, and where compensation was fair, just and reasonable. Our proposal has not been accepted, and the provision that the loss must have been within the reasonable contemplation of the parties has been deleted.

In our view, Clause 107 goes considerably further than common law liability for misrepresentation. While we do not object in principle to a statutory right of action for negligent misrepresentations, we consider that the qualifications (mentioned above) on the scope of the right of action are essential to guard against the risk of unmeritorious claims and, potentially, unduly wide-ranging liability.

Clause 208

We strongly urged the deletion of Clause 208 (formerly Clause 200) and, instead, making some minor changes to Clause 107 instead. This has not been adopted in the Blue Bill. Apart from shifting the onus of proof as regards negligence (which is welcomed), and including a defence for persons involved in re-transmission of information, there are no significant changes, as compared with the previous version.

While we do not object in principle to civil rights of action being created in respect of negligent misrepresentations, Clause 208 as currently drafted is too broad in scope. Potentially, it seems that any communication made available to a number of persons (e.g. a newsletter to clients, or a brochure available in a firm's reception area) could be treated as a communication to the public. If Clause 208 is to remain in the Bill, we consider that it should be limited to announcements made to the public at large e.g. through public media such as newspapers, TV and financial portals, and to communications to holders of securities in a listed corporation.

If a communication is issued, the range of persons who can be liable under Clause 208 for any inaccuracy in that communication is still very wide. A person is treated as "responsible" for a communication if he issued it, caused or authorised the material to be issued, or in any material manner participated in, or approved, the making or issuing of it. This creates a risk of multiple liability and of a person with "deep pockets" being sued for misstatements contained in communications with which he had limited involvement.

In order to attract liability for negligent misrepresentation under Clause 208, it is only necessary that the representation "concerns" securities or futures contracts, or "may affect" the price of securities or futures contracts. This is very wide, and if Clause 208 is to remain in the Bill, it would be better if it was limited to a situation where the person making the communication was aware that it was likely to have a material effect on the price of specific securities. It would not apply to more general statements on political or economic events that may have an impact on the securities market. We do not see any reason for it to apply in respect of the futures market.

Liability under Clause 208 now arises either if this is "fair, just and reasonable" <u>or</u> if the person has "assumed a responsibility" with respect to the claimant in connection with the relevant communication. It is not at all clear when there would be such an assumption of responsibility, and even if there is, there should be no obligation to compensate unless this would be "fair, just and reasonable". It would be better if it was necessary for the claimant to show <u>both</u> an assumption of responsibility and that compensation is fair, just and reasonable.

We question why Clause 208 is necessary and it is our strong view that it should be deleted. Clause 107 could easily be amended to cover a number of situations which are outside its current scope but potentially within Clause 208 i.e. misrepresentations relating to futures contracts, and misrepresentations inducing a person to refrain from disposing of securities. If these changes were made, we see no need to perpetuate the overlap between Clause 208 and 107.

1.4 Market Misconduct

We address below some major issues, for discussion.

1.4.1 Insider Dealing

A few drafting changes have been made to the position as set out in the White Bill.

As far as the defences are concerned:

- since insider dealing has been extended to dealings, or counselling or procuring dealings, in shares as yet unissued and unlisted, there should be wider defences for pre-IPO marketing and underwriting;
- we find the meaning of the new defence in Clause 262(7) and 284(7) unclear. Presumably it is intended as a defence for someone who counsels or procures a transaction rather than a "person who enters into a transaction…as a person who has counselled or procured"? The latter does not seem to make much sense.

More generally, we consider that there should be additional defences equivalent to those in the Criminal Justice Act 1993 of the United Kingdom (the UK law on insider dealing) relating to market making, dealing on market information, acting with a view to facilitating a transaction and/or price stabilisation. In the absence of such defences, there is a risk that many legitimate market activities would constitute “insider dealing”.

For example:

(i) A securities dealer is planning to effect a large derivatives transaction with a substantial shareholder of a listed corporation and wishes to pre-hedge its position by buying shares in the listed corporation. The derivatives transaction could itself be “relevant information” and the securities dealer would be “connected with” the listed corporation because of the relationship with the substantial shareholder. The hedging transaction would therefore be prohibited, and none of the existing defences would appear to apply.

(ii) A person who already holds 5% of the shares in a listed corporation (and is therefore a substantial shareholder) wishes to increase its stake (subject to compliance with the rules on disclosure of interests and the Takeovers Code) and its broker is instructed to buy shares in the market. The information about the increase in the stake may be “relevant information”. If so, the acquisition of the shares in the market by the broker would seem to constitute “insider dealing” both by the substantial shareholder and the broker.

(iii) If the securities dealer is a participant on the Stock Exchange of Hong Kong, the position is even worse because if he receives “relevant information” in his capacity as an Exchange participant, (whether or not from an insider) dealing on that information constitutes insider dealing (Clause 240(2)(e) and (f)). Accordingly, an Exchange participant who received instructions to execute a large dealing order (whether or not the order was placed by a “substantial shareholder”) could be guilty of insider dealing if he accepted that order.

The intention in proposing these additional defences is not to weaken protections against insider dealing in the Hong Kong market. Instead, the Bill provides an opportunity to create greater certainty in respect of transactions that regularly take place as part of the normal operation of the market in Hong Kong (as in other international markets) but where, currently, uncertainty arises as to the potential application of the insider dealing legislation. This is particularly important now that insider dealing is to be made a criminal offence.

1.4.2 False Trading

This is “market misconduct” under Clause 265, and a criminal offence under Clause 287.

