English translation of the original Chinese text

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Bills Committee on Securities and Futures (Amendment) Bill 2011
Attn.: Mr CHAN Kam-lam, Chairman

Sent via email address yhcheung@legco.gov.hk

Dear Chairman and all members,

Our Comment submitted to the Bills Committee on Securities and Futures (Amendment) Bill 2011

Thank you for Chairman Hon. Mr. Chan Kam-lam inviting us on 29th July 2011 to submit our comment on the Securities and Futures (Amendment) Bill 2011 (below simply known as "the Bill").

We welcome the relevant legislation and would like to submit our comment below on the details of the Bill:

1. The Bill s. 307D(2)(c)(i)and (ii)

These two sections of the Bill allow all information concerning an incomplete proposal or negotiation or being a trade secret to be exceptions to disclosure requirements. We, however, queried whether these will make the scope of exceptions too big and treat the non-insider, minority shareholders and small investors, unfairly. Should preconditions be added to these two sections, in line with similar regulations in other international markets? We suggest to add two preconditions for the committee's consideration:

(a) it is unlikely that the delayed disclosure or non-disclosure of the information would have misled the market; and

We hope this precondition will eliminate the situation like the following example: Let's say a listed company had disclosed in its annual report that it was its policy not to do speculative derivative trading. Later on when it changed its business strategy and decided to commence speculative trading plan, it did not disclosed in pursuant of s 307D(2)(c)(i) or (ii) as the plan was incomplete or a trade secret. This would have misled the minority shareholders and the market, which could not adjust their investment in the company in response to its strategic change. This type of misleading act should not be the wish of the Hong Kong market.

(b) <u>It is the best interest of the company to delay disclosure or not to make disclosure</u>

Other factors like the personal interest of major shareholders or directors should not be considered as preconditions.

2. *Paragraph (1c) of the Annex B of the Legislative Council Brief of the Securities and Futures (Amendment) Bill 2011 prepared by the Financial Services Branch, Financial Services and the Treasury Bureau dated 22nd June 2011 (below simply known as "the Annex B") Trade secret as a safe harbor*

The Annex B (1c) states: "A trade secret generally refers to proprietary information owned by a corporation used in the trade or business in which the corporation operates. This may concern inventions, manufacturing processes or customer lists". S. 307D(2)(c)(ii) of the Bill, however, only defines "the information is a trade secret" as a safe harbor, which conveys a broad and vague literal meaning. In pursuant to this section, will a listed company be only required to disclose those situations precisely required by law, like acquisition/merger, profit warning etc? Will other situations involving trade secret that are not specifically required to disclose by law be not required to disclose? However, most insider information, to a certain extent, relates to trade secret. So, should s. 307D(2)(c)(ii) of the Bill be tightened to the scope as provided in the Annex B (1c) to reflect the legislative intent of the Bill.

3. *The Annex B (1d) The provision to listed banking institutions of liquidity support by Government or central banks, as a safe harbor*

The Annex B(1d) explains that this safe harbour is for: "very rare circumstances when the need to maintain and safeguard financial stability overrides the benefit of making public a given piece of information." S. 307D(2)(c)(iii), however, does not specify the purpose of the liquidity support before qualifying it as a safe harbor. Thus, **<u>liquidity support for nationalization, political and other purposes will also become exceptions to disclosure. This would exploit the public rights to know. Should "maintain and safeguard financial stability" be added as a necessary precondition for this section?</u>**

4. *The Annex B (2) Exemption*

The Annex B (2) states: "…the SFC to grant waivers to listed corporations on a case-by-case basis, if the disclosure is prohibited by legislation or a court outside Hong Kong, or if the prohibition is made by a law enforcement agency outside Hong Kong or a government authority…"

If the disclosure is clearly prohibited by foreign laws, it may warrant SFC's exemption. However, many Hong Kong listed companies operate in Mainland China and/or foreign countries in which some rules are not stated clearly. Under s. 307E(1)(a) and (1)(b), it accepts "<u>would</u> constitute a contravention" as ground of granting an exemption, which is inevitably weak and may make a legal loophole. **<u>We therefore suggest to change it from "would constitute" to an emphatic wording "would probably constitute".</u>**

We also suggest to modify s. 307E(2) into: "The Commission may grant a waiver **to the whole information or the part of information** under subsection (1) subject to any condition that it considers appropriate to impose." **This modification enables SFC to have more flexibility and to be able to command the listed company to disclose the unrestricted part of information as much as possible.**

5. *The Bill S. 307N Orders of Tribunal (Penalty)*

(a) Since the basis of penalty is stipulated in s. 307N(3) saying that: "…in all the circumstances of the case, the fine is proportionate and reasonable in relation to the breach of the disclosure requirement…", **in order to enhance the deterrent effect of the penalty, should the cap on fine under s. 307N(1)(d) be removed?**

(b) Even a cap is set, is $8,000,000 adequate? According to past experience in Hong Kong and overseas, breach of disclosure requirements mostly involves senior officers of listed companies including their Chief Executive Officer and/or Chief Financial Officer. Cap of $8,000,000 fine is quite an amount relative to the annual remuneration package of a senior officer working in a small listed company. However, such amount of cap is relatively small when compared with the annual remuneration package of a senior officer working in a sizeable listed company and is hard to be an effective deterrent. We therefore suggest to:

(i) **either remove the cap or to raise the cap to "the greater of $8,000,000 and two years' remuneration"; and**

(ii) **harmonize with other international markets by making serious breach of disclosure requirements a criminal offense. We suggest that a person commits an offense of serious breach of a disclosure requirement intentionally and without reasonable excuse is liable:**

(A) on conviction on indictment to imprisonment for 2 years or less; or

(B) on summary conviction to imprisonment for 6 months or less.

