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Via e-mail – cszeto@legco.gov.hk

Hon. Sin Chung-Kai, Chairman
Bills Committee on Securities and Futures Bill and
Banking (Amendment) Bill 2000
Legislative Council
Hong Kong Special Administrative Region of the
People's Republic of China

Re: Securities and Futures Bill – November 2000

Dear Hon. Sin Chung-Kai:

I am writing on the Securities and Future Bill published in November 2000 (the 'Bill') as Dealing Director and Regional General Manager of Charles Schwab, Hong Kong, Limited ('Schwab Hong Kong'), a securities dealer and commodity trading advising firm regulated by the Securities and Futures Commission ('SFC' or 'Commission'), and as President of Charles Schwab Hong Kong Securities, Limited ('Schwab Hong Kong Securities'), a securities dealer regulated by the SFC and an exchange participant of The Stock Exchange of Hong Kong Limited (the 'Exchange'). These comments follow our 30 June 2000 comment on the 'White Bill' published in April 2000 (the 'April Draft Bill').

Since April 1997 Schwab Hong Kong has provided U.S. securities and Hong Kong-authorized, \$US-denominated mutual funds to Hong Kong investors through several communications media or 'channels', including investing by Web, telephone, and in-person visits to Schwab Hong Kong's office. In 2000 Schwab Hong Kong began to make Hong Kong-listed securities available to its customers (placing orders through its affiliate, Schwab Hong Kong Securities), and has added wireless investing as an additional channel.

My comments on the Bill will draw not only on the regulatory and business experience of Schwab Hong Kong and Schwab Hong Kong Securities, but also on the experience of Charles Schwab & Co., Inc. ('CS&Co.'), which is a leader and recognized market innovator in the U.S. financial services market. It was a pioneer of so-called 'discount brokerage' in 1975 with the 'Big Bang' in the U.S., the inventor of the mutual fund supermarket, and a pioneer and leader of electronic investing. The various Charles Schwab brokerage firms have internationally tried to benefit individual investors by creating market innovations that limit conflicts of interest and by leveling the playing field for individual investors with access to resources that were formerly only available to market professionals, such as extensive online research and information. From the beginnings of our company, we have made the interests of the individual investor our

primary goal, and our comments on the Draft Bill as our comments on other legislation and regulation should be understood in that spirit.

We are very interested in aiding the Legislative Council in gaining information useful for provisions of the Bill, and are, of course, certainly willing to make ourselves available to your committee and to answer any questions you may have regarding the issues we raise in this letter or other issues that may relate to our experience or that of our foreign affiliates.

SFC's Regulatory Objectives (Part II, Div. 1).

Objectives Correctly Identified. As we mentioned in our earlier comment letter, we agree with the regulatory objectives for the SFC enumerated in Part II, Div. 1, Cl. 4, its mandate to maintain and promote fairness, efficiency, competitiveness, transparency, and orderliness of the securities and futures industry; to promote the public understanding of the operation and functioning of the securities and futures industry; to secure the appropriate degree of protection for members of the public investing in or holding financial products; to minimize crime and misconduct in the securities and futures industry; to reduce systemic risks in the securities and futures industry; and to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

Expanded to Include Investor Education and Promoting Innovation. Nevertheless, we believe that certain of the items listed in Clauses 5 (Functions and powers of Commission) and 6 (General Duties of Commission) should be elevated to the status of regulatory objectives. This is particularly true of promoting an 'understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefore', which we at Schwab Hong Kong view as central to our effort to benefit individual investors and believe that the market as a whole should be geared towards an informed investing public. Similarly, we feel that 'facilitating innovation' is so central to the health and development of the financial markets that it, too, should be identified as one of the SFC's regulatory objectives. Indeed, one of the principal reasons for promoting competition in the financial markets is the encouragement of innovation.

Should Be Cast Broader than Concern with 'Industry'. Finally, we would suggest that each reference to the 'securities and futures industry' in the clause should be reformulated to refer to the 'securities and futures market'. We feel that the reference to 'industry' might not be read expansively enough to include the entire environment in which securities investments are made. In essence, use of the word 'industry' might be too narrowly interpreted as a reference limited to the providers of financial services, and we feel that the SFC has a wider range of concern that includes persons who are not licensees – whether sanctioning individual officers or directors of an issuer engaged in

insider dealing (which is explicitly part of the Draft Bill) or educating investors about the risks of information learned in an online ‘chat room’ sponsored by a non-licensed entity.

Exchange Companies (Part III, Div. 1).

Concerns Regarding Potential Monopoly. Although the Draft Bill provides at Cl. 19 not only for the Exchange but also for other potential ‘recognized exchange companies’ to be authorised to operate a stock market in Hong Kong, we are concerned that, as a practical matter, the Exchange may continue to enjoy its monopoly to operate an exchange (which is presently statutorily granted). We recognize that the flexibility provided for ‘automated trading services’ helps to address this concern. Nevertheless, that flexibility does not fully address our understanding that the securities market may be predicated on the existence of a single exchange. Consequently, we were gratified to learn from Annex A of the Legislative Council Brief (¶3.8) that the matter is under review, but we are concerned about the additional statement regarding the ‘need for HKEx to consolidate the market position to meet the competitive challenge presented by globalization’.

