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Paper for the House Committee meeting
on 23 June 2000

Report of the Subcommittee on
Securities and Futures Bill

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures Bill ("the Subcommittee") after its work was re-activated in April 2000. This paper provides a summary of the concerns raised by members of the Subcommittee in relation to the White Bill on the proposed overhaul of the legislation governing the securities and futures markets gazetted on 7 April 2000 for public consultation.

Background

2. Following the announcement of a major overhaul of the legislation governing the securities and futures markets in the Financial Secretary's 1999-2000 Budget Speech, the Administration conducted a public consultation exercise in July 1999 on the major reform proposals to be embodied in a composite Securities and Futures Bill ("the Bill"). The Panel on Financial Affairs was briefed on the subject on 5 July 1999. In view of the complexity of the proposed reform proposals, the House Committee decided at its meeting on 9 July 1999 that a subcommittee should be formed to conduct a detailed study of the proposals prior to the introduction of the composite Bill to the Legislative Council. On 22 October 1999, the Subcommittee on Securities and Futures Bill ("the Subcommittee"), after conducting a series of meetings with the Administration on the different aspects of the reform proposals, submitted a report to the House Committee. The House Committee endorsed the recommendation of the report that the work of the Subcommittee be held in abeyance until a Bills Committee was formed to study the Bill upon its formal introduction to the Council.

3. In response to the requests from professional bodies, stockbrokers and the banking industry, the Administration decided that another round of public

consultation should be conducted to allow the draft Bill to be exposed to the market for comments before introduction to the Legislative Council. On 7 April 2000, the Bill was published in the form of a White Bill for public consultation. The period of consultation will last until the end of June 2000. The Administration intends to introduce the Bill in October/November 2000 and implement the reform proposals after the enactment in April 2001.

4. With the agreement of the House Committee, the Subcommittee was reactivated to study the major new policy issues set out in the White Bill.

The White Bill

5. The White Bill aims to create a modern regulatory framework to facilitate effective enforcement by the Securities and Futures Commission (SFC) and efficient compliance by market users and intermediaries. The White Bill, which is a composite bill to replace the current ten ordinances to regulate the securities and futures markets, also aims to rectify the gaps in the legal framework resulting from recent advances in technology, markets and financial instruments and practices so that the Hong Kong financial markets can be on a par with best international standards and remain competitive.

6. The major proposals in the White Bill include the following aspects:

(a) Streamlining the licensing regime for intermediaries by providing one single licence for regulated activities;

(b) Enhancing management liability by making senior management of intermediaries liable for breaches;

(c) Providing for proportionate disciplinary sanctions against improper conduct by intermediaries;

(d) Protecting clients' assets from dissipation;

(e) Establishing a dual civil and criminal route to deal with specified market misconduct;

(f) Providing statutory right of civil action against perpetrators of market misconduct;

(g) Adopting a flexible and pragmatic approach to regulation of automated trading services; and

(h) Enhancing transparency in the professional investors' markets.

The Subcommittee

7. The Subcommittee reconvened on 3 April 2000. Under the chairmanship of Hon Ronald ARCULLI, a total of six meetings have been held, including one meeting dedicated to receiving oral representations from deputations. The membership list of the Subcommittee is in **Appendix I**.

8. The Subcommittee has examined the various chapters in the Consultation Document and exchanged views with the Administration on the major new policy issues therein. The Subcommittee has also invited views from the market bodies and professional organizations. A list of the submissions received as at 20 June 2000 is given in **Appendix II**.

9. The concerns raised by the deputations include issues regarding consumer protection, competitiveness in the securities and futures markets, market misconduct, disclosure of interests in shares, and effectiveness of the licensing regime.

Deliberations of the Subcommittee

10. In examining the White Bill, the Subcommittee has placed special emphasis on the new aspects as compared to the reform proposals published in July 1999.

Market misconduct

11. The Bill proposes to establish a Market Misconduct Tribunal to counter the destabilizing effects of manipulation and other unfair practices in financial markets. The Market Misconduct Tribunal will cover not only insider dealing as presently handled by the Insider Dealing Tribunal, but also other instances of market misconduct. The Subcommittee notes the support of the Consumer Council for the proposal as well as its suggestion of including provisions that would address anti-competitive conduct in the definition of market misconduct. A deputation however has grave concern about the wide-ranging criminal liability for market misconduct. It considers the creation of 20 categories of market misconduct and two other criminal offences unnecessarily complex. Besides, the scope of some of the criminal offences is extremely unclear. These offences include sanctions against disclosure of false or misleading information which is subject to a defence for a person to prove that he did not know and could not reasonably have been expected to know that the information was false or misleading. The deputation considers that such extensive market misconduct provisions, with the uncertainties as to their scope and the serious criminal and civil penalties on companies and their senior management, are likely to discourage legitimate market activities such as hedging and arbitrage that facilitate market efficiency and liquidity.

