SECURITIES AND FUTURES BILL
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3rd Submission on the Blue Bill

by

Hong Kong Stockbrokers Association

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(Part VII to Part IX)

dated
23 March 2001

Part VII

Section 163

Regarding the Commission's power to make rules on practices and standards relating to the conduct of intermediaries we are firmly of the opinion that the contravention of such rules should not carry criminal liabilities under the law as provided in subsection (4). We suggest this is a matter of principle despite the fact that at present the rules are not available for comment in draft. A licensed corporation is always accountable to its client in respect of a regulated activity either by the contract between them or in tort under common law which imposes on the former a duty to exercise reasonable care. The making of rules as a subsidiary legislation imposes a further and more onerous duty known as statutory duty on the licensed person. A breach by a licensed person of a rule is therefore actionable at the suit of an investor if he suffers loss as a result of the breach. This in itself already affords a good and sufficient protection for the investor.

These rules concern practices and standards between intermediaries and as between intermediaries and clients. A contravention of them may suggest a deviation from a certain advisable trade custom or practice but it does not necessarily follow that it is in essence a criminal act and therefore has to be punished by criminal punishment. If a contravention of a rule results in loss being suffered by a client, then he can bring a case against the licensed person in an action which shall be dealt with by a court of civil jurisdiction. And the matter should rest there. Apart from cases of fraud which is a separate issue, there is little cause to brand all such contravention of rules en bloc as criminal activities.

In comparison, the Authority of the securities industry in UK has similar power to make rules under the Financial Services and Markets Act. However, they recognize that a contravention of the rules is actionable as a civil action but not a criminal offence. For ease of reference, part of the relevant sections is copied here:

"Section 150.– (1) A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

Section 151. – (1) A person is not guilty of an offence by reason of a contravention of a rule made by the Authority.

(2) No such contravention makes any transaction void or unenforceable."

We therefore suggest in this section as well as in all other sections in relation to rules made as a subsidiary legislation in the Bill, that where no intent to defraud is involved, provisions for criminal offence should be removed.

Subsection 163(2)

A lot can be said regarding the practicability and workability of the rules under the various paragraphs of the subsection which can be discussed when a draft is ready. However, paragraphs (e),

(f) and (j) may need some special attention. Under (e), suitability of information or advice is a highly controversial issue, let alone the requirement of an intermediary to take "specified" steps to ensure it. There is scarcely any hard and fast rule to test the suitability of information and advice to be provided to a client. It depends on a formidable myriad of circumstances which may be pertaining to a client personally, or exogenous factors affecting a particular type of investment, or the local market in Hong Kong at the point in time, without excluding factors influencing foreign markets, such as markets in China or the US, which in turn affect Hong Kong. In respect of a client alone, his or her age, sex, occupation, financial resources and liabilities, family background, education, past experience in the market, personal preferences in stocks are all relevant if they are to be taken into consideration.

The Commission may wish to take the precedent of the Australian model and follow a set of "suitability rules" but even that would not solve the problem satisfactorily. The endless string of litigation in the US and Australian markets on "suitability of information and advice" bears witness to this. It goes without saying that in the real world, a client's test of suitability of advice or information basically rests on the subsequent behaviour of the market. We have yet to hear of a single case where a client finds it a cause of complaint if an "unsuitable" piece of advice or information has caused him to make a good profit in his investment.

Sub-paragraph (f) requires the intermediary to disclose the financial risks involved in the financial product recommended to a client. This is the real test. Once a client is aware of the risks involved, it is his or her decision whether to take the financial risks or not. Once the decision, together with the risks, is taken, it would obviously be against the rules of fair play if the risks do occur but the client can be allowed to avoid the loss and put the blame on the intermediary retrospectively on the ground of "suitability of advice or information". The maxim of "caveat emptor" (let the buyer beware) has a good and time-honoured commercial sense here. With the provision of financial risk disclosure, the question of suitability under (e) should be rendered redundant and superseded.

Sub-paragraph (j) requires an intermediary to take specified steps to avoid cases of conflict between their interests and those of a client. It is noted that sometimes it is not entirely possible to avoid some conflicts of interests. It is not possible for example for an existing market participant to take an order to buy or sell shares of the Stock Exchange (code:388) in which almost all of them have vested interest as shareholders. A further example: we have to consider the position of brokerage houses which are associate entities of the Hongkong Shanghai Banking Corporation. Do we disallow them to trade in stocks of the Hongkong Bank (code: 05) or for those matter similar entities of the Bank of China if in future it is to be listed? We suggest that it would suffice if the interest is obvious or is declared.

Section 164 provides for the power of the Commission to make codes of conduct relating to the practices and standards to be complied by intermediaries and their representatives. Subsection (3) provides that the Commission may from time to time amend such codes of conduct. It is suggested that since these codes are for the intermediaries and their representatives to follow, they must be compatible with their existing trade custom and prove to be workable and practical to that

effect. Market practitioners must therefore be consulted before these codes are compiled or modified. It is further suggested that section 163 can be merged with section 164 without the two overlapping each other in function. For reasons mentioned under the previous section that a contravention of a code of business conduct do not necessarily by itself give rise to an offence, there is no need to stipulate a criminal punishment under section 163.

Section 165 Short Selling

It is not exaggerating to say that short selling exists in all sophisticated markets in the world and it is considered to be a means of hedging for the protection of investments with the aggregate result of correcting the market in an orderly fashion before it is carried to the extremes. It is a perfectly legitimate activity in the market in the United States. We are inclined to believe that short selling should be allowed. We certainly do not support the notion that short selling should be made a strict criminal offence. Whether by default of a client or not, short selling not by way of pre-arrangements can sometimes happen but it is basically an act of not being able to deliver physically the securities at the appointed time and can be dealt with as a breach of settlement, triggering a buy-back of the same quantity to square off an unperformed contract. As at present the defaulter is put to expenses in a compulsory buy-back. It merely boils down to failing to deliver in time a contractual obligation and by its nature a matter of contract law, not criminal. Attention is drawn to Article 7 of the Hong Kong Bill of Rights which states:

"No one shall be imprisoned merely on the ground of inability to fulfill a contractual obligation."