The U.S. Debate. The Consultation Document published with the April Draft (the ‘April Consultation Document’), in its discussion of ‘Reforms in Other Jurisdictions’, references the debate in the United States regarding ‘the increased fragmentation of markets and the proliferation of exchanges; and the need to allow the markets and intermediaries to be competitive and flexible to meet global competition’ (¶1.11). In this context, we would like to bring to your attention the fact that Schwab has taken an active role in that debate and that Charles R Schwab, the Chairman of The Charles Schwab Corporation, explained in his testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs: ‘Government imposed centralization will cost all investors in terms of less competition, less choice, and ultimately less efficiency’. Indeed, we are committed to competition and customer choice, and believe both to be essential to the health of a financial market.

Encouraging Competition in Hong Kong. As mentioned above, the April Draft Bill clearly places the promotion of ‘competitiveness’ among the SFC’s regulatory objectives and references the SFC’s regard to competition as one of its general duties. We have learned from our international experience that competition and customer choice provide important safeguards for investors because of the resulting motivation to provide comparative advantages to investors and because they spur technological and other innovation. By comparison, a single choice – even with rigorous regulatory oversight – works to limit the motivation to create advantages and to speed innovation. For these reasons, we urge that the Bill make explicit reference to the value of competition in the clauses introducing the regulation of exchange companies.

Investor Compensation Companies (Part III, Div. 5).

Importance of Sound Compensation Scheme. As we mentioned in our June 2000 letter, a sound investor compensation scheme is critical both to the protection of investors and addressing systemic risk to the Hong Kong markets. We are generally supportive of the Bill's effort at providing flexibility or, as explained in the April Consultation Document, the April Draft Bill 'provides for a flexible and broad framework for such discussions and should not restrict the development of these proposals and arrangements' (¶3.8). Nevertheless, because of the importance of the protections that an investor compensation scheme provides both to investors and the market, we believe that at least two important issues should not be left to future deliberation by the SFC.

Clarity for Individual Investors. First, the April Consultation Document in its Executive Summary explains that the Exchange's existing compensation funds have 'compensation ceilings [that] are respectively \$8 million per stockbroker and \$2 million per futures broker' and 'give an uncertain level of investor protection, as it does not communicate to investors the amount of coverage available to them individually' (¶35). Although the document further states that '[w]e also propose a per investor compensation ceiling to be prescribed by the Chief Executive in Council', we believe that the Bill should set this out as an objective for an investor compensation company.

Coverage Should Not Depend Upon Direct Exchange Membership. Furthermore, our view, as we expressed earlier, is that the end-customer should have the full protection of the fund on the default either of the securities firm of which he or she is a customer or on the default of another securities firm in Hong Kong used by the customer's firm for execution, clearing or settlement purposes. As a result, an investor with a securities firm that in turn places trades through an Exchange member should be given clearly stated protection levels for his or her account. In the United States, for example, the investor compensation fund ('SIPC') provides protection that runs from a clearing broker even to the customers of an introducing broker that has an omnibus account with the clearing broker – and this is the case even where the introducing broker is a non-U.S. firm with customers resident outside the United States. We are convinced that if a similar structure were applied in Hong Kong, it would provide more certainty to each investor.

Addressing Systemic Risk. Second, we are concerned that systemic risks are not sufficiently addressed in the Bill. The failure of major securities companies in Japan highlighted issues regarding the potential impact of large failures on other firms that have an obligation to replenish a drained investor compensation scheme. The question of whether there is a requirement of securities firms to 'top up' the fund should be explicitly addressed in the Bill. In an emergency, the U.S. investor compensation fund may borrow from the U.S. government and it may determine the extent to which it should replenish the fund from assessments on brokerage firms or, alternatively, by placing a per-transaction fee on securities trading. In essence, flexibility with regard to the fund in an emergency is written into the SIPC rules, and we suggest that – despite the Bill's

admirable expression of flexibility – flexibility with regard to emergencies should not be left to the future but incorporated in the Bill.

Automated Trading Services (Part III, Div. 6).

Market Structure. In addressing automated trading services ('ATS'), the April Consultation Document admirably expressed an understanding that each 'individual ATS can operate very differently, depending on accessibility, target investor group, product range, services provided, size of transactions, total trading volumes, etc.' and expresses the need for a 'flexible and pragmatic approach' (¶3.9) as we thought the 'Guide to Legislative Proposals on Automated Trading Systems and Related Issues' (issued 5 July 1999) also reflected admirable flexibility. The Executive Summary of the April Consultation Document notes in its discussion of 'Reforms in Other Jurisdictions' that in the United States there have been 'legal and regulatory issues surrounding the increased fragmentation of markets and proliferation of exchanges; and the need to allow markets and intermediaries to be competitive and flexible to meet global competition' (¶1.11). As we will describe, we feel quite deeply about the issue that has been called 'market fragmentation' by some but we understand as the creation of investor-oriented choice and competition.