These sections cover a number of different types of activity:

(i) Creating a False or Misleading Appearance

There is no significant change in the drafting. As in the White Bill, it must be shown that the person acted “intentionally or recklessly”. However, despite the minor drafting change made in the Blue Bill, we remain concerned that, if a person intentionally does something that, in the view of the Tribunal or court, had the result of misleading the market, he would be guilty of “false trading” even though his dealings were effected for legitimate reasons and not for the purpose of creating a false or misleading appearance with respect to the market. In other words, it is not clear that the intention or recklessness must relate to all the elements of the offence.

We understand that the Government's intention in both versions of the Bill has been that the element of intention/recklessness should relate to the creation of a false or misleading appearance (and therefore the Government has not changed its policy by shifting the burden of proof to the prosecution in the light of comments received as has been suggested in the press). We would urge the Government to clarify the position by a further minor drafting amendment i.e.:

"False trading takes place when, in Hong Kong or elsewhere, a person does anything with the intention of, or being reckless as to whether it has, or is likely to have, the effect of, creating a false or misleading appearance."

Alternatively, we suggest that the defence in Clause 265(6) (for situations where the purpose of the conduct was not to create a false or misleading appearance) be extended to cover all types of "false trading".

(ii) Artificial price

Clauses 265(3) and (4) apply where <u>one or more</u> transactions creates or is likely to create an "artificial price" or to maintain the market at an "artificial" level. We believe that the concept of an "artificial price" is too uncertain to be the basis of criminal and civil liabilities. We consider that Clauses 265(3) and (4) are unnecessary in the light of the other provisions on "market misconduct" under the Bill and should be deleted.

(iii) "Matched orders"

Under Clause 265(5), an on-exchange transaction that does not involve a change in beneficial ownership is deemed to constitute "false trading". 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. Furthermore, Clause 265(5)(b) also prohibits the input of sale and purchase orders around the same time and around the same price by a company and its associates. There is a defence (under Clause 265(6)) if the person concerned can demonstrate that his purpose was something other than creating a false or misleading appearance.

Because of the width of Clause 265(5), there will be many cases where entirely legitimate transactions may appear to infringe the sub-section, and the onus is then on the relevant person to establish that the defence in Clause 265(6) is available. Failing a change to the drafting of Clause 265(5), we would urge FSB/SFC, at the very least, to issue some guidance on prosecution policy in this area, and to make clear that prosecutions would not be commenced except where transactions appeared to have been effected for the purpose of creating a false or misleading appearance.

The same comments apply to the criminal offence of false trading in Clause 287.

1.4.3 Price Rigging

This is market misconduct under Clause 266 and a criminal offence under Clause 288. Creating a separate offence of price rigging goes further than the Australian Corporations Law. There is very considerable duplication between Clauses 265 (false trading) and Clause 266, and we see no reason to retain Clauses 266 and 288 in the Bill.

If Clauses 266/288 are to remain in the Bill, our comments are as follows:

The provisions previously in Clause 258(1)(a) have been divided into two separate sub-sections, covering (a) transactions not involving a change in the beneficial ownership of securities, and (b) fictitious or artificial transactions or devices, respectively. Only in the latter case is "intention or recklessness" required, and Clause 266(1)(a) and (2)(a) create offences of strict liability. The same comments as set out above in respect of Clause 265 apply.

Clause 266(1)(b) prohibits artificial transactions carried out with the intention that, or being reckless as to whether, the transaction may have the effect of causing price fluctuations. If a transaction is regarded by the regulators as "artificial", the reference to "intention or recklessness" is unlikely to assist the defendant. For example, if a transaction is effected in order to carry out index arbitrage activities, and such transactions are considered "artificial", the person carrying out the transactions will be perfectly aware that they may have an effect on market prices (even though the purpose is not to move the market price) and, therefore, the element of recklessness would be satisfied.

As in relation to "false trading", one possible way forward might be to expand the defence in Clause 266(4) to apply to any charge of "price rigging". This creates a defence (in relation only to transactions not involving a change of beneficial ownership) where the defendant can prove that his purpose was not to create a false or misleading appearance.

The same comments apply in respect of the criminal offence of price rigging in Clause 288.

1.4.4 Fraudulent or Deceptive Devices

We have suggested deleting the reference to practices which are "deceptive" because this may impose a purely objective standard, not involving any fraud or intention to deceive. "Fraudulent" conduct is already caught by Clause 292.

1.4.5 Falsely representing dealings in Futures Contracts

This is now in Clause 294 of the Bill.

This is a strict liability offence. We do not object to this as such, but we propose that a minor amendment is made to ensure that if a person had made a genuine mistake and thought that an order from a client had been executed when it had not, he would have a defence.

1.4.6 Other points on market misconduct

If a corporation has engaged in market misconduct, the Tribunal may rule that any officer of the corporation has also engaged in the misconduct, if the market misconduct was directly or indirectly attributable to, or occurred with the consent or connivance of, him as an officer of the corporation (Clause 244(4)(b)).

Also, under Clause 250 of the Bill, the Market Misconduct Tribunal may make an order against any officer of a corporation where the corporation has engaged in "market misconduct" and the officer has failed to take all reasonable measures to ensure that proper safeguards existed to prevent this (see Clause 270).

We consider that Clause 250 should be deleted since it may have the effect of a person being treated as having engaged in market misconduct where that person had no personal involvement in the wrongdoing.

2 Disclosure of Interests in Shares

2.1 General

We have previously provided detailed written comments to the FSB, SFC and Legco expressing serious concerns on the provisions in Part XV of the Bill. In addition to reducing the disclosure threshold to 5% (to which we have no objection), the Bill substantially expands the scope of the current disclosure requirements by requiring disclosure of:

- interests in unissued shares
- interests arising under cash-settled derivatives
- short positions (with no netting of long positions in same stock)
- changes in the nature of a person's interest.