12. The Subcommittee notes that the Administration was aware of the concerns pointed out by the deputation when drafting the Bill and has taken into account the need to protect those engaging in legitimate securities or futures trading. Most proposed offences will require the prosecution to establish that the defendant had the intention or purpose to commit the misconduct. In the case of disclosure of false or misleading information, the offences will contain a defence for the defendants to prove that they acted in good faith and did not know and could not have known that the information they disclosed was false or misleading. Such a defence provision is already a protection for the defendant. The Administration stresses that the purpose of the provisions is not to discourage legitimate financial market activities but to deter blatantly manipulative conduct. Nevertheless, in view of the deputation's concern over the complexity of the 20 categories of market misconduct proposed in the Bill, the Administration is prepared to take a fresh look at the relevant provisions to see how they could be improved.

Private right of action

13. The Subcommittee notes that the Bill creates a right of civil action for those who suffer pecuniary loss as a result of market misconduct and relying on any public communication (relating to securities or futures contracts) which is false or misleading. While the Consumer Council shows support for such provisions, the other deputation has grave concern about the potential for unlimited exposure of individuals, companies and their management to civil actions by investors.

14. The Subcommittee also has concern on whether the provision for statutory private right of action could benefit the majority of the investors, who may not have the resources to take their cases to the court. As legal proceedings would be costly and time-consuming, this statutory right might only be meaningful to large companies or institutional investors with the necessary resources to take legal actions for remedies. Although the provision serves to enhance the standard of disclosure, it is likely that the creation of statutory right of civil action would upset the level playing field in the market since small and medium size listed companies would not have the same financial ability to meet claims for remedies.

15. In view of the far-reaching implication of the provisions, the Administration agrees to take into consideration the public views gauged during the consultation period before finalizing the drafting of the Bill.

Disclosure of interests in shares

16. To bring Hong Kong in line with international disclosure and regulatory standards, the Bill proposes to reduce the substantial shareholding disclosure threshold from 10% to 5% and to shorten the notification period for

disclosure from 5 days to 3 business days. The Subcommittee notes that the market is supportive of these revised disclosure requirements. Nevertheless, a deputation considers that the extension of the concept of an "interest in shares" to interests in unissued shares and interests arising under equity derivatives will make financial markets groups reach the 5% disclosure threshold easily. Further disclosures will need to be made on virtually a daily basis. Besides, the need to disclose changes in the "nature" of an interest goes beyond international market practice. Coupled with the extensive amount of information to be disclosed, a significant additional workload will be created. The proposed arrangement will make the law immensely complex and onerous to comply with. The new disclosure regime will have an adverse impact on the development of derivatives markets in Hong Kong, and make hedging transactions more costly.

17. The Subcommittee also notes that the proposed requirement to disclose short positions is not in line with international standards. A person who has a notifiable interest in shares of 5% or more has to include in his disclosure particulars of any short position which he has. An independent duty of disclosure arises if a person with a notifiable interest in shares (i.e., 5% or more) acquires a short position of more than 1%, if the percentage level of the short position subsequently changes by more than a whole percentage level, or if the percentage level of his short position drops below 1%. Such proposed disclosure requirement not permitting netting-off of long and short positions for the purpose of calculating the percentage level of notifiable interests will add compliance burden for disclosure on market participants.

<u>The new licensing regime - responsibility and liability of senior management</u>

18. The Bill has introduced a "management responsibility and liability" concept to enhance investor protection. Under the proposal, each intermediary has to nominate at least two "responsible officers" for approval by SFC. The "responsible officers" will be responsible and accountable for directly supervising the conduct of the regulated activities of an intermediary. At the same time, these "responsible officers" as well as the corporation itself are liable for breaches by the corporation of certain fundamental regulatory requirements.

19. The Consumer Council is in support of this concept as holding a "responsible officer" liable for a corporation's breaches, not only provides adequate and appropriate controls on management side, but also ensures such persons responsible for making decision exercise due care and diligence, thereby providing better investor protection.

20. The Subcommittee notes the views of a deputation that the range of sanctions, the basis on which liability is imposed and the severity of the penalties provided for under the Bill are greater than those in other jurisdictions.

This may discourage international financial markets participants to assume management responsibilities in the Hong Kong market. The Subcommittee also notes the possibility of people unwilling to accept the appointment as "responsible officers" of an intermediary because of the liability for breaches of regulatory requirements by the corporation.

21. The Administration's explanation is that it would be inadequate for the SFC to rely solely on its supervision of intermediaries to promote compliance at all times. As in other jurisdictions, the regulator must also rely upon the senior personnel of the intermediaries to ensure compliance. There are defence provisions in clause 367 of the Bill that a "responsible officer" will not be liable if he can prove that he honestly and reasonably believed that the corporation was in compliance, and he acted promptly in notifying SFC of the relevant breach once it became known to him. The Subcommittee notes that the Administration's explanation is not accepted by the deputation. The deputation considers that such a defence will in practice be extremely difficult to prove. As a general matter, it is wrong in principle to place the burden of proof on the defendant and it is not appropriate to impose criminal liability except where the individual knowingly participates in the wrongdoing. The Subcommittee notes that the Administration will address this point at the end of the consultation period when all comments from the market have been received.

