COMMENTS ON THE SECURITIES AND FUTURES BILL

By

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INTRODUCTION

The Securities and Futures Bill, hereafter 'the Bill', is a positive step towards streamlining and enhancing the effectiveness of the securities and futures industry in the Hong Kong Special Administrative Region. By consolidating the different ordinances and introducing some new initiatives, the Bill addresses many of the concerns that have arisen from a regulatory regime that has its genesis in the Australian system of some three decades ago. However, despite its substantial 1125 pages, the Bill must be regarded as a means to the end rather than the end itself. It must, therefore, be seen as merely the first step in a longer-term process to establish an appropriate regulatory framework that addresses the various concerns and meets the different, and sometimes conflicting, objectives of the capital markets in Hong Kong.

SPECIFIC COMMENTS

The ensuing paragraphs assume the philosophy as set out above, namely, that the enactment of an appropriate regulatory framework involves a series of incremental steps so as to maintain a sense of stability and continuity in the market place. It further assumes that such amendments are necessary to enhance the competitiveness of financial markets in Hong Kong against a background of an increasingly borderless global securities and futures industry.

However, it takes cognisance of the fact that broader issues including, amongst others, the rationale for maintaining the exempt status of banking institutions, the revised licensing requirements and the need to further enhance corporate governance,[1] may be addressed elsewhere by others. As such, the comments herein will focus on specific issues in the hope that they will encourage debate within the Legislative Council and lead to some amendments to the Bill. In particular, it will turn on three issues, namely:

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1 Some interesting proposals on enhancing corporate governance may be learnt from Malaysia, which includes the accreditation and continuing certification of directors. For a summary of the pertinent recommendations of the high level Finance Committee on Corporate Governance, see Low C.K. 'Corporate Governance in Malaysia' in Low C.K. (ed) (2000) *Financial Markets in Malaysia*, Malayan Law Journal, Kuala Lumpur.

i. the role of the auditor;
ii. civil liability for market misconduct; and
iii. disclosure of interests.

i. The Role of the Auditor

The foregoing is set out in Part VI Division 5 of the Bill. The function of an auditor is to carry out an audit and present a reliable, independent report on the accounts and financial position of a company.[2] As gatekeepers of the integrity of financial markets, auditors provide a vital service as aptly summarised by Lord Denning in *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd*[3]

> 'An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional "adder-upper and subtractor". His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind – not suspicious of dishonesty, I agree – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.'

While the legal duty to audit with reasonable care and skill has not changed, it is important to note that the standard of care changes with the effluxion of time in line with the development of society. As the public places greater expectation on the competence of auditors, the standard of care and skill of auditors is correspondingly more exacting. Some guidance of this requirement may be derived from the judgment of Lopes LJ in *Re Kingston Cotton Mill Co (No 2)*[4] in which his Lordship opined as follows

> 'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as it was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.'

While the above does not mean that the auditor has no responsibility to discover errors or fraud, he or she must nonetheless adopt adequate and suitable tests to satisfy himself or herself that the internal systems can be reasonably relied upon as effective. Where these tests prove unsatisfactory, it shall be the duty of the auditor to probe further. The auditor should, therefore, be constantly alert to possible errors or misappropriations by employees as well as by the management so as to discharge their duty to present a 'true and fair view' of the financial position to the company.

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2 For an overview please refer Arjunan K. and Low C.K. (1996) *Lipton & Herzberg's Understanding Company Law in Hong Kong*, LBC Information Services, Sydney, Chapter 16.

3 [1958] 1 All ER 11.

4 [1896] 2 Ch 279.

A recent survey of some 1500 companies in Hong Kong by the international accounting firm KPMG indicates that corporate fraud, defined to include misdemeanours, false accounting and bribery, is expected to rise, with most cases involving the employees and management of companies.[5] In fact, so significant is the problem that one in four companies surveyed reported experiences of at least one case of fraud in the past two years. The fact that these are not reported suggests that companies are either reluctant to attract adverse publicity and/or believe that the chances of recouping lost assets may be compromised.