Compared to the White Bill, no substantial changes have been made to the scope of the proposed disclosure regime, although some minor amendments have been adopted: ie the information to be provided when a disclosure is to be made has been somewhat modified, to reduce the need to divulge commercially sensitive information to the market. Also, the drafting has been streamlined to some extent, to delete the previous Schedule 9 and include all the provisions on disclosure of interests in Part XV of the Bill. The exemptions from disclosure for trustees and custodians of funds, and for "exempt security interests" have been extended so that they can be relied upon by persons outside Hong Kong, and new exemptions have been introduced for agency brokers and for inter-group transfers. These changes are welcomed.

However, the proposed disclosure regime still goes considerably further than the equivalent legislation in other international markets. We remain of the view that the information required to be disclosed will be of little real value to listed corporations, regulators and investors, and that any benefits arising from wider disclosure are far outweighed by the cost burden created by the regime. Errors or delays in compliance are likely to occur very frequently and it is objectionable in principle that any such error or delay, even though inadvertent, is a criminal offence punishable with up to 2 years imprisonment and a fine of HK$100,000.

The SFC are producing standard Forms on which to disclose, but the drafts we have seen to date are (despite the SFC's aim of creating user-friendly, self-explanatory documents), lengthy and in a number of respects, confusing. This highlights the complexity that has been introduced to this area as a result of extending the disclosure regime.

The rest of this Section comments on some of the changes to Part XV of the Blue Bill, as compared with the proposals in the White Bill, and also raises some further drafting comments and queries.

2.2 Stock lending and borrowing

In our view, Part XV of the Bill will create significant difficulties for both borrowers and lenders of Hong Kong stock, and as a consequence will reduce the availability of stock for borrowing.

From the point of view of the borrower, a stock borrower acquires an "interest" in the borrowed shares and, as a result, would need to disclose his interest as a substantial shareholder if his aggregate interest in shares exceeded the disclosure threshold. (This view was confirmed by the SFC in its Consultation Paper on disclosure of interests). This would not appear to change under the new legislation. However, the new legislation also deems the borrower to have a "short position" in the amount of securities borrowed, because it must eventually return equivalent securities (see the definition of "short position" in Clause 299).

Therefore, it would appear that if a borrower borrows 5% of a class of relevant share capital, delivers out the stock into the market in settlement of a short sale and subsequently buys 5% in the market and then makes a stock return, numerous notifications would be required (as well as the borrower having to comply with its obligations as a short seller to provide "documentary assurances" under Part VII of the Bill).

If a fund, or its custodian, is acting as a stock lender, this may also lead to various disclosures having to be made by the custodian and the fund.

The overall result is very complex, and it is highly likely that, as end-lenders and custodians become aware of the extent of their reporting obligations and the criminal sanctions for non-compliance, they will be unwilling to lend out Hong Kong stock.

In our view, it would be far more satisfactory if a change "in the nature of the interest" was defined in such a way as <u>not</u> to include stock lending. Instead, an exemption, has been proposed in Clause 304(11) of the Bill, for "conduit" stock lending and borrowing i.e. where a stock loan desk borrows securities and on-lends them on the same business day.

This exemption would not apply to the end-lender or its custodian. Even in relation to "conduit" lenders and borrowers it is unlikely to be helpful - it only applies where the shares are borrowed and lent on the same day and in accordance with the rules of a recognised exchange company. It would only apply if the corporation was an Exchange Participant on the Stock Exchange and does not apply, for example, where the activities are conducted through a company outside Hong Kong, or through a Hong Kong-registered securities dealer which is not an Exchange Participant. So far as we are aware, all significant volumes of "conduit" stock borrowing and lending in the Hong Kong market are carried on by persons other than Exchange Participants and only a small proportion of all conduit borrowing and on-lending is actually completed on the same day.

The reason for the exemption generally not applying to intra-group borrowing and lending is unclear. There is a separate exemption, in Clauses 304(9) and (10), for intra-group transfers, which could exempt the borrower, but this is not drafted widely enough to cover a lender, where the lender remains "interested" in the shares and the change triggering a disclosure requirement is a change in the "nature" of the interest.

We understand that the FSB and SFC are giving further consideration to the application of the disclosure regime to such lending and borrowing activities, including considering alternative ways of obtaining the information they require in relation to stock borrowing and lending. We are supportive of this, but if the alternatives do not prove feasible we would urge them to make further changes to address our concerns.

2.3 Investigations by listed corporation

In our comments on the White Bill, we expressed concern about the wider concept of "interests" in shares applying in respect of inquiries by a listed corporation. Under the Blue Bill, a listed corporation has very wide powers to investigate interests in its shares, short positions in its shares and interests in equity derivatives over its shares arising at any time in the preceding three years, however small the interest.

Because of the expansion in scope of the meaning of “interests” in shares under the Bill as compared with the existing legislation, and the expansion to cover short positions and equity derivatives, the amount of information that must be provided in response to an inquiry by a listed corporation could be voluminous. Much of that information will be commercially sensitive and may be of no legitimate interest to the listed corporation, which will usually be concerned only to identify possible stake building in its issued share capital. The information must be provided within such reasonable time as may be specified in the notification from the listed corporation, and it is very unclear what would constitute a “reasonable time” where the information being sought is very extensive and therefore very time-consuming to provide.

