

23rd January 2001

Clerk to the Bills Committee
on the Securities and Futures Bill
3/F, Citibank Tower
3 Garden Road
Central, Hong Kong

BY FAX only
(28696794)

Dear Sir,

Securities and Futures Bill (the "Composite Bill")

We would like to submit our following comments on the Securities and Futures Bill for consideration by the Bills Committee.

A) Investors Compensation under Part XII

Currently, investors have a statutory right under section 109 of the Securities Ordinance to claim the compensation fund.

Under the Composite Bill, such right would be based on "rules" made under section 235 by the SFC that set out the right, circumstances, procedures, and manner to claim compensation.

Whilst such arrangement provides tremendous flexibility for the Administration, it would need to ensure that: -

- (a) investors' right to ICF is not relegated to an inferior right under the new law; and
- (b) there is certainty and improvement on the compensation coverage under the new ICF.

As such, the Administration should clarify whether those rules would become subsidiary legislation or mere administrative arrangements. The compensation framework contemplated under the new ICF should also be highlighted with demonstration on how the new ICF addresses current market reality and provides corresponding redress to the investing public.

This is particularly so in view of the recent SFC and SEHK comments that the current section 109 only provides for a right of compensation to clients of stockbrokers who are Exchange Participants. It follows that in case of default by other SFC registered securities dealers who are not Exchange Participants, their clients would have no protection under the compensation fund.

In other words, unless the Composite Bill brings about changes in that regard, the compensation fund only provides protection to the clients of around 513 Stock

Exchange Participants and 45 holders of trading right. This is grossly inadequate bearing in mind that there are around 1,370 SFC licensed securities dealers and advisers and 19,414 registered representatives providing securities dealing and advisory services to clients in the market.

The Administration needs to demonstrate what compensation arrangements are contemplated for those investors whose brokers are not Exchange Participants.

B) Civil Liabilities of Market Misconduct under Part XIII

We welcome the Administration's attempt to facilitate private actions against market misconduct through a statutory recognition of MMT findings in court proceedings. However, we believe a more effective way to do so is to empower the SFC to conduct class actions on behalf of aggrieved investors.

With respect to certain investor protection provisions under this Part, we believe that they should be carefully scrutinized by the Legco to ensure that the arrangement is precise enough and aligns with our established legal practice. In this regard, we have the following observations.

1. Admissibility of MMT evidence and findings in other civil and criminal proceedings

Cases brought before MMT have usually been investigated by the SFC exercising its powers under Part VIII which includes the power to compel incriminating information to be used as evidence in the MMT (section 180). Moreover, under section 247, the MMT may receive and consider any material or evidence which would otherwise be inadmissible in civil or criminal proceedings in a court of law.

Such powers, though extensive, may be acceptable from a regulatory's point of view.

However, if they are to be indirectly generalized into other civil or criminal actions, it may mean a serious canvass of the established legal rights of litigants. This would need the careful consideration of Legco.

Recently, the court has ruled in one case that the admission of SFC compelled evidence in criminal proceedings is an abuse of process.

2. Insufficient regard of "Causation" in the statutory right of compensation

The proposed section 272(1) provides for a right of compensation to investors who have sustained any pecuniary loss as a result of the market misconduct.

The current wording of the section seems to include investor losses whether or not they are "caused" by the market misconduct. If this is the case, it would pose serious problems to the court, create a floodgate of claims and cast unfairness to the wrongdoers. This is illustrated in the example below.

Assuming that there is a case of Mr X manipulating the stock price of #8888 during 1 Jan - 31 March 2001 with the result that the share price surged from \$1 to \$5. When the SFC started to look into the matter in March and with certain adverse rumors in the market, the stock price plummeted from \$5 to \$0.5 in April. In July, the MMT ruled against Mr X for price rigging. Under section 272, the following claims which would otherwise be rejected, would become legitimized: -

- (a) Mr A, having purchased #8888 at \$0.8@ in 1999, lodged a claim for damages as a result of the share price fall associated with the market misconduct;
- (b) Mr B, a market participant, observing the stock price movement for over one month and suspecting that someone was pegging the share price, decided to buy the stock at \$4 in early March. He hoped to sell it at \$6 and make a 50% profit. However, the stock went up to \$5 and dived down to \$0.5 after that. As a result, Mr B suffered a loss of \$3.5 and he lodged a claim for damages as a result of the share price fall associated with the market misconduct; and
- (c) Ms C, a lay investor, noticed the stock price rise and speculated that there are insider dealing activities undergoing. In anticipation of the good news, she purchased the stock at \$4.5 in mid March and hoped to make profit out of this. Following the stock price collapse, Ms C made a loss of \$4 and lodged a claim for damages as a result of the share price fall associated with the market misconduct.

In these cases, the established practice involves the claimant (i.e. Mr A, Mr B and Ms C) substantiating their claims and for the court to make a decision differentiating between damages caused by the market misconduct and damages associated with the market misconduct.