Regulation of licensed persons

22. The Bill proposes that all "responsible officers" are required to be licensed with the SFC as licensed representatives. The prerequisites for licensing include the passing of the specific Hong Kong professional examination and on-going training requirements. The Subcommittee supports the objective of the provision in promoting sound business standards and ensuring a reasonable level of investor protection. Members however note that the executive directors who are based outside Hong Kong might have practical difficulties in meeting the criteria. The Subcommittee understands that the Administration will consider the suggestion made by the deputation that overseas qualifications and experience should suffice for licensing in Hong Kong and it will take into account further views regarding the granting of exemption from the proposed requirements.

Supervision and investigation by SFC - access to audit working papers and records of transaction counterparties

23. The current Section 29A of the Securities and Futures Commission Ordinance concerns inquiries relating to listed companies. The provision allows the SFC to require production of and make limited inquiries about the records and documents of a listed company and its group companies where there are reasons to suspect fraud, misfeasance or other misconduct in relation

to the formation, management or business of that listed company or to suspect that there has not been proper disclosure to shareholders. However, under this current provision, the SFC does not have the power to verify information obtained from records or documents produced by a listed company or its group companies. To remedy the problem, clause 165 of the Bill enhances the SFC's powers by enabling it to seek records and documents relating to the affairs of a listed company or its group companies from third parties, namely such companies' auditors, bankers, persons who have dealings with such companies ("transaction counterparties") and persons in possession of such records and documents.

24. Some members of the Subcommittee have raised concerns about the power of the SFC to gain access into auditors' working papers and transaction counterparties' records. Although the Administration claims that adequate safeguards have been put in place, e.g. the record or document sought has to relate to the affairs of the listed company or one of its group companies and is relevant to the grounds for the inquiry, some members still consider that SFC's power in this respect is greater than the powers of its overseas counterparts. In the event that an auditor refuses to produce the records requested by SFC, SFC could seek assistance from the court under the provisions of Part VIII of the Bill. To avoid the possible burden of paying the court fee, a small auditing firm may have no alternative but to supply the working papers sought by the SFC.

25. As regards transaction counterparties and persons in possession of records or documents relating to the affairs of the listed company under inquiry or one of its group companies, members note that under clause 165(10), the SFC is required to certify in writing that it has reasonable cause to believe that the record or document sought cannot be obtained from the listed company under inquiry or any of its group companies, or any bank or auditor of such a company before it can exercise the power to require production of such records and documents.

Checks and balances on the power of SFC

26. The Subcommittee has noted that the Bill has vested new powers in SFC including investigative and disciplinary powers. Members therefore have concerns on whether there are adequate checks and balances on the exercise by the SFC of these powers.

27. In this respect, the Administration has assured members that measures of checks and balances have been in place, including statutory thresholds that the SFC has to satisfy before invoking certain powers; requirement for prior approval by the Financial Secretary, Chief Executive in Council, Legislative Council or the court before the SFC may take certain actions; and the review of certain SFC decisions by an independent body. Two notable initiatives are the

establishment of a Securities and Futures Appeals Tribunal to hear appeals against a wide range of SFC decisions, and a Process Review Panel to review SFC's internal operations including its investigatory process. Members also note the avenues of redress available under the general law, such as judicial review and complaints to the Office of the Ombudsman.

28. Apart from the establishment of a system of checks and balances, members are of the view that improvement should also be made to the communication with the industry. Some members have suggested that the Administration should establish a consultative committee of market intermediaries. The members of the committee should be elected from the industry. As such, the elected members will be able to formally represent the industry and reflect its views to the Administration, in particular on the reform of the securities and futures sector. The Administration has undertaken to consider the proposal.

Recommendation

29. Given the complexity of the Bill and its far-reaching impact on the securities and futures market, the Subcommittee considers that members should have sufficient time to scrutinize the Bill before its enactment. The Subcommittee therefore recommends that a Bills Committee be formed to study the Bill after the Bill has been introduced to the Council at the start of the next LegCo session.

Advice sought

30. Members are invited to support the recommendation in paragraph 29 above.

Prepared by
Council Business Division 1
Legislative Council Secretariat
22 June 2000

Appendix I

Subcommittee on Securities and Futures Bill

Membership List

Hon Ronald ARCULLI, JP (Chairman)
Hon Albert HO Chun-yan (Deputy Chairman)
Hon Eric LI Ka-cheung, JP
Hon James TO Kun-sun (until 18 April 2000)
Hon Ambrose CHEUNG Wing-sum (until 31 December 1999)
Hon Christine LOH (until 2 April 2000)
Hon SIN Chung-kai
Dr Hon Philip WONG Yu-hong
Hon Jasper TSANG Yok-sing, JP
Hon Ambrose LAU Hon-chuen, JP
Hon FUNG Chi-kin

Appendix II

Subcommittee on Securities and Futures Bill

List of organizations which have submitted views to the Subcommittee
(as at 20 June 2000)

1. Consumer Council

2. Linklaters