We suggest that there is no justification for extending the powers of a listed corporation to make inquiries going beyond inquiries as to interests in issued share capital. We also consider that there is no justification for seeking information going back over a period of as long as 3 years. We believe that such extensive powers could be open to abuse (for example, by a corporation issuing inquiry notices to competitors to tie up resources and oblige them to incur significant costs).

2.4 Commencement of legislation

When Part XV of the Bill comes into force, disclosure will be required of all “interests” not previously discloseable and of changes in respect of interests previously notified, and of short positions, within 10 business days. This will be a very major exercise for substantial shareholders, particularly those who previously fell below the existing disclosure threshold of 10%. It is therefore essential that Part XV does not come into force immediately on enactment of the Bill, and that substantial advance notice (at least 6 months) is given of its commencement date.

2.5 Drafting Comments/Queries

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 the shares in such companies, but the exemption needs to be applied for and the fee paid. The definition should, in our view, be confined to companies with share capital listed on the Exchange, and disclosure only required in respect of share capital which is listed.

Definition of “relevant share capital” - in respect of issued share capital, this means shares of a particular class. It also includes unissued shares of any class which, when issued, would carry voting rights. It would seem illogical if a person has shares of class A, and holds convertible bonds in respect of class B shares, it would need to aggregate these holdings to determine the amount of “relevant share capital” held. The provision in Clause 299(2), which provides for interests to be calculated based on the shares in each class separately, does not assist because it refers to classes of the listed corporation’s <u>issued</u> equity share capital. Clause 305(1) also appears to require aggregation of interests in all classes of relevant share capital in determining the percentage level of a person’s “interest”. The same applies to Clause 305(4) in respect of “short positions”.

In relation to the White Bill, there was some discussion as to whether a derivative over a basket of shares would be regarded as creating an “interest” and/or a “short position” in respect of each of the underlying shares. Clause 299(6) now indicates that if the value of shares in more than one listed corporation represents a <u>substantial</u> part in the determination of the value of the derivative, no interest or short position arises in respect of the underlying shares. We would be grateful for some clarification as to what would be considered “substantial” for this purpose (e.g. if shares of one company represent 95% of a basket and another represent 5%, is the latter “substantial”?). Clause 299(6) as drafted seems defective because if there was a very large basket and no single stock in the basket was of itself substantial, the exemption would not apply, and therefore the holder of the derivative would have an interest in all the underlying stocks.

Clause 305(2) appears to have the effect that if a person holds 10% of the issued share capital, and the company issues more shares in a rights issue that the person does not take up, no disclosure obligation under Clause 304(1)(b) or (c) arises, even though the holding is diluted by more than 0.5%. However, if the person had taken up his pro-rata entitlement, the effect of Clause 305(2) is that he would have to calculate his prior holding based on the new issued share capital. This would appear to trigger a disclosure obligation, even though in reality his percentage interest has not increased.

The purpose of Clause 307(7) is obscure. If Company A is the parent company of Company B and Company B (for example) holds warrants to subscribe for shares in a Hong Kong listed company, Clause 307(7) is not necessary in order to apply the provisions of Clause 313 (interests to be taken into account) to Company B, because Company B is a “person” to which Clause 313 applies in any event. We suggest Clause 307(7) be deleted.

3 Licensing Regime

We welcome the fact that certain of the comments contained in our earlier submission have been incorporated into the Blue Bill, most notably introducing a definition of “executive director”.

3.1 Scope of activities requiring a licence

Part 1 of Schedule 6 contains the list, and definitions of, the regulated activities for which a licence will be required. The Group’s comments on particular regulated activities are set out below.

3.1.1 “Dealing in securities” (Type 1 regulated activity)

As compared with the existing law, there is a new limb of the definition:

“… providing a facility for bringing together on a regular basis sellers and purchasers of securities, or for negotiating or concluding sales and purchases of securities.”

This is extremely wide, and would appear to catch vendors of dealing systems that provide facilities to licensed intermediaries to assist those intermediaries to enter into securities transaction with their clients. Arguably, even the installation of a telephone system in a dealing room of an investment bank would fall within the definition.

The part of the definition of “dealing in securities” which deems a person to be “dealing in securities” if, for remuneration, he receives or communicates orders, or effects introductions, is equivalent to Section 3(1A) of the existing Securities Ordinance. However, it may require further consideration, since it also appears wide enough to apply to passive providers of electronic communication services.

There seems no good reason for extending the scope of definition of “dealing in securities” in this way. To the extent that providers of electronic trading facilities should be regulated, this is more appropriately addressed under the separate regulated activity of “providing automated trading services”.

If the definition is to remain as drafted, we suggest that the SFC should have power to give binding written confirmations that particular persons or facilities do not fall within the definition of “dealing in securities” (and/or “providing automated trading services”).

The exemption in paragraph (b)(xiii) of the definition of “dealing in securities”, for investment advisers or corporate finance advisers, who issue documents in accordance with Clause 108 of the Ordinance, is difficult to follow. Clause 108 as drafted does not refer to Type 6 intermediaries (i.e. corporate finance advisers) at all.

In addition to the exemption (currently in Section 3 of the Securities Ordinance) for dealing as principal with a “person whose business involves the acquisition, disposal or holding of securities, either as principal or agent”, an exemption has been added for dealing as principal with a “professional investor”. It is rather confusing to have both categories and therefore, as a general comment on the Bill, it would seem more logical if the first category were included in the definition of “professional investor”.

3.1.2 "Dealing in futures contracts" (Type 2 regulated activity)

Generally, as compared with the existing legislation, the definition has been amended to bring it more into line with the definition of "dealing in securities".