Choice, Competition, Innovation. Mostly from our experience in the United States, we have learned, and feel strongly about it, that multiple trading venues, including the emerging electronic communications networks or 'ECNs' provide important elements of choice, democracy, and competition in the capital markets. The idea proposed by some of a central limit order book or 'CLOB', supposedly offers market transparency and fairness by having a system of complete time and price priority. But, unfortunately, its advertised virtues turn out to be superficial largely because institutional trades could be held back as non-limit order trades – essentially, the market professionals trading institutional positions could take advantage of the individual investors' limit orders to their benefit. Consequently, what appears to be a fair system turns out to be manipulable by institutional investors. Also quite important is that the competition represented by a multiple execution venue environment spurs market and technological innovation. The very efficiency of the market is greatly enhanced by these innovations.

Multiple Venues Do Not Harm Market Transparency. We would like to add that the creation of multiple execution venues does not mean that the market should not have a system for trade reporting to aid the transparency of trading. Rather, it means simply that the Hong Kong capital markets system should not have a central limit order book. For that reason, we feel the flexibility given to automated trading services in the Draft Bill appropriately addresses the issue of market structure in Hong Kong.

Too Broad a Definition of Automated Trading Services. Although we clearly support the flexibility created for the emergence of ECNs and other automated trading platforms, we are concerned that the Bill may have created a definition of 'automated

trading system' that is too broad, perhaps unintentionally broad. The definition of 'automated trading services' found in Schedule 6 to the Bill provides:

'automated trading services' means services provided by means of electronic facilities provided by a person other than a recognized exchange company or a recognized clearing house by which –

- (a) offers to purchase or sell of securities or futures contracts are regularly made, communicated or accepted;*
- (b) people regularly communicate with other people for the purposes of negotiating or concluding amongst themselves purchases and sales of securities or futures; or*
- (c) transactions resulting from the activities referred to in paragraph (a) or (b), or transactions effected on, or subject to the rules of, a stock market or futures market are novated, cleared, settled or guaranteed.*

but does not include such services provided by a corporation operated by or on behalf of the Government.

We are indeed concerned – and we understand this concern to be shared by others – that a concept that was probably intended to apply to ECNs and other trade-matching platforms that provide some of the functionality of an exchange was drafted in such a way that it potentially includes a range of activities that are provided in the normal course by securities companies, basically providing in electronic form functions that they may otherwise – or also – provide by non-electronic means.

We expressed this concern in our June letter and the Legislative Council Brief has graciously referenced this as a one of the concerns addressed in Annex A to the brief. It suggests that the definition was '[m]odelled on similar definitions in overseas' (¶3.5). We are not, however, completely in accord with this assessment. Regulation ATS issued by the SEC, for example, defines an 'alternative trading system' to require that it 'constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of . . . this chapter'. We think it essential that the definition in Schedule 6 be revised so that it is not so broad as to pick up activities of a securities firm in its normal course. Unfortunately, the full impact of the definition will only be clear when the SFC produces ATS regulations.

Disadvantaging Electronic Systems. If, as we are concerned, the definition of 'automated trading services' may be interpreted to include activities that a securities firm may do in the normal course of business but is brought under the definition because of the electronic systems element, what emerges is a legislative and regulatory regime that not only provides additional requirements for securities firms beyond their standard securities firm requirements, but also may disadvantage firms for automating their trading. What is not clear from the definition is how automated the trading function must be to

come under the definition – most traditional firms have some electronic component to their trading function, and firms providing electronic investing have a manual component to the extent certain types of trades – whether for risk, credit or other purposes – are ‘kicked out’ for manual review. Nevertheless, we are deeply concerned, as we mentioned in our June 2000 letter, that the electronic nature of ‘automated trading services’ is an element that appears to authorise extra requirements under the Bill.

Advantages of Electronic Trading. Schwab has been a pioneer of electronic investing as one of the ‘channels’ or media of accessing our brokerage services for our customers and has been so because of the significant advantages it provides to the individual investor. In addition to the immense library of online information that aids investors in making more informed decisions and levels the playing field with institutional investors, investors benefit also from the automated nature of their trading, including lowered costs, increased speed that can lessen the market risk of trades, elimination of human error, elimination of intervention by an individual who may urge an investor to make a different investment decision (which may be subject to conflicts of interest), and gives investors easier access to account information and trading in their account.