6. *The Bill s. 307Q Report of Tribunal*

S. 307Q(2)(b) stipulates that: "…except where the Tribunal sat in private for the whole or any part of its proceedings, by — (i) publishing the report so that copies of the report are available to the public…" Whether the whole or any part of the hearings sat in private is to be made available to the public or individual will leave to SFC's decision, who will assess whether to disclose the whole or the part of hearings sat in private under s.

307Q(3): "…if the Commission is of the opinion that it is in the public interest to do so, cause the whole or any part of the report to be made available to the public or to a particular person or body in the manner the Commission directs." However, will the public interest as standard of provision of the report of hearing sat in private be too high? Will the act of hiding part of the hearings treat the defrauded minority shareholders unfairly? For equal treatment to individual shareholders, we suggest to lower the standard of public disclosure to:

"**If it is just and equitable to individual defrauded shareholders and at their individual's best interest,** the Commission causes the whole or any part of the report to be made available to the public or to a particular person or body in the manner the Commission directs. **If disclosing any part of the report to the public will act against the public interest, the relevant part should not be reported.**"

7. The Bill s. 307z Civil liability for breach of a disclosure requirement

Since early 2000's, several statutes were added to the Securities and Futures Ordinance to enable a defrauded investor to make a civil claim against a listed company or its senior officer for compensation for loss as a result of market misconducts. So far no investor has successfully won a court case thereby for compensation. Two reasons, among others, why the statutes are inoperative are obvious:

Firstly, the amount of losses (which may involve thousands of dollars to a low six-digit amount of money) that most defrauded small investors incurred are not huge in each listed company case. Therefore, it may not be financially viable to incur a potential cost of hundreds of thousands or million dollars to make a legal claim.

Even several minority shareholders sued, in CITIC Pacific case, the former Chairman of the company for civil compensation in the low-cost Small Claim Tribunal, the defendant successfully made a request for transferring the case to the high-cost High Court, by arguing that the case involved complex facts and legal issues. **However, does any legal case of a listed company's improper disclosure and market misconduct not involve complex facts and legal issues? We thus believe that all related claims will eventually proceed in the costly senior courts for judgment. Furthermore, most small investors' assets or income exceed the financial resources limits for Legal Aid. Hong Kong also does not have any public fund available to support such legal action. Class action is also not available to finance the legal cost. In practice, s. 307Z is expected to be only a useless law under which the small investor will not be able to make any effective claim.**

Secondly, even a small investor makes a claim without seriously taking into account its costs and efforts involved, the chance of winning such case is also remote under the common law. In CITIC Pacific case, the judge of the Small Claims Tribunal stated in the judgment that one small investor plaintiff, prima facie, did not have a cause to claim her loss under common law. In his opinion, the small investor had bought the stock of CITIC Pacific with reference to the company's analysis published in a newspaper and her own share price analysis. The small investor had not read the company's announcement

alleged to be misleading. Having said that, the claim was not definitely refused if the case proceeded in the High Court. Nevertheless the common law does not favor small investor's claim of investment loss as a result of his reliance upon "second hand information/analysis".

However, in modern investment era, Hong Kong stock market consists of thousands of listed companies and each listed company may make ten thousands pages or more of announcement/report annually. **A small investor generally diversifies his investment in ten or more listed companies. For obtaining sure protection granted by common laws, does he need to read million pages of listed companies' public announcements/reports every year?**

In practice, most small investors nowadays rely on "2nd hand" analyst reports. According to some foreign researches, stock prices of listed companies more or less reflect disclosure information made. For example, a "2nd hand" analyst report contains bad information and analysis of a listed company due to its reliance on bad corporate disclosure. **An investor does his investment homework by reading the "2nd hand" report and is misled indirectly by the bad corporate disclosure. Consequently he incurs loss. Should a law be made to protect this type of investor to facilitate him to obtain compensation? How do other international markets offer any practical legal protection through which a defrauded small investor can take action?**

In U.S., Sabanes-Oxley Act 2002 s. 308 created a Fair Fund for Investors. U.S. Securities and Exchange Commission is empowered by law to take legal action on behalf of investors against a person in breach of a disclosure requirement and market misconduct. The receipts obtained from the case are deposited into the Fair Fund for Investors. As U.S. SEC has comparable financial strengths as the listed company and its senior officer involved, cases often reach settlements. **Defrauded investors have obtained over billion dollars of compensation in total from the Fund. This type of legal arrangement saves a lot of time and cost in legal proceedings. It also makes the small investor to obtain juster and fairer treatment and protection. In the long run it will enhance the confidence of local and international investors in Hong Kong financial market, and will strengthen the competitiveness of Hong Kong financial market.**

We therefore strongly suggest the Government to consider:

(a) to develop this type of Fair Fund for Investors or other laws under which the small investors can practically take action, at a reasonable cost, for compensation against the listed company or its senior officer;

(b) to empower Hong Kong Securities and Futures Commission to take legal action on behalf of investors to claim compensation from a person or a body in breach of law.

Should you require further information regarding this, please call Mr. Yip at 94172135, or Mr. Leung at 90356946.

Best regards,

Legislative Council Member
James To Kun-sun

Representatives of CITIC Pacific Small Investors Concerned Group
Bernad Yip
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cc Hon. Mr. Ho Chun-yan