SECURITIES AND FUTURES BILL

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A Submission on the Blue Bill

by

Hong Kong Stockbrokers Association

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(Part Two)
dated
2 March 2001

Re： Part VI

Section 141 Financial resources rules

The section provides that the Commission may make rules requiring licensed corporations to maintain a certain level of financial resources as specified. The rules may specify requirements as to the amount of financial resources to be maintained and among others, requirements as to assets, liabilities and other matters to be taken into account. Apart from the empowering section of 384 for the Commission to make rules, detail aspects of these rules are laid down in sub-paragraphs (2)(a) to (h).

There is little argument in the profession of stockbroking that it is necessary and advisable to have sufficient financial resources to meet one's commitment on a daily basis and to be able to manage some contingencies such as an unexpected default by a client in case such a need arises. However, at the same time, one cannot falsely hope to eliminate all possibilities of risk in any enterprise under our capitalistic system, regardless of the nature of the business and least of all, financial. It would be quite dangerous to be presumptive on the theory that "good " rules can make an enterprise risk-free. So long it is a business, it is going to be risky. What is important is to strike a balance. The fundamental concept therefore is that we cannot treat future unascertainable events as evil. Anything that happens not in accordance with our expectations and to our rules made in anticipation of them cannot be treated as a vice and they are not generally, nor necessarily, attributable to somebody's fault. The test could only rest on whether one is reckless in managing others' financial affairs on their behalf in such a way that a prudent person in that profession would not have done. This will bring us to the question of criminal liability which is under section 142 to be discussed later.

It is sufficient to mention here that, in this light, rules should not be so rigid that any divergence is a contravention. Presently under the FRR there are stock concentration and client concentration formulae to be observed which are a complicated matter and not easy to be followed in practice. One can only know the final figures at the end of a trading day and by which time a contravention could have happened. There is nothing inherently wrong with that but one of the possibilities is that future events may develop to prove on hind-sight that "all eggs in one basket" is dangerous. This contravention however, can be adjusted or corrected in the following days. We suggest in matters of this nature, the deviation should be taken as a "wake-up call" whereupon attention should be paid and they should not be viewed as an absolute breach and a subject of criminality.

We further mention here is that exempt persons including banks are not subject to these financial resources rules. We have heard that banks are subject to more stringent rules under their law and the supervision of the HKMA. However, those are not the same rules, they are entirely incompatible to our present FRR or to securities in particular. There is for instance no corresponding rule in the banking business to provide for specified amount requirements, the breach of which results in criminal liability. We have commented on this in general in our overview and we reiterate again that this section and others serve to illustrate that as between exempt persons and persons who are not exempted, there is little to resemble a level playing field.

Section 142

Subsection (1) provides that a licensed corporation shall notify the Commission in writing if it fails to comply with the specified amount requirements under the FRR on the same day it

becomes aware of it. Failure to do so is an offence punishable on indictment by imprisonment for 2 years and a fine of $1 million. Subsection (3) provides for notification within one business day for non-compliance of the same rules but regarding requirements other than specified amount requirements. Failure to do this is again a criminal offence, though with a lesser penalty than subsection (1).

The reasons in support of the concept of a "wake-up call" are given under the previous section and for the purposes of practicality we would suggest that time-frames be incorporated into these provisions. For example subsection (1) can be amended to the effect that if a licensed corporation has become aware of its inability to maintain financial resources in accordance with the specified amount requirements and this position is not likely to be remedied within the next few business days and continued trading would be prejudicial to its clients or a section of the investing public, then it is obliged to give notice. Subsection (3) can be similarly dealt with. What sort of a time-frame is considered to be workable can be a matter of further research when the detailed rules and requirements are known.

Subsections (2) and (5)(b) provide that the Commission may impose conditions orally or in writing. Subsection (6) provides that such conditions given in writing may be amended orally or in writing. It is suggested that for matters of this serious nature a written notice is more precise, accurate and sensible in that it is less likely to be misunderstood or misinterpreted as in a verbal communication. In today's technology a facsimile message is received in real time, so is a fax by e-mail and the effect of a verbal notice has no real advantage in terms of time but adds to the risk of mistaken understanding. The situation is more confusing when conditions in written notices can be countermanded or amended orally subsequently. It is a practical problem when oral instructions are to be taken to vary a previous written notice and the law does not specify at what level the delegation of such important orally instructions can be given.

Similar comments apply to **Section 143** subsections (3) and (4) which provide that the Commission may impose oral conditions and that a written notice may be amended orally.