It is against this background that the failure to impose a positive duty to report fraud by the auditor of the company becomes a glaring omission in the Bill.[6] To be sure, there must be a clear and unequivocal distinction between the ***detecting*** of fraud, and the ***reporting*** thereof to the relevant authorities. The author does not advocate, whether expressly or by implication, that there should be a duty to detect fraud as this would impose an unnecessary, and possibly prohibitive, burden on businesses without any guarantees that fraud will be discovered. However, what is vital is that the auditor be mandated to report such irregularities if these are detected in the ordinary course of the audit.

The above would be consistent with the provisions of Clause 154(1)(b) which calls for communication of information to the Securities and Futures Commission and the Hong Kong Monetary Authority, where this is '*relevant*' to any of their respective functions. The proposed functions of the SFC are set out in Clause 5, and the mandatory requirement to report fraud would be in furtherance of sub-clauses (1)(a), (d), (g), (m) and (n). In addition, it would be fully consistent with the proposed statutory objectives of the SFC as set out in Clause 4.

ii. *Civil Liability for Market Misconduct*

It is proposed that the scope of Clause 272 be expanded to act as a deterrent against market misconduct. As presented, the clause allows for the recovery of losses by victims against the 'market manipulator'[7] if the court deems this to be fair, just and reasonable. The author believes this to be unnecessarily restrictive and would propose a framework that will allow victims to 'piggy-back' on any finding of liability by the Market Misconduct Tribunal.

The principal advantage of this proposal is that it would allow investors to sue the market manipulator as a ***matter of right*** where the latter is found guilty of the various forms of market misconduct as set out in the Bill. If implemented, it would simultaneously reduce the onus of proof on the part of the victim, while enhancing the burden of proof on part of the market manipulator. To this end, it is envisaged that the framework would comprise two inter-related steps, namely:

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[5] Tsang, D. "Fraud Cases Seen Soaring", *South China Morning Post, Business Post*, 19 January 2001, p 1.

[6] The Bill provides the auditor with a choice to report fraud but makes this completely voluntary. However, it does facilitate reporting by the proposal to grant statutory immunity from civil liability under the common law: Clauses 154, 368 and 369.

[7] This term is used generically to refer to those who have been found liable for market misconduct as will be governed under the proposed Part XIII of the Bill.

i. for the alleged victim to show that he or she traded in the securities and/or futures markets within the period which the alleged market misconduct is supposed to have taken place; and
ii. for the alleged market manipulator to thereafter adduce evidence to establish that he or she did not do the particular trade whether directly or through his or her agents.

The standard of proof would be that of a civil standard, namely, on the balance of probability on both the part of the alleged victim as well as the alleged market manipulator. The foregoing has its merits if based solely on the ground that it would reduce the costs of litigation since the alleged victim can 'piggy-back' on the findings of the Market Misconduct Tribunal to discharge his or her evidentiary burden.

Another area of concern is the wording of Clause 247(1), which may allow collaborators of market manipulators to escape civil liability. By declaring that evidence provided by third parties 'is not admissible', the unintended consequence could be a loss of a right of legal action by victims against these collaborators. By offering to testify and provide evidence, these collaborators could effectively claim limited immunity from civil or criminal liability by raising the defence circumscribed by Clause 247. It must be noted that this does not prevent the Financial Secretary from instituting appropriate proceedings before the Market Misconduct Tribunal, but the existing framework is such that only the government, rather than the individual investor, stands to benefit from this.[8] The better approach would, therefore, be to expand the application of Clause 249 such that the Market Misconduct Tribunal may order such collaborators to account for their aiding and abetting of the market misconduct in the same manner as market manipulators are held accountable.

iii. Disclosure of Interests

The *Securities (Disclosure of Interests) Ordinance,* which owes its legislative history to the recommendations contained in the Hay Davison Report, has been the cornerstone of disclosure requirements in Hong Kong since 1991. Adequate disclosure was seen as necessary towards the attainment of three objectives, namely, the orderly and smooth functioning of the markets, the creation and maintenance of a fair market, and the protection of investors. The Ordinance has had a rather chequered history, for although it was passed in 1988, it took the government more than 3 years to proclaim the same. Even then, it failed to fully implement the recommendations of the Hay Davison Report, which had called for disclosure threshold of 5 percent. One, therefore, has to wonder whether the government was itself serious about promoting transparency of the market place in Hong Kong.