While we have no comments on the above definition, there is some concern about the width of the definitions of "futures market" and "futures contracts". A "futures market" is defined (in Schedule 1) widely enough to include a place at which facilities are provided for persons to negotiate contracts for differences. This could apply not just to futures exchanges but also to systems for facilitating transactions by professional investors in swaps etc. While the swaps counterparties would not require registration as futures dealers, because of the exemptions from the definition as summarised above, the systems provider could require regulation as an ATS provider and the contracts negotiated through the system would be "futures contracts", which could have various implications under the provisions of the Bill relating to marketing of investments, conduct of business rules for licensed intermediaries, market misconduct etc.

3.1.3 "Leveraged foreign exchange trading" (Type 3 regulated activity)

The exemption in the White Bill for transactions done by an individual through a licensed leveraged foreign exchange trader or a bank has been extended to such transactions by any person, which is to be welcomed. However, a number of concerns remain:

- the exemption for contracts for hedging purposes may now apply to any "corporation", but only if the hedging transaction is effected with a "company" i.e. a Hong Kong incorporated-company. The exemption should extend to transactions effected by a corporation with any other corporation.
- there should be a wider exemption for inter-professionals business (whether or not for hedging purposes and whether or not one of the parties to the transaction is itself a licensed leveraged foreign exchange trader or bank).
- it is extremely important that the existing exemptions in the Leveraged Foreign Exchange Trading (Exemption) Rules (the "Rules") are retained, so that those entities that are currently entitled to rely on exemptions under the Rules may continue to do so.

3.1.4 Advising on securities, and advising on futures (Types 4 and 5 regulated activities)

The exemption (set out in the existing legislation and Part V of the White Bill) for a person who gives such advice otherwise than for remuneration and as part of a regular business has been deleted. As long as the advice constitutes a "business" activity, a licence would therefore be required (although there are exemptions for persons licensed as securities dealers, or futures dealers, respectively, which give advice wholly incidental to their securities dealing or futures dealing activities).

This may be of concern to financial portals and website providers, which post research reports and other financial information on their sites. While there is an exemption for newspapers and TV and radio broadcasters, there is no exemption for persons who transmit financial information electronically. This contrasts with Parts XIII and XIV of the Bill (market misconduct) where the safe harbours for distribution of false or misleading information by printers and broadcasters have been extended to other persons whose business involves re-transmission of information.

3.1.5 "Advising on corporate finance" (Type 6 regulated activity)

The definition includes advice concerning offers of securities to the public. Can the FSB confirm that this is intended to mean offers to the public in Hong Kong? Also, while paragraph (c) has been narrowed in scope, as compared with the White Bill, so as only to include advice concerning corporate restructuring, including the issue, cancellation or variation of rights attaching to securities, there is still a concern (because of the word "including") that this would extend to general strategic advice or advice on restructuring of loans, and not just to advice involving securities.

The exemption in Part V of the White Bill for advising on corporate finance, other than on a regular basis and for remuneration, has been deleted. If giving such advice (even though not for remuneration and/or not given regularly) is regarded as carrying on a "business" then a Type 6 licence will be required. Therefore, for example, a securities dealer who may occasionally give incidental corporate finance advice will need to be licensed for both Type 1 and Type 6 activities. Whether this is of practical concern will depend on the requirements imposed by the SFC in order to act as a corporate finance adviser. Currently, the SFC tends to require Chinese Wall arrangements, and separate personnel registered as investment adviser/investment adviser's representatives in respect of corporate finance activities. This could be a concern if a Type 6 licence was needed for occasional or incidental corporate finance advice by a dealer.

3.1.6 "Providing automated trading services" (Type 7 regulated activity)

This is very widely defined. For example, it would appear to include a "bulletin board" on which persons accessing a website may display securities prices, even though the transactions would then be included on a bilateral basis off-line, with the bulletin board provider having no involvement.

As mentioned in 1.1.1 above, we suggest that the SFC should have power to give binding confirmations that particular persons or facilities do not fall within the definition.

The other matter on which clarification is sought is the territorial application of the licensing requirement for providing automated trading services. In principle, this activity should only be regulated under the Bill if conducted in Hong Kong. However, it is unclear how this is to be interpreted where a person outside Hong Kong provides services which are accessible on-line by persons in Hong Kong. Clause 95 of the Bill seems to assume that (for example) a stock exchange or futures exchange outside Hong Kong may require authorisation as an ATS provider in Hong Kong. At the very least, the SFC should issue guidance on this topic. We suggest that (consistent with the SFC Guidance Note on Internet Regulation) an offshore ATS provider should not require to become licensed in Hong Kong unless it is targeting the public in Hong Kong to use its services. The operation, outside Hong Kong, of an ATS used only by intermediaries and professional investors in Hong Kong should not trigger a licensing requirement for the ATS provider.

3.1.7 "Securities margin financing" (Type 8 regulated activity)

In the White Bill certain activities were excluded from the definition of "securities margin financing". In the Blue Bill, four of these excluded activities have been removed from the exemption to the definition of securities margin financing. Instead, under Clause 114(5), a person whose only securities margin financing activities are one or more of those four excluded activities would not be regarded as contravening the requirement to be licensed to carry on securities margin financing.

The effect of treating these activities as excluded activities, rather than as falling outside the definition of securities margin financing, appears to be that if those activities are engaged in by a licensed securities margin financier, the rules on securities margin financing made under Part VI of the Bill will still apply (see Clause 117(1)(d)(ii)). However, it seems likely that such rules will be inappropriate in respect of these excluded activities and we see no reason for the treatment of these activities in the Blue Bill. We would prefer to see the excluded activities being treated as exclusions from the definition of securities margin financing, as in the White Bill.