Importance of Technological Neutrality. We are concerned by any regulation that creates additional requirements for any brokerage activity *based* on the fact that it is done by electronic means. We feel strongly that all law and regulation of the financial services must aim at broad standards that do not advantage – either explicitly or implicitly – traditional media, such as telephone and paper-based communication (often called ‘functional equivalence’), or advantage one of the newer electronic media over another (which is, unfortunately, the case in the Hong Kong law on electronic signatures because it is limited to a single technological solution, public key infrastructure or ‘PKI’). In sum, the definition of ‘automated trading services’ should not be so broad as to potentially encompass activities performed by a securities firm in the normal course, and it should not hinge on the electronic nature of the service or system.

Overseas Entities. In our earlier letter we discussed the extraterritorial application of the April Draft Bill’s regulation and registration requirements for automated trading services. We were pleased that the concern we expressed was addressed in Annex A to the Legislative Council Brief, which explained that a foreign financial services provider would not be required to ‘obtain an ATS license or authorisation unless they themselves conduct the specified regulated activities in Hong Kong’. We feel that was an important recognition of the structure of introduced foreign securities business in Hong Kong and would not create unnecessary double regulation in the context of introduced securities trading. It is a clear recognition that Hong Kong is quintessentially an international financial services center and further that it is important not to create unnecessary burdens for international securities market participants.

Waiver of Licensing Requirements (Part V, Cl. 129)

Waiver Authority vs. Full-Fledged Exemptive and No-Action Power. We appreciate the grant of power to the SFC to provide modifications or waivers of licensing requirements under Cl. 131 of the Bill (a revision of Cl. 129 of the April Draft Bill) and think it important. However, we believe strongly that in order to have the flexibility that is a keynote to the April Consultation Document as well as the Legislative Council Brief and to promote the innovation that is enumerated as one of the SFC's general duties in Cl. 6, the SFC should have statutory exemptive and no-action power.

In our earlier letter we expressed concern that a waiver under Cl. 129 (now Cl. 131) was only 'effected by a notice in writing served on the person applying for it' and was not published so as to provide guidance to the market as whole. The present Cl. 131 has addressed exactly this point by adding a subsection (6) providing for publishing a notice in the Gazette. In addition, a new subsection (7) provides that the 'Commission may by rules grant a modification or waiver, in relation to a class of licensed persons or exempt persons or associated entities, in respect of any of the requirements or rules referred to in subsection 1 of Cl. 131'. We applaud these steps because they add significant transparency to the regulatory exercise of waivers – we do hope, in fact, that the SFC will adopt by its own regulations a practice of explaining the purpose or reasoning for each waiver so that the market may understand the principles being engaged.

Full-Fledged Exemptive and No-Action Powers. In addition to the significant improvements in the licensing waiver provisions, we would like to emphasize the importance of full-fledged exemptive and no-action powers being given to the SFC by legislation. For comparison and in light of the significance placed on foreign models in the Legislative Council Brief,¹ in the United States, the exemptive authority of the U.S. Securities and Exchange Commission (the 'SEC') is provided directly in the securities statutes. For example, the U.S. Securities Act of 1933, the act governing the issuance of securities, states at §28: 'The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.' Similar language appears at §36 of the U.S. Securities Exchange Act of 1934, the act regulating markets and, among other things, exchanges and brokerage firms. By comparison to the SEC's exemptive authority, the SEC's no-action powers are not statutory, and we believe that those powers should also be statutory both in the case of the SEC in the United States and in that of the SFC in Hong Kong.

¹ The Legislative Council Brief stated in §7 that 'the new regime should be on par with international standards and comparable with international practices, with necessary adjustments to address local characteristics and need.'

Importance for Innovation. Our international experience underscores the importance of exemptive and no-action powers for innovation in the financial services. The entire Schwab family, but particularly CS&Co. in the United States, has been responsible for major innovations in the provision of financial services, such as some of the more well-known examples we mentioned in our introductory remarks – the development of ‘discount’ or execution-only brokerage, the creation of a mutual fund supermarket, and the pioneering of electronic investing. Because Schwab has so often created new structures to create new opportunities for its customers, it has consistently needed to address laws and regulation that have been written with a traditional model in mind. Repeatedly, CS&Co. has needed to go to the U.S. SEC to receive no-action relief in order to pioneer a new structure or a new service. The ability of CS&Co. to be able to turn to the U.S. securities regulator for relief has been indispensable to Schwab’s role in introducing important innovations to the American investing public, many of which are now central to the way investing is done in the United States and elsewhere in the world.

Why the SFC Should Have These Powers. In Hong Kong, the grant of exemptive power and the statutory incorporation of no-action power would add to the flexibility of the Hong Kong market in allowing for new technologies, structures, and products that serve the Hong Kong investing public and strengthen Hong Kong’s position as an international financial center while maintaining appropriate protections. We think that the SFC as the regulatory body directly engaged in the day-to-day operations of the financial services is properly situated to gauge the appropriateness of no-action and exemptive relief, and these powers should be included in the final Bill.