Save for the reduction of the threshold and time period for disclosure of interests,[9] the approach taken under the Bill is much the same as that of the existing *Securities (Disclosure of Interests) Ordinance.* This, by definition, means that the proposed Part XV inherits the same deficiencies that impaired the establishment of a framework of disclosure, which original intention it was to mirror the more transparent English model as provided under its *Companies Act.*

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[8] See Clause 249 on the orders that may be made by the Market Misconduct Tribunal.

[9] However, it is nonetheless conceded that the Bill does extend the type of disclosure required, such as, on the short positions held.

Two issues ought to be addressed, namely, the adequacy of the proposed disclosure threshold of 5 percent, and the sanctions for non-compliance. On the former, in view of the abnormally small public float of shares in Hong Kong listed companies when compared with international standards,[10] it would be more effective if the disclosure threshold were further reduced to 3 percent. Even if the disclosure threshold were lowered to 3 percent, which is highly unlikely, it will represent a higher percentage of the free float as compared with other developed markets. At this level, it theoretically means that a person would need to hold 30 percent of the free float before he or she needs to disclose his or her interests on the assumption that the latter only offers ten percent of the same for sale to the public.[11] This does not bode well for the development of a transparent and fair market place since Hong Kong will still be behind by international standards on the basis of *relative* influence exercised by the size of the shareholding.

A more pressing issue is that of the sanctions that may be imposed under the provisions of the Bill. These have a common theme, namely, the prevention of the transfer of ownership in the securities. This is hardly surprising as it merely adopts the current position of imposing 'freezing orders' under the *Securities (Disclosure of Interests) Ordinance.* It is submitted that a better position would be to examine ***control*** as opposed to simply ***ownership*** for purposes of such freezing orders. This would be fully consistent with the comments of the then Financial Secretary, whose view it was that the aim of the Ordinance was to 'look through corporate interests to get at the reality of controlling shareholders.'[12]

While ownership may, by itself, be an important aspect of holding shares, there are equally, if not more, important considerations. These would include the right to vote and the right to receive a dividend when declared, whether this takes the form of cash or bonus issues of shares. By allowing such rights to continue to vest despite the non-disclosure of interests as specified under the Bill, the sanctions thereon would be impotent. It is completely naïve to think that the mere restriction on the transfer of ownership of shares is a sufficient incentive to disclose one's interest, especially if the same person can freely exercise his or her right to vote at general meetings and continue to receive dividends in an unfettered manner. Therefore, the provisions of the Bill should be amended to reflect this, if indeed the intention is to enhance market transparency.

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10 Under the existing framework, companies need only offer 10 percent of their shares to the public if their market capitalisation exceeds $4 billion on listing on the Stock Exchange of Hong Kong. This percentage increases to 25 percent where the market capitalisation of the company is less than the specified $4 billion.

11 Admittedly, this figure reduces to about 12 percent in cases of companies which free float is 25 percent. However, the message remains the same, namely, the threshold level needs to be reduced further if the intention is to enhance market transparency. As a comparison, the disclosure threshold is currently 3 percent in the United Kingdom and an even lower 2 percent in Malaysia.