The conception and suitability of attaching criminal liabilities to these rules have been mentioned under the previous section and we do not propose to discuss further other than the fact that the rules are not available for sight at this stage. We have argued strongly previously in our submission on the White Bill against passing a law of such importance with a host of blank subsidiary legislation which provides for criminal penalties with strict liability. For ease of reference, we repeat part of our conclusion under that heading:

"The right of passing these rules, a host of subsidiary legislation, is left unattended by the legislature at the moment with the Bill in this form. This is not a small gap that can be overlooked and subsequently remedied but a whole city-gate wide open, through which four-horse chariots can drive. If the legislature is prepared to surrender its power of law-making to this extent, leaving a blank cheque with full signature, on which this Bill can be steered and implemented, we do not know if this is the beginning of a trend when the administrative will merge with the legislative."

For the above reasons we strongly endorse and support the view expressed by the Law Society that in the interests of certainty and justice, any matter which are intended to attract criminal penalties should be set out in the Bill itself or alternatively, any rules proposed to be made by the SFC which would attract criminal liability should be subject to public consultation, vetting by the Legislative Council and/or approval by the Chief Executive in Council.

Section 144

Subsection (1) provides that the Commission may make rules requiring intermediaries and their associated entitles to treat and deal with client securities and collateral held by them in such manner as specified in the rules.

Subsection (2)(i) states: "require a person who becomes aware that he does not comply with any specified provision of the rules that apply to him to notify the Commission of that fact and of any further specified information within the specified time;"

Subsection (4) provides that where an intermediary or its associated entity contravenes any specified provision of the rules without reasonable excuse, it commits an offence and is liable to a fine and imprisonment for 2 years.

The spirit of our existing common law system is that in criminal law one is not forced to incriminate oneself whether by law or by administrative means. In the present provision, the breach of any of the rules is already an offence under subsection (4) and failing to report a breach within the time specified is another offence under subsection (2)(i). The arrangement of these provisions is exactly built on self-incrimination and a direct contravention of the spirit of our existing legal system. We suggest that subsection (2)(i) and provisions of similar effects in the Bill should be removed.

Section 145

Section 145 provides that the Commission may make rules requiring licensed corporations and their associated entities to treat and deal with client money in such manner as is specified in the rules.

Subsection (2)(k) states: "…require a person who becomes aware that he does not comply with any specified provision of the rules to notify the Commission of that fact and of any further specified information, within the specified time;"

Subsection (4) provides that where a licensed corporation or its associated entity fails to comply with any specified provisions of the rules, it commits an offence and is liable to a fine and imprisonment for 2 years.

Our comments on the previous section also apply here. Firstly, we should not impose on a person a duty , by law, to incriminate oneself to the authorities and secondly make it a further offence if one does not do so. Both offences arise out of the same incident but we are imposing upon a person an extra duty punishable as a crime that one should report oneself. This form of legislation is most undesirable in the interest of natural justice.

Section 84 of the existing Securities Ordinance which deals with the keeping of clients' money in trusts accounts and subsection (7) states: "A person who (a) **without reasonable excuse**, contravenes any provision of this section shall be guilty of an offence and shall be liable on conviction to a fine of $10,000; or (b) with intent to defraud, o a fine of $50,000 and to imprisonment for 5 years."

On comparison one can notice that in the Securities Ordinance, the licensed person is given the benefit of a "reasonable excuse", whereas in the Bill, any contravention which may be technical

or may arise out of clerical error has a strict liability and there is no place for any reasonable excuse no matter how reasonable and compelling it is. It is noted that existing contravention under section 84(7)(a) carries no term of imprisonment whereas in the Bill it is 2 years under subsection (4). In this particular instant, fines under subsection (4) in the region of $100,000 to $200,000 would be entirely out of proportions for offences of a nature without any element of criminal intent to defraud, which is separately and adequately dealt with under subsection (5).

It is suggested that the spirit of the existing law should continue to prevail that any contravention which does not touch upon defraud should not attract criminal punishment by imprisonment. Any contravention which does not contain an element of criminal intent should not be dealt with criminally. We suggest this not only in respect of this particular section or these particular rules but as a general principle which can be used to apply to all the rules and provisions in the Bill.

Section 147 provides for the Commission making rules for the keeping of accounts and records by intermediaries and their associated entities. Subsection (2)(d) states as follows:

"require a person who becomes aware that he does not comply with any specified provision of the rules that applies to him to notify the Commission of that fact and of any further specified information, within the specified time;"

Section 148 provides for the Commission making rules for the preparation of contract notes receipts, statement of account etc. by intermediaries. Subsection (2)(f) states:

"require a person who becomes aware that he does not comply with any specified provision of the rules that applied to him to notify the Commission of that fact and of any further specified information, within the specified time;"

Both the abovementioned subsections impose a duty on the intermediaries to report to the Commission on a basis of self-incrimination and failing to so report in the specified time is itself a breach of the rules. For reasons given under section 145 we consider these subsections examples of legislating against natural justice which goes deeper into the roots of our legal system and wider than the ambit of mere securities legislation.