SFC Accountability and Creation of the SFAT (Part XI)

Creation of the SFAT. The April Consultation Document at ¶1.20 -1.21 identifies the importance of addressing the accountability of the SFC and states that ‘[t]he public is rightly entitled to expect that there are measures to ensure that the SFC is performing its functions fairly, properly, efficiently and with due propriety’. After enumerating the existing accountability measures, the April Consultation Document turned to the measures that are to be introduced, principally the reconfiguration of the Securities and Futures Appeals Panel into a ‘full-time, judicial tribunal to become the Securities and Futures Appeals Tribunal (the ‘SFAT’)’.

Guidance for the SFAT. We believe that the expansion of the SFAP to the SFAT demonstrates a commitment to the accountability and transparency of securities regulation in Hong Kong. Nevertheless, we thought that the mandate of the SFAT may have been weakened by not giving it – as well as the investing public – clearer guidance as to its role. The present Cl. 211 (Cl. 203 of the April Draft Bill) provides that ‘a person aggrieved by a specified decision of the Commission made in respect of him may, by notice in writing served on the Tribunal, apply to the Tribunal for a review of the decision’. We urge that the Bill include language outlining a nonexclusive list of the grievances it may redress, such as an abuse of discretion by the SFC or a failure by the

SFC to follow procedures in arriving at a decision. By giving a clearer mandate as to what constitutes a failure of appropriate action by the SFC, the Bill would add to the transparency that is its goal and would serve to increase public confidence in a transparently regulated securities market. Indeed, we believe that general guidelines regarding the parameters of review governing all of the accountability measures referenced in the April Consultation Document would similarly serve to enhance the accountability of the SFC by giving it a clearer sense of the sort of activity that would be subject to redress.

Market Misconduct (Parts XIII and XIV)

General. All participants in the market – whether investors, issuers, or financial services companies – depend upon the integrity of the financial markets and confidence in Hong Kong’s ability to deter market misconduct. For that reason, we commend the drafters of the April Draft Bill and the Bill for the amount of effort and thought that has been devoted to provisions devoted to the definition of, and sanctions for, market misconduct.

Nevertheless, we have serious concerns about the scope of some of the definitions and particular concerns that an individual or entity may unwittingly commit an offence under the Bill, essentially ‘back into’ an act defined as market misconduct. Certain of the individual offences as part of their definition require some sort of mental state. The definition of ‘false trading in securities’, for example, requires an act done ‘intentionally or recklessly’ (Cl. 257), and ‘stock market manipulation’ requires the ‘intention of inducing another person’ (Cl. 260). Nevertheless, we feel that all acts of the market misconduct should include an element of scienter, a requisite mental state.

False or Misleading Language (Part XIII, Cl. 268 & Part XIV Cl.290)

Disclosure of False or Misleading Information. In our June letter regarding the potential impact of the false and misleading information language in Cl. 261 the April Draft Bill, we discussed, among other things, our concern that it could have a chilling effect on the provision of third-party news, analysis, and research that brokerage firms provide online for their customers. We were quite pleased that, as described in §39 of the Legislative Council Brief: ‘During the White Bill consultation, we have liaised with automated trading service providers and identified ways to refine the Bill to provide that these persons not be legally liable for disclosure of false information to the public if they act in the capacity of a “conduit” in disseminating information from third parties (in certain cases via hyperlinks) from their web sites, without editing the contents or in such as way as to adopt them.’ This has resulted in a very important addition to the clause represented by subsection (3) of Cl. 268.

Suggested Improvements. We are deeply grateful for that addition, and believe it very important to the dissemination of information by financial service providers.

Nevertheless, the additional clause has only addressed one, although a very important, element of the issues created by the original Cl. 261 of the April Draft Bill and we would like to express our continuing concern regarding the present Cl. 268. As the Legislative Council Brief states at §34, 'Information is at the centre of an efficient market. It enables investors to make informed decisions and helps maintain a level playing field among market participants.' We think it critical that securities laws address attempts to manipulate the market by manipulating information that reaches the market – market confidence is essential to everyone involved in the market, especially the investing public. Indeed, Schwab is committed to a view that there is nothing more important than the integrity of the securities markets and understands that an essential element to maintaining that integrity is the presence of strong anti-fraud provisions in the securities law that can address market manipulation. Ultimately, however, we believe that the present Cl. 268 and Cl. 290, even with the added subsections, may not do enough to encourage the robust dissemination of information to investors and the marketplace.

The main places for improvement, as we will discuss below, are that (1) despite the significant change from altering the knowledge requirement regarding the falseness of the information from a defense to an element of the law's violation, the knowledge requirement could use further modification to create an atmosphere that stimulates the provision of information, online or otherwise, to investors, (2) the provision should have a strong mental state requirement with regard not only to the false character of the information disclosed but also to the impact on the market, and (3) the various conduit exemptions do not truly address the chilling effect created by the provision and we believe do not sufficiently encourage the provision of online information.