If the drafting is not amended, can the FSB/SFC clarify, for the avoidance of doubt, that rules made under Part VI relating to securities margin financing will not apply to any excluded activities conducted by exempt persons?

The definition of "securities margin financing" applies where financial accommodation is provided in order to facilitate the acquisition etc. of securities. Since the definition relates to the provider rather than the recipient, the better view is that a licensing requirement is only triggered if the provider of the financial accommodation was aware that the funding was to be used for this purpose. Assuming that the FSB/SFC agree with this view, the defence in Clause 114(6) of the Bill appears unnecessary, and may in fact be regarded as expanding the scope of the licensing requirement. The defence is only available if the provider reasonably believed that the funding was not to be used to facilitate the acquisition etc. of securities. If a person makes a loan, and the borrower is free to use the loan for any purpose, this defence would not seem to be available, and if the borrower happened to use the loan to buy listed securities, there is a risk that the lender would therefore be regarded as having engaged in securities margin financing (even though the loan was not made in order to finance the acquisition of securities).

We suggest that the defence should be available to a lender unless he had reasonable grounds to believe that the funding would be used to acquire listed securities.

The definition of "financial accommodation" includes an arrangement under which a person is provided with credit, whether directly or through a third party. As mentioned in our previous submissions, there is concern that this would extend to a person in Hong Kong who arranges for an investor to open a margin financing account with an affiliate outside Hong Kong. It should be made clear in the Bill that such a person would not be regarded as providing financial accommodation.

3.1.8 "Asset management" (Type 9 regulated activity)

The provision in Clause 114(3) of the White Bill exempting a person who manages a portfolio for another person without remuneration has been deleted. Can the FSB/SFC confirm that no change of substance is intended (since a person who acted without remuneration would not be conducting a "business" of asset management)?

3.2 The new licensing regime

3.2.1 Corporations

Only a company which is incorporated in Hong Kong or an overseas corporation which has registered a branch in Hong Kong under Part XI of the Companies Ordinance, and not a partnership or individual, will be eligible to be licensed. The position of foreign limited partnerships that have separate legal personality is unclear. Arguably, such a partnership may be regarded as a "corporation" in any event and we would like confirmation from the SFC (and the Registrar of Companies) that a foreign limited partnership can be regarded as a corporation for this purpose.

3.2.2 Individual registrations

(a) **Responsible officers**

In order to become a responsible officer a person must also be licensed with the SFC as a licensed representative. It is not clear whether this will require significant duplication when making applications for approval as a responsible officer, and licensing as a representative, respectively.

(b) **Licensed representatives**

The revised Bill has introduced the concept of a "regulated function", being "in relation to a regulated activity carried on as a business by any person, any function performed for or on behalf of or by arrangement with the person relating to the regulated activity, other than work ordinarily performed by an accountant, clerk or cashier". Any individual who performs a regulated function will need to be licensed as a licensed representative. Even with the definition of regulated function, there is still some uncertainty as to which activities will require an individual to be licensed. This is important as breach, without reasonable excuse, of this licensing requirement is a criminal offence punishable with a two-year prison sentence, a fine of HK$1,000,000 and a daily default fine of HK$20,000.

(c) **Substantial shareholders**

Although the notification period in Clause 130 for a person becoming aware of being a substantial shareholder has increased from 2 to 3 business days, this is still an unreasonably short timescale, given the existing 14-day period in Section 26A of the Securities and Futures Commission Ordinance. It is suggested that 5 business days would be more appropriate.

3.2.3 Transitional arrangements

We note that Part I of Schedule 10 contains transitional arrangements in respect of existing registered persons (both corporations and individuals), whereby such registered persons will be regarded as being licensed to do particular regulated activities for a period of 2 years from the date of commencement of Part V, but that within the 2 year period the registered person must apply to be licensed for each regulated activity it wishes to undertake.

With respect to "providing automated trading services", only a registered dealer, commodities dealer or exempt dealer that is, immediately before the commencement of Part V, carrying on a business in providing automated trading services will be regarded as licensed for a Type 7 regulated activity. As the definition of providing automated trading services is unclear, the Group believes that all registered or exempt dealers should automatically be regarded as being licensed to provide automated trading services.

It is not clear what an application to be licensed will involve for existing registered persons, and for exempt dealers that will not be eligible for exempt person status under the new regime. If it requires submitting fresh applications, this would be a major exercise for the industry, and we doubt that the SFC would have sufficient resources to process all the applications on a timely basis. Also, existing licensed individuals (and those currently working for an exempt dealer) should not be required to take additional examinations in order to be licensed under the new regime. There should be a “grandfathering” procedure for such persons.

We believe that there should also be “grandfathering” for directors of licensed persons or exempt dealers who are not currently registered, but may need to become registered as “responsible officers” under the new regime.

We also consider that transitional relief should be given (in the Bill and/or in rules and codes to be made by the SFC) in respect of other matters besides licensing. This is particularly of concern to persons who are currently exempt dealers but will no longer be eligible to be “exempt persons”. Under the Bill, although exempt dealers are deemed to be licensed during the transitional period, they will need to comply from the outset with all the provisions of the Bill applicable to a licensed person, such as those relating to capital adequacy, prudential requirements and conduct of business. As such, major changes in systems and, in some cases, injection of additional capital or capital restructuring may be required from the effective date of the Bill. In light of this substantially increased compliance burden, we believe that a two year transitional period should also apply in respect of all other requirements related to a licensed person, at least to the extent that the requirements create new obligations to which licensed persons and/or exempt dealers are not currently subject.