12 Hong Kong Legislative Council Papers, 8 June 1988, at 1560-62.

GENERAL COMMENTS

This section of the paper may perhaps be termed the 'Wish List' going forward. At the outset, it must be stressed that not everything contained herein come within the purview of a particular bureau within the government machinery. In fact, these proposals call for effective inter-bureaux cooperation so as to establish a regulatory framework that meets the demands of the international investor as well as enhance the participation of the local investing community. As these are but preliminary ideas, it will be necessary to develop them further since the ensuing paragraphs merely provide for an overview of the same.

a. Free Float

It is, and always has been, an anomaly that despite its standing as a leading international financial centre, the float of most publicly listed companies in Hong Kong remain relatively low by international standards. This is compounded by the high incidence of cross-shareholdings in many listed companies, thereby effectively focusing control of corporate Hong Kong upon the hands of a few. While this may reflect an underlying cultural trend, it does not contribute to the further development of the financial markets in the longer-term, especially against a background of increasing globalisation. An increase in the size of the free float from its current levels would therefore be favourable although the final percentage will need to be arrived at after consultations with different parties. If pushed to state a number, I would recommend that the minimum free float be lifted to at least 30 percent, with an even higher free float of 50 percent for smaller capitalised companies. This historical distinction should be gradually phased out, with the higher free float of 50 percent being ultimately common for all companies.

b. Threshold for Takeovers

This issue has gained prominence of late as control of a number of companies effectively changed without the minority shareholders being provided with the opportunity to participate.[13] It is submitted that such practices go against the 'General Principles' of the *Code on Takeovers and Share Repurchases*, which makes it all the more disappointing to witness an increasingly number of cases where the spirit of the Code is ignored. The existing threshold of 35 percent is definitely excessive and impractical in view of the comparatively low free float of shares in Hong Kong. It also compares poorly with regional counterparts, as the threshold in Australia is 20 percent while that in Singapore is 25 percent. In the interests of enhancing corporate governance, for which Hong Kong aspires to set the regional benchmark,[14] the threshold for takeovers should be progressively reduced to half of the free float as proposed in the paragraph above, namely, 25 percent.

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[13] For a commentary, please visit www.webb-site.com.

[14] Budget speech of the Financial Secretary on 8 March 2000.

c. Enhanced Disclosure

'Chinese walls' have been instituted to prevent conflicts of interest between the various operating departments of securities firms, principally their research and trading divisions. If properly implemented, it serves a useful function in minimising inter-divisional collusive actions that could potentially impede the efficient functioning of the price discovery system, the hallmark of all capital markets. At the moment, all that is required is a 'caution statement' to the effect that the securities firm may hold or trade the securities as recommended by its research department, and that the investors should therefore exercise judgment in dealing with the recommendations. This practice may perhaps be improved upon, namely, by the imposition of a limited 'trading prohibition' in tandem with the existing requirement for disclosure. This would effectively mean that where a securities firm publishes a recommendation, the firm should ensure that it does not deal in the said securities on its own account at least three trading days before and after the publication. As such a requirement entails some degree of cooperation between the various departments of the securities firm, there exists a risk that the requisite level of protection against potential conflicts of interest may be compromised. To this end, it may be necessary to appoint a 'Compliance Officer' at a sufficiently senior level of management to ensure compliance with all aspects of the regulatory framework within which the firm operates.

d. Enforcement of Regulations

The judiciary plays a vital role in the smooth and efficient functioning of the capital markets by enforcing the laws and regulations that hold together the market infrastructure. However, there appears to be an apparent reluctance on the part of the judiciary to impose tough sanctions as provided for by the various ordinances. A couple of examples best illustrate this point, namely, the recent cases involving Hwa Tay Thai Limited and South East Asia Wood Limited.[15] In the former, the controlling shareholder of the company disposed off a total of more than 330 million shares in the company, representing some 16 percent of its issued capital, without the requisite disclosure under the *Securities (Disclosure of Interests) Ordinance* and was fined only $18,000 for the offences. The South East Asia Wood case involved the creation of false markets for securities in breach of the *Securities Ordinance*. The perpetrator ended up with a fine of $80,000 and was ordered to pay the Securities and Futures Commission $50,000 being costs related to the investigation. The total sum of $130,000 is benign and casts substantial doubt over the willingness of the judiciary to impose strict sanctions in accordance with the provisions of the applicable ordinances.[16] These decisions send out the wrong message to the market place and may impede the establishment of a level playing field. While it is perhaps unfair to highlight two cases to cast aspersions on the judiciary, it nonetheless serves to draw attention to the important issue of effective enforcement of laws and regulations.