Importance of Electronic Information. In light of our experience – both in Hong Kong and internationally – providing investors with numerous sources of information, news, and research so that they may make informed choices about their personal investments, we find the definition of the 'disclosure of false and misleading information inducing transactions in securities' is particularly troubling, and we believe its impact will be to chill the production of electronic investor information. Brokerage firms like Schwab Hong Kong turn to reliable (mostly third-party) sources for their news, information, and research, the very sort of news, information, and research that Arthur Levitt, Jr., the Chairman of the SEC, had in mind when he stated:

Information and ideas are flowing constantly over an affordable, accessible system – giving individuals the same access to market information as large institutions. The Internet is a supremely powerful force for the democratization of our marketplace: For anyone with a computer and a modem, the Internet ensures timely access to accurate data.²

² 'Investor Protection in the Age of Technology', Remarks by Chairman Arthur Levitt, Jr., U.S. Securities and Exchange Commission, Salt Lake City, Utah, 6 March 1998 (available at www.sec.gov/news/speeches/spch205.txt)

However, just such important information provided to investors with an interest in helping them make better-educated investment decisions may be surrounded by such a cloud of potential liability that both the providers of information to Schwab Hong Kong would be discouraged from creating customer access to the wealth of information, news, and research that is presently on the Schwab Hong Kong Web site as it is on the site of CS&Co. for U.S. investors. We believe deeply that securities firms should help investors make informed decisions, and the offence as it is constructed may hamper what we see as a securities firm's role in the SFC-designated mandate for the Commission at Cl. 5 to 'promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor.'

Knowledge that Information is False or Misleading. We had earlier expressed a concern that the knowledge exemption provided by Cls. 261 and 287 of the April Draft Bill created a defense if the person were able to 'establish' certain elements. We applaud the redrafting that alters the evidentiary burden, which we think is in line with other amendments to April Draft Bill. In this light, the three republishing or conduit-style exemptions at the new subsections (3), (4) and (5) have retained a requirement to 'establish' not only the conduit character of the persons' activity but also their lack of knowledge, and we think the knowledge elements should certainly not be a matter that must be established in defense.

In our earlier letter we also expressed a concern that Cls. 261 and 287 required that a person be acting in good faith *and* not know or could not in the circumstances reasonably have known that the information was materially misleading as to a material fact – we thought that good faith or not knowing should each have provided a sufficient defense. This subsection has been replaced at Cl. 268(1) by a simpler element that 'the person knows that or is reckless or negligent as to whether, the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact.' We believe, however, that the creation of a negligence standard sets too high a threshold for the sort of market misconduct violations intended to be addressed by Parts XIII and XIV of the Bill – we would suggest that the purposes of the Bill would be enhanced if the reference to negligence were eliminated.

We expressed above our strong agreement that the new subsection 268(3) and its criminal parallel subsection 290(4) have created important new exemptions for persons, such as online financial service providers, to redistribute information provided to them. Nevertheless, we believe – as we will discuss in more detail below – this ultimately does not address the authors or vendors of the information, and as a result we believe that unless the negligence threshold is not addressed for them, the source of information for Hong Kong investors will be impeded.

Scienter with Regard to Securities Sales or Market Manipulation. At present, the only mental state requirement in Clauses 268 and 290 is with regard to the knowledge (or

outside the three redistribution exceptions, imputed knowledge) that the information distributed is false or misleading. Although the information has to be ‘likely’ to induce a securities transaction or affect the price of a security, there is no requirement that the person even know, let alone intend, that the information is likely to impact the market or induce a transaction.

An anti-fraud provision like that in Clause 268, and especially one carrying criminal liability like that in Clause 290, should include a strong mental-state requirement not only with regard to the false or misleading character of the information distributed but also with regard to its impact. The mental state required should be intent, but at the very least recklessness.³ We feel it extremely important that the Hong Kong Securities and Futures Bill be clearly focused and not reach beyond a true anti-fraud provision that requires a subjective mental state beyond the standard that presently seems embodied by Clauses 268 and 290.

Authors or Vendors of Information. As we mentioned above the redistribution exemption added to Clauses 268 and 290, although very significant improvements to the language in the April Draft Bill, we ultimately believe that the Bill could be improved so as to address its investor and market protection concerns while enhancing the critical dissemination of information. Our view is that if the provisions are not more fairly drafted with the creators of information in mind, they will be inhibited from providing information or they will insist on prohibitive indemnifications by financial service firms and others who distribute their information – the market as a whole would be hurt and the flow of important information limited.

Certain jurisdictions have considered by creating a journalism exception – that, for example, has been debated in the United Kingdom. We believe, however, that it is no longer easy to distinguish journalistic and other sources of information. The lines are blurred and that exception may finally not work very effectively. We suggest, rather, that two of the improvements we proposed above will address the creators of information – first, that the knowledge standard be raised above mere negligence and, second, that Clauses 268 and 290 include a high mental state requirement relating to the information’s impact on the market. Those changes would be consistent with the overall need of maintaining the integrity of the market while not inhibiting one of the most important functions of the present marketplace the dissemination of information.