Section 155

Subsection (4) states: " Where an auditor appointed under subsection (1) has examined and audited the accounts and records of a licensed corporation or an associated entity of a licensed corporation, the Commission may, where it is of the opinion that it is appropriate to do so having regard to the conduct (whether before or after the appointment) of the licensed corporation or the associated entity(as the case may be) to pay a specified amount, being the whole or a part of the costs and expenses of the examination and audit, within the specified time and in the specified manner."

This subsection empowers the Commission to order, at its entire discretion, the whole or any part of the costs and expenses of an auditor appointed by it under subsection (1) to be borne by the licensed corporation whose accounts are being examined even before such appointment, within the specified time and in the specified manner.

In this provision, it seems that the Commission can prejudge the case and the expenses can be ordered to be paid in advance even before the appointment of the auditor and therefore well before any auditing has commenced. This is most prejudicial to the licensed corporation to be audited. It is not clear how the opinion of the Commission is to be formed on the question of payment of costs and expenses and under what circumstances is a person liable for such costs. It is suggested that these circumstances should be expressly spelt out in a policy statement so that the Commission would have to exercise its discretion carefully and weigh the possibility of paying such costs itself if audit results do not show any adverse situations. If there is no better transparency in the process, this administrative power to order payment of costs and expenses would become a threatening element in the form of a fine in advance.

Section 156

This section provides that the Commission may appoint an auditor to examine and audit either generally or in respect of any particular matter, the accounts and records of the licensed corporation and its associated entity in the event of an application in writing by a person who alleges that a licensed corporation or its associated entity has failed—

"(a) to account to the person for any client assets held on behalf of the person by the licensed corporation or the associated entity (as the case may be); or

(b) to act in accordance with instructions given by the person to the licensed corporation or the associated entity (as the case may be), and-

(i) has failed to account to the person for any profit that may have been secured or increased by the person had the instructions been followed; or

(ii) has failed to compensate the person for any loss that may have been avoided or reduced by the person had the instructions been followed,"

Subsection 153 (1)(a) is on similar line to the existing section 91(1) of the Securities Ordinance which reads: "On receipt of an application in writing from a person who alleges that a dealer has failed to account to him in respect of any money or securities held or received by that dealer for him or on his behalf, the Commission may, after first giving the dealer an opportunity to give an explanation of the failure, appoint in writing an auditor to examine, audit, and report, either generally or in relation to any particular matter, on the books, accounts, and records of, and securities held by, that dealer."

There is little cause for objection to the existing Section 91 since it deals with client's money or securities held in trust. However, the concept behind subsection 153(1)(b) which is a novel addition to the existing law is entirely another matter. It deals with client instructions without any qualifications and therefore, for all purposes and intent, is to be interpreted to include market instructions.

Paragraph (1)(b) is to be objected to for its presumptions which, if put into practice, may prove unworkable and the effect of it will place the licensed corporation to a most vulnerable position. The fault lies in the presumption that market instructions can be taken literally to the letter and carried out accordingly to the satisfaction of a client. In a real-world market, this is not always the case. A number of illustrations have been given in the submission to the White Bill and they are not to be repeated here. But it is important to understand the principle that market instructions are always given by a client in a set of circumstances known to him at the time and if those market circumstances changed dramatically, instructions relating to the buying or selling of securities may become obsolete and cannot be followed. If such "failure" by a licensed corporation for reason of changed circumstances can be a statutory cause for complaint by a client who has either earned less

profit or suffered more loss, leading to the Commission requiring an audit on the licensed corporation generally, it could become a frequent nuisance to the latter when the situation is taken advantage of by disillusioned clients trying to settle a hard bargain against a stockbroker.

It is suggested that if a client feels aggrieved as a result of his broker's action or omission, it should be a matter for civil action or investigation by the Commission and not be resolved by the appointment of an auditor, which process tend to be cumbersome, time-consuming and not cost effective. Definitely, it is not a case for auditing generally since the exercise is to investigate the facts in respect of one particular complaint and nothing more. We suggest that paragraph 153(1)(b) be removed.

Subsection 156(6) provides that the Commission shall not appoint an auditor under subsection (1) to examine and audit the accounts and records of an associated entity that is an authorized financial institution unless the Commission has first consulted the Monetary Authority. It is not known who has the right of a final decision and whether the Commission can override the wishes of the Monetary Authority. It is a grey area in the way that it is written. In any event it serves to illustrate that authorized financial institutions who are exempt persons at present are in a more privileged position.