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[15] For a more in-depth discussion of the various issues please refer Mobius M., and Chan D., "Corporate Governance in Hong Kong – Gaps That Need to be Filled" in Low C.K. (ed) (2000) *Financial Markets in Hong Kong*, Springer-Verlag, Singapore.

[16] In both cases the court could have imposed much heavier fines as well as terms of imprisonment under the *Securities (Disclosure of Interests) Ordinance* and the *Securities Ordinance* but apparently chose not to. The offences in each case were indictable and yet neither served even a day in jail despite their serious breaches of securities laws. Neither accused could claim that they were novices as they both had considerable experience within the corporate arena to be fully aware of their actions and the penalties for breach of the law. Details of these, and other, cases may be viewed at www.hksfc.org.hk/eng/enforce.

e. Independent Directors

This issue has surfaced on numerous occasions and the central question that is often asked is whether the independent director remains a myth in Hong Kong. Given the low free float and the tight control that majority shareholders exercise over the appointment of directors, it is not uncommon for the 'independent' director to be less than fully independent for a variety of reasons. While the Listing Rules of the Stock Exchange of Hong Kong addresses some of these concerns, largely from a view of the pecuniary interests, this has proved largely ineffective since the rights of minority shareholders continue to be ignored.[17] One cause for this could be that the independent director is unable, or unwilling, to state the case for the minority shareholders. This is usually so because directors are voted in by the shareholders of the company at the general meeting in which the majority or controlling shareholder holds the key. By casting his or her vote in favour of a particular person, or persons, that shareholder can effectively dominate the composition of the board of directors, which includes the independent directors. To preserve the notion of independence, it is proposed that the election of independent directors be limited to independent shareholders at general meetings. In addition, it is further proposed that the percentage of independent directors should be at least a third of the composition of the board of directors, so as to provide them with the opportunity to better represent the interests of the minority shareholders.[18]

f. Shareholders Support Fund

The empowerment of shareholders contributes positively towards the enhancement of corporate governance. However, the low free float of the shares of public listed companies in Hong Kong means that the interests of minority shareholders are sometimes compromised. These instances include transactions that are not in their favour, or by precluding their participation from the same as evident by a series of recent corporate maneuvers where change in control were effected. The foregoing provides sound reasons for the establishment of a 'Shareholder Support Fund', hereafter 'the Fund', which objective it is to protect the interests of minority shareholders so as to enhance the standard of corporate governance in Hong Kong. The initial funding for the establishment of this Fund could be grants from the government of the Hong Kong SAR, the Securities and Futures Commission, the Hong Kong Monetary Authority, the Hong Kong Exchanges and Clearing, and 'independent' private donors such as the Hong Kong Jockey Club. A percentage of the levy that is imposed on securities and futures transactions could be assigned to the Fund, which operations will be overseen by a board comprising a cross-section of the community. This would include regulators, professional advisers, public listed companies and academics. The Fund may assist aggrieved shareholders in a number of ways, such as, the provision of advice or support in litigation against the company and/or its directors. To ensure the proper application of funds, charges will be imposed and support for litigation must be on a 'cost plus risk premium' recovery basis. The latter means that the Fund will share a part of the damages awarded by the court in a successful action by the minority shareholder. In addition, investments in shares of companies should also be considered as this ensures the right of the Fund to attend general meetings and ask questions of directors.

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17 For a sampling of these instances, please visit www.webb-site.com.

18 A review of the standard of care of directors may also be timely particularly if the requisite amendments to the relevant ordinances were enacted in tandem with this proposal. For a discussion of a possible framework please refer Low C.K. (1997) 'The AWA Case: Implications for the Hong Kong Director', 13(2) *Journal of Asian Business.*