As a final point on the dissemination of false or misleading information, we suggest that the offence in Cl. 106 based on ‘any fraudulent or reckless

³ This is settled law, for example in the United States regarding Section 10(b) of the U.S. Securities Act of 1933 and Rule 10b-5 promulgated under it. The U.S. Supreme Court was very firm in its decision that simple negligence was not sufficient to invoke the U.S. federal anti-fraud rules. Indeed, the U.S. Supreme Court discussed the ‘hazards’ of conducting business under something less than a scienter standard. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

misrepresentation' be eliminated or revised so that it does not create overlapping liability with Cl. 268 and 290.

Liability of Corporations and Officers (Part XVI, Cl. 378) .

Expansiveness of Former Provisions. Cls. 267 and 368 of the April Draft Bill created far too broad liability for a firm and for its officers (with insufficient exemptions for officers and directors) as a result of an 'act, omission or failure of a director, employee, agent or other person acting, or purporting to act, for or on behalf of a corporation within, or apparently within, the scope of his office or employment'. Taken literally, the inclusion of other persons who may be 'purporting to act' for or on behalf of a firm could have allowed a reading that made a securities firm liable for a criminal act by unrelated persons who fraudulently convince third-parties that they were acting on the firm's behalf. We certainly appreciate the significant attempt to limit market misconduct and other violations of securities law by placing responsibility on firms so that they in turn are further compelled to maintain strict supervision of their staffs. However, we thought the original language was both too broad and too severe.

New Provisions. The new Cl. 378 of the Bill helps significantly to address some of issues with Cls. 267 and 368 of the April Draft Bill. The new provision, rather than making every act done by or on behalf (even purportedly) of a corporation automatically an offence by the corporation as well as an offence by all its officers and directors with certain defenses offered to officers and directors. The new Cl. 378 only creates an offence where an offence *by the corporation* is 'proved to have been aided, abetted, counselled, procured or induced by, or committed with the consent or connivance of, or attributable to any recklessness on the part of, any officer of the corporation, or any person who was purporting to acting in any such capacity, that person, as well as the corporation, is guilty of the offence and is liable to be proceeded against and punished accordingly'. We feel the revised language represents substantial improvement in terms of fairness and equity. Nevertheless, we believe that it may be further refined to increase that same fairness and equity.

Specific Concerns with Provision's Severity. The list that ends in 'or attributable to any recklessness' includes 'committed with the consent . . . of'. It might be fairer to use an intentional and reckless standard for the entire clause. In addition, we believe that the reference to 'purporting to act in such capacity' should be amended to include 'as authorized by the corporation'. In the latter case, we want to make sure that the act of an individual – especially an unrelated third party – outside of activities authorized by the corporation should not create liability for the corporation (the present clause although beginning with the premise of an offence by a corporation could possibly be read so that the act of an unrelated, unauthorized third party could create corporate liability).

Rules by the SFC (Part XVI, Cl. 384).

Importance of Rulemaking Power. We believe that the power for the SFC in Cl. 374 to promulgate codes and guidelines is essential to the flexibility and timely responsiveness of the SFC to developments in the market. We also support the breadth of that power provided both in Cl. 384(1)(p), which after a list where the Commission is granted power to make rules, states that it may do so 'for any other matters for the better carrying out of the objects and purposes of this Ordinance', and in Cl. 384(2) regarding the making of 'such other rules as are necessary for the furtherance of its regulatory objectives and the performance of its functions'. These open grants significantly do not leave the rulemaking authority to items specified in the individual clauses of the Draft Bill.

Confusion over Power in Subsections (1) and (2). The present Draft Bill does not make clear how matters might fall under 'other matters for the better carrying out of the objects and purposes of this Ordinance' of subsection (1) and which matters might fall under 'necessary for the furtherance of its regulatory objectives and the performance of its functions' of subsection (2). This is significant because the two subsections are, as the earlier versions in the April Draft Bill were, subject to different procedural steps and we believe it important that all SFC rules be subject to public notice.

Public Notice. Adequate notice for public comment on proposed rules is critical to the functioning of a transparent market. We note that the SFC rulemaking provided under subsection (2) provides for the publishing of the draft rules. We believe that publication is essential for all rulemaking, whether under subsection (1) or (2) because it is essential that the public, including investors, industry participants, and other persons who may be impacted by the proposed rule be given an adequate opportunity for comment. In the United States, for example, the Administrative Procedures Act requires proposed rules of administrative agencies, including the SEC, to be published in the *Federal Register* (US Code, Title 5, §553), and in Canada the Ontario Securities Act requires rules promulgated by the Ontario Securities Commission to be published in the Commission's Bulletin (Ontario Securities Act §143.2(1)). We urge that all rulemaking by the SFC, not merely those under subsection 2, be subject to public comment.