4 Offers of investments - Part IV of the Bill

4.1 Clause 102 - issue of advertisements, invitations etc.

The new definition of "regulated investment agreement" is extremely broad, and would seem wide enough to include any agreement for sale of an asset (for example, real estate or precious metals) bought with a view to capital growth. We question why it should be necessary to obtain the SFC's authorisation for the marketing of "regulated investment agreements", unless the arrangements in question fall within the definition of a collective investment scheme.

Although Clause 102 only applies to the issue of advertisements, invitations or documents containing an invitation <u>to the public</u>, the meaning of this term is unclear. The terms "issue" and "invitation" are defined extremely widely, to include an oral invitation made during any visit in person. Therefore, if a securities dealer has a meeting with an established customer, and proposes that the customer invest in a collective investment scheme not authorised by the SFC, would this be regarded as issuing an invitation <u>to the public</u> for the purposes of Clause 102? We assume that this is not intended, but further guidance would be welcome as to when marketing will be regarded as constituting marketing <u>to the public</u>.

The exemption in Clause 102 for marketing to "professional investors" reflects the new definition of "professional investors" in Schedule 1 to the Bill. Unless rules are made under Clause 384 of the Bill to extend the scope of the definition, it appears to be narrower than the existing definition, which encompasses persons whose business involves buying, selling or holding securities, whether as principal or agent. For example, this would include a corporate treasurer, or a personal investment holding company, neither of which would fall within the new definition. We suggest that, in addition to the existing categories in the definition of "professional investor", a further category be added, covering persons whose business involves buying, selling or holding securities, futures contracts or leveraged foreign exchange contracts.

Also, in our previous comments, we proposed additional safe harbours. For example, for securities offered to no more than 50 persons and/or for securities with a substantial minimum subscription level. No such safe harbours have been introduced.

4.2 Clause 108 - offers by intermediaries

We have already commented, in the Section above on Market Misconduct and Misrepresentations, on the provisions of Clauses 106 and 107. Turning to Clause 108, which expands on the current Section 72 of the Securities Ordinance, in our view, the "mischief" at which this provision is aimed is unclear. It seems that it is meant to apply to the situation where a securities dealer/investment adviser is acting on behalf of an offeror, to facilitate a general offer to buy or sell securities. If so, it should, in our view, be significant redrafted. Currently, it would seem to apply (subject to the defences in Clause 108(5)) to any situation where a securities dealer/investment adviser "invites" a customer to acquire or dispose of any securities, even if the transaction will simply be a normal secondary market transaction.

Unless Clause 108 is to be redrafted more narrowly, there should at least be an exemption for offers relating to the purchase or sale of securities to take place on-exchange, and an exemption for communications with an existing client, whether or not the person has acted on at least three transactions for the client in the preceding 3 years.

We also note that the exemption in the White Bill (and in Section 72 of the Securities Ordinance) for offers made to a person whose business involves the acquisition, disposal or holding of securities, has been replaced by an exemption for offers to “professional investors”. As already mentioned, the definition of “professional investor” appears to be narrower in some respects than the category of “persons whose business involves the acquisition, disposal or holding of securities, and such exemption should be reinstated (as well as providing for an exemption for offers to persons falling within the current definition in the Bill of “professional investors”).

If there is a breach of Clause 108, the investor has a right to rescind the transaction within 14 days after the date <u>on which he becomes aware</u> that the offer was made without material compliance with Clause 108. This could mean that an investor seeks to rescind a transaction a long time after it took place (for example, because of subsequent market movements). If there is to be a right of rescission, we believe that (to create certainty) it should only apply within 14 days of acceptance of the offer (as under the existing Section 72 of the Securities Ordinance).

4.3 Clause 109 - advertisements relating to the carrying on of regulated activities etc.

Our previous comments on Clause 109 have not been addressed in the Blue Bill. We see no particular reason for Clause 109 at all (and the fact that it is an expansion of an existing statutory provision, Section 5 of the PIO, does not appear to be a valid reason for its inclusion in the Bill). If Clause 109 is to remain in the Bill, we propose that it should be expressly limited to advertisements in which an unregulated person holds himself out as being prepared to carry on <u>in Hong Kong</u> the regulated activity for which he is not licensed or exempt. Also, there should be an exemption for Type 1 intermediaries, who are not licensed to conduct investment advisory activities, and are not exempt persons, but who are permitted to engage in investment advisory activities if wholly incidental to a securities dealing business. Also, we consider that (for consistency with Clause 102) Clause 109 should be restricted to advertisements issued <u>to the public</u>.

5 Prudential and conduct of business requirements - Parts VI and VII of the Bill

5.1 General

We have previously raised concerns about the scope of the SFC's rule-making powers. These comments have not been addressed in the Blue Bill. We note that the SFC has very extensive rule making powers under Parts VI and VII of the Bill, as well as having more general rule making powers under Clause 384 (formerly Clause 373) of the Bill.

We still find it contrary to principle that the SFC has power to make rules a breach of which, without reasonable excuse, constitutes a criminal offence punishable with up to two years imprisonment and a fine of HK$200,000. We have no objection to criminal liability applying where the person concerned acts with intent to defraud, or to the higher penalties applying in such cases, for example under Clause 148(4). However, it appears that the rules may well create offences of strict liability (subject only to the "reasonable excuse" defence).

The SFC will have, under the Bill, extensive powers to take disciplinary action against intermediaries (including the power to impose civil fines of up to HK$10 million). It seems unnecessary, and unconstitutional, for the SFC to have power to create criminal offences as well, punishable with imprisonment and a fine.