It is not sure whether section 272(1) has operated to change this established practice by automatically conferring a statutory right of compensation on the claimants and shifting the onus on the wrongdoer to prove that it is not just, fair or reasonable to require him to pay compensation. This would be unduly prejudicial on the wrongdoer.

3. Imputed Liabilities under section 272(1) and (2)

Besides commissioners of market misconduct, persons conducting a relevant act of the market misconduct are also liable to pay damages under section 272(1) irrespective of their state of mind and motive.

This includes persons or corporations who have perpetuated in, are attributable to, assisting in, conniving of, and consenting to the perpetuation of activities which are subsequently found to constitute market misconduct. Section 272(1) also applies irrespective of whether these people are involved in the market misconduct tribunal proceedings or that the tribunal has not identified them as having engaged in the market misconduct.

Such an approach might be appropriate as a regulatory standard. But if it goes further to impose an unequivocal liability of civil damages, it may entrap innocent parties. For instance, brokers are implicated in every market misconduct involving improper trading because they are the ones to execute the trade orders.

With such wide and imprecise wordings, innocent parties might be snared. This is very contrary to the existing approach of looking into each individual case and considering factors including the party's role, his duty involved, the subject conduct, his state of mind, causation, and so on before deciding on whether one is liable. Under the proposed section, he would be deemed liable under section 272(1) with the onus on him to rebut that asking him to pay damages is just, fair and reasonable.

Moreover, this section would burden the court with complex issues of causation, circumstances and apportionment of liability.

C) Absolute Liability under section 370

To be just, one should be taken to have committed an offence under section 370 if he, without reasonable cause, obstructs the performance of the SFC functions.

D) SFC's power to intervene in court proceedings under section 373

Section 373 allows the SFC to intervene in private litigations on matters concerning provisions of the Securities and Futures Ordinance and the SFC's functions where it is in the public interest to do so. As a result, the SFC would have a right to be heard and be regarded as a party to the proceedings.

It is not sure if this section allows the SFC to intervene proceedings in the form of class actions on behalf of the investing public. Section 373 would be welcomed if this is so contemplated.

If this section is designed to give the SFC standing to intervene in private proceedings and to provide its expert opinion on regulatory perspective (as mentioned in the April 2000 Consultation Document), it would need the careful consideration of the Legco to ensure that such powers are properly exercised. In that regard, we have the following observations: -

- (a) arrangement allowing the SFC to assist private court proceedings by providing its opinion on certain regulatory matters when called upon to do so is welcome. However, if the SFC is to intrude into the court proceedings against the wishes of the litigating parties and gives its view as expert opinion with a view to set the practice right, there would be inherent risk in the matter.
- (b) we trust the SFC would implement seasoned securities regulations for the Hong Kong market from time to time and do not anticipate that there would be substantial practices bearing material impact on the market as uncovered by the SFC. If this happens, perhaps the more proper approach would be to understand the court ruling, and then issue guidelines to address the weaknesses and set the practice straight. Intruding into court proceedings and proffering opinion in such a "weighty" manner would upset market certainty and cast substantial unjust to the litigants.
- (c) the section allows the SFC to provide expert opinion on certain regulatory matters in such a way as if it were an arbitrator of securities regulations and market practice. Whilst hearing the SFC's view would complement the picture, it should not be understated that expert opinion on market practice should come from market participants whilst the legal interpretation of securities regulation should come from the court.
- (d) The SFC is the law enforcer of securities law. Allowing it to give expert opinion on market practice and securities regulations is like calling the Immigration Department to give expert opinion on what constitutes a right of abode in Hong Kong. There is an inherent conflict in the matter.
- (e) Moreover, the SFC's right to intervene and give opinion should not be allowed in cases where the SFC has a direct or indirect regulatory interest. This includes cases which have been inquired into or are purportedly investigated by the SFC as there is an inherent conflict in the matter.

E) Criminalization of Contravention of SFC Rules

Section 384 empowers the SFC to make rules on numerous areas to set standards for licensed dealers. Such rules are by nature administrative arrangements unless they are specifically stated to be subsidiary legislation and have undergone the scrutiny of the Legco.

Under section 384(8), it is purported that contravention of rules would constitute an offence and is punishable on a fine of \$500,000 and a term of 2 years imprisonment upon conviction on indictment if: -

- (a) it is provided in the rules that contravention of them would constitute an offence;
or
- (b) the Chief Executive in Council makes regulations providing that contravention of any specified rules would constitute an offence.

Such arrangement should be carefully scrutinized by the Legco to ensure that the relevant conduct is serious enough to merit a criminal sanction. Moreover, the propriety of employing an administrative or executive process to provide for the criminalisation of conduct should also be considered.

Yours faithfully,

(p.p. Cindy Leung)

for Albert Pun
KGI Asia Limited