Meaningful Comment Period. Adequate notice for comment requires a meaningful period for analysis and review. In this regard, the Ontario Securities Act provides at §143.3(4) that '[u]pon publication of a notice under [of a proposed rule], the Commission shall invite, and shall give a reasonable opportunity to, interested persons and companies to make written representations with respect to the proposed rule within a period of at least 90 days after the publication'. Indeed, it is so important that the comment period be adequate for the task of analysis and expression that we urge the Bill not only to provide a public notice provision for all SFC rules but also to add a clear provision regarding 'adequate notice and opportunity for public comment, which shall not be less than 90 days'.

Other Rulemaking under the Bill. The Bill authorizes the SFC, at Cl. 141 (formerly Cl. 138) and Cl. 163 (formerly Cl.159), respectively, to promulgate rules regarding the financial resources of licensed corporations and the conduct of intermediaries and their representatives in their regulated activities. In neither of these clauses is there a notice and comment requirement. As with the other rules discussed above, these rules should require adequate notice and an opportunity for public comment. Similarly, the Bill provides for rulemaking by a recognized exchange company at Cl. 23 (formerly Cl. 24) and by a recognized exchange controller at Cl. 66 (formerly Cl. 66) and sets out a process for approval by the SFC (at Cl. 24 and 67, respectively) but not for public notice and comment. Because of their significant impact on the market and the investing public, these rules too should require adequate notice and opportunity for public comment. Indeed, any rule that forms part of the regulatory scheme in Hong Kong needs to be brought under the light of public deliberation and be subjected to the sort of public debate that is so crucial to the transparency at which the Bill generally aims.

Codes or Guidelines by Commission. The Commission is authorised to publish codes and guidelines to provide guidance. Although we understand the need for regulatory speed and flexibility, we believe that even Guidelines should be subject to public notice and adequate time for comment. Otherwise, despite differences in legal dignity between Guidelines and Rules, the Commission may be able to impact the behavior of market participants without the transparency and important input provided by robust public notice and comment.

Technological Neutrality.

General. As a company that is dedicated both in Hong Kong and internationally to bringing investors the advantages of technology, we are deeply committed to the view that law and regulation need to be technologically neutral. We believe that technologically neutral law is essential for fostering an environment for technological change that will advantage Hong Kong's investors and will help to secure Hong Kong's place in the international market.

Functional Equivalence. As we mentioned above, law and regulation should not favor – either explicitly or implicitly – traditional modes of communication such as paper and telephone over electronic means of communication. Rather, legislators and regulators should aim at what is called ‘functional equivalence’ and not place newer, electronic media at a disadvantage at the very time that such media are adding so many advantages to the investor.

Eliminate Examples in Bill. The Bill may not have adequately achieved this functional equivalence in a number of places. It does so explicitly, as we mentioned above, in the case of its treatment of ‘automated trading services’. And in its treatment of the ‘disclosure of false or misleading information’, it may have done so also implicitly.

And we feel, as another example, that the range of references to ‘verbal communication’, such as in Cl. 108 regarding offers by intermediaries or representatives, give a special treatment for oral (we assume that verbal here refers to oral communication) communication that, for example, may not include an e-mail that has the same informality of a phone conversation. We believe that the Bill as the core legislation for Hong Kong’s securities law should be drafted very carefully not disadvantage electronic media and other technological advances either explicitly or implicitly.

Technological Neutrality among Newer Media. It is also critical that law and legislation be careful not to advantage one newer technology over other existing or future technologies. The Hong Kong Electronic Transaction Ordinance (No. 1 of 2000)(the ‘ETO’) provides a useful example of providing an advantage to a single technological solution. The ETO explicitly favors public key infrastructure or ‘PKI’ and refers specifically to PKI terms, such as the fact that a ‘certification authority’ under the law will hold the ‘key pair’. Our technology experts and technology experts in a number of major technology companies have serious concerns about whether PKI will ultimately provide the best solution for electronic authentication. We believe that law relating to electronic authentication should set broad standards and not reference either explicitly or implicitly a specific technology or technological solution. Similarly, we believe that law and regulation in the financial services should set broad standards rather than reference technologically bound rules. For that reason, we urge the Financial Services Bureau to incorporate the notion of ‘technological neutrality’ in Clauses 4 – 6 of the Draft Bill and specifically provide technological neutrality as a mandate for the SFC’s drafting of regulations and performance of its functions.

Conclusion.

We encourage the Bills Committee or its staff to discuss with us any of the issues raised in this letter, particularly our concerns about ‘automated trading services’, the lack of exemptive and no-action power for the SFC, or the definition of ‘disclosure of false or misleading information’, as well as our views on technological neutrality. If you would like to discuss any of these issues or other issues that you think we may help your understanding, please contact me at 2810-9019.

Yours sincerely,

Christina Hui

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