We note that there is not even any requirement in the Bill for the rules (except rules made under Clause 384(2) of the Bill) to be issued in draft for public consultation. There should be a requirement for public consultation before rules or a code of conduct is issued. There should also be guidance on when the SFC will exercise its rule-making power (under Clause 163) or instead choose to issue a code of conduct (under Clause 164).

We see no reason for the inclusion of Clause 168 (option trading) as a separate section. Any rule-making power is more appropriately included in Clause 163.

5.2 Cold calling

The rationale for prohibitions on cold calling is to prevent high-pressure sales techniques. The prohibition in Clause 169 should only apply in respect of personal visits or telephone calls. The definition of "call" in Clause 169(7) is far too wide. It would appear to be wide enough to cover television advertising, banner advertising on websites etc. as well as mailshots. This is impractical.

The exemption for calls on persons whose business involves the acquisition, disposal or holding of securities has been replaced by an exemption for calls on professional investors. As discussed earlier, this is in some respects narrower and the previous exemption should be reinstated (in addition to the exemption for calls on professional investors).

Under Clause 169(2)(a)(i) there is an exemption for calls on an "existing client". "Existing client" means "a client who has entered into an agreement … in accordance with requirements prescribed by rules made under S384 …". Clarification is sought on the matters which may be prescribed for this purpose.

Clause 169(6) (right of rescission) is far too widely drafted. A person who receives an unsolicited call will be aware of this from the time the call is made. If a person wishes to avoid a contract which has turned out to be unprofitable, there is a significant risk that he will argue that he has only just realised that he has a right of rescission, and seek to set the contract aside a long time after it was entered into.

The Group notes that breach of Clause 169 is no longer punishable by imprisonment, which is to be welcomed.

6 Comments on other aspects of Bill

This Section sets out our comments on other aspects of the Bill.

6.1 Stock markets and futures markets - Part III of the Bill

While Clause 19 prohibits the operation of a stock market or futures market except by a recognised exchange company, we assume that (on general principles of statutory interpretation) this only applies to a stock market or futures market operated from a place in Hong Kong. However, as set out in our previous comments, there is a concern that a person based in Hong Kong who (for example) accepts orders from its customers and inputs them for execution on overseas exchange could contravene Clause 19(1)(c) or (d), because it would be “assisting” in the operation of the overseas exchange.

6.2 Investor compensation - Parts III and XII of the Bill

We note that there have been minor drafting changes in the provisions of the Bill relating to the Investors Compensation Scheme. However, as noted in our previous comments:

- The range of persons required to contribute to this fund, and the types of claim that can be made against the fund are not spelt out in the legislation.
- It appears that overseas stock exchanges which are authorised as providers of automated trading services may need to contribute to the fund (and, presumably, claims could be made against the fund if such an exchange went into default).

We remain concerned about the risk of cross-subsidisation between different sectors of the industry, and “moral hazard”. The funding of the compensation scheme, and the scope of the claims that can be made against the scheme are so fundamental that we believe they should be set out in the legislation. Failing this, it is essential to have extensive public consultation on the rules proposed to be made under the Bill by the Chief Executive in Council, the SFC and/or the ICC.

6.3 Supervision and Investigations - Part VIII of the Bill

In our previous comments on the White Bill, we noted that protection against self-incrimination applies with respect to a number of the provisions of Part VIII (now Clauses 172 and 176). However, the privilege against self-incrimination should also, in our view, apply where the SFC is making enquiries under Clause 173 (Supervision of intermediaries and associated entities).

6.4 Discipline etc. - Part IX of the Bill

In our previous comments, we expressed concern about Clause 186(2). This has the effect that if any person is guilty of “misconduct”, and the misconduct is attributable to any “neglect” on the part of another person as a responsible officer, or as a person involved in the management of the business, of a licensed person, the conduct is also regarded as “misconduct” on the part of that other person.

We see no need to include Clause 186(2) in the Bill. If, for example, the responsible officer had seriously failed in carrying out his supervisory responsibilities, this could of itself be grounds for disciplinary action against that person, on the basis that his “fitness and properness” had been impugned. This seems far more appropriate than to deem the responsible officer to be guilty of “misconduct” in which he was not personally involved. For example, if a senior manager had failed to take reasonable steps to prevent “rat trading”, this might result in disciplinary action for failure to comply with the Fit and Proper Criteria and the SFC Code of Conduct, but it would be inappropriate to treat the manager as guilty of rat trading. We suggest that Clause 186(2) be deleted. Alternatively, Clause 186(2) should be amended in the same way as Clause 378, relating to criminal liability, which requires that the misconduct was attributable to recklessness of an officer of the corporation.

A new ground has been introduced, in Clause 188(1)(d), for the SFC to revoke or suspend a licensed person's licence. This applies if circumstances exist which would require or entitle the SFC to refuse to issue a licence to the licensed person if the licence had already been issued. This is of concern, because it would give the SFC the power to revoke the licence where the licensed person had not done anything wrong, but where the SFC had, subsequent to granting the licence, changed its policy on some aspects of the licensing requirements. We accept that it could be reasonable for the SFC to change its standards on matters such as qualifications for licensed persons, and operational controls within a licensed person's business, from time to time. However, we believe that there should be scope for "grandfathering" in respect of matters such as qualifications, and that in respect of matters such as operational controls there should be a long lead-time to enable existing licensed persons to implement the necessary changes. If a person failed to do so, this might lead to disciplinary action based on the concept of "fitness and properness", and Clause 188(1)(d) appears unnecessary.

List of Submitting Group Members

Bear Stearns Asia Limited

Credit Suisse First Boston (Hong Kong) Limited

Dresdner 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