Section 158 Power of auditors

Subsection (3) states that:" A person who, without reasonable excuse, fails to comply with any requirement imposed on him (including the requirement to answer any question put to him) under this section (whether by an auditor appointed under section 155 or156 or a person authorized under subsection (1)(g) commits an offence.." which is punishable by a fine of $200,000 and imprisonment for 1 year.

It has been our basic common law right to remain silent when being accused of an offence and the accused is not forced by any administrative powers compelling him to answer anything to incriminate himself. The Basic Law provides that this right shall be maintained. Article 8 of the Basic Law states:

"The laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene this Law, and subject to any amendment by the legislature of the Hong Kong Special Administrative Region."

Article 39 of the Basic Law states (inter alia):

"The rights and freedoms enjoyed by Hong Kong residents shall not be restricted unless as prescribed by law."

The proviso in 158(3) directly affects one of our basic rights in common law as promulgated to be maintained by the Basic Law and the matter goes to the rights and freedoms enjoyed by us, to issues of criminal justice, which are much further and wider than the ambit of the Bill itself. We vouch for the deletion of subsection 158(3).

For the same reason, subsection 158(4) is equally objectionable to the extent that one is obliged to comply with the requirement of giving an answer. It is the spirit of our law that one commits no criminal offence for anything one says except in specific cases such as statements made in public which constitute criminal libel in the law of defamation or statements made under oath in a

court of law which amount to perjury. We do not suggest that an offence equivalent to perjury in nature, with such heavy penalties, be delegated to an agent employed by the auditor (under subsection (1)(g)), who may conduct a process of questioning removed from our courts of law to places unascertained, where questions might be asked. We suggest that the parts which relate to verbal questions and answers be deleted entirely from subsection 158(4).

Section 159

Subsection (1) provides that a person commits an offence if he, with intent to prevent, delay or obstruct the performance of an auditor appointed under this Part –

(a) deletes, destroys, mutilates, falsifies, conceals, alters or otherwise makes unavailable any accounts, records or documents…;
(b) disposes or procures the disposal, in any manner and by any means, of any property belonging to or in the possession of a licensed corporation…: or
(c) leaves, or attempts to leave, Hong Kong.

Subsection (3) states: " If, in proceedings of an offence under subsection (1), it is proved that the accused person deleted, destroyed, mutilated, falsified, concealed or altered any accounts, records or documents concerning any matter relating to the business of a licensed corporation or any of its associated entities or to the client assets of a licensed corporation, or aided or abetted or conspired with another person to have done so with intent to prevent, delay or obstruct the carrying out of any examination and audit which an auditor appointed under this part is required to carry out."

Under subsection (1) it is noted that the words "deletes" and "alters" can be quite neutral in interpretation whereas words such as "destroys", "mutilates", "conceals" carry a sense of ill motives. It is not clear what is meant by "or otherwise makes unavailable". It is not known under what circumstances and what sort of actions or non-actions that would come under this category. If one is guilty of falsifying accounts or records one must have a criminal intent but it is not necessarily so when one "alters" or "deletes" accounts or records, which can be perfectly innocent. The phrase "with intent to prevent, delay or obstruct." in subsection (1) is completely circumvented by the presumption in subsection (3) in circumstances under paragraph (1)(a).

With the introduction of the Hong Kong Bill of Rights Ordinance in 1991, it is suggested that presumption of this nature is no longer compatible with our existing law. Article 11 of that Ordinance states:

"Everyone charged with a criminal offence shall have the right to be presumed innocent until proved guilty according to law."

In the Australian securities legislation there is a similar provision under the ambit of investigation by the Commission, which is a more serious situation than auditing. That provision, yet, has nothing to presume a guilty intent. For ease of reference that particular section is reproduced here:

"SECTION 67 CONCEALING BOOKS RELEVANT TO INVESTIGATION

67(1) [Offences relating to books] Where the Commission is investigating, or is about to investigate, a matter, a person shall not:

(a) in any case – conceal, destroy, mutilate or alter a book relating to that matter; or
(b) if a book relating to that matter is in a particular State or Territory – take or send the book out of that State or Territory or out of Australia.

Penalty: $20,000 or imprisonment for 5 years, or both.

67(2) [Defence of lack of requisite intent] It is a defence to a prosecution for a contravention of subsection (1) if it is proved that the defendant intended neither to defeats the purposes of a national scheme law of this jurisdiction nor to delay or obstruct an investigation, or a proposed investigation, by the Commission.

For reasons as mentioned above, we suggest that subsection (3) be removed and instead a paragraph on defence of lack of requisite intent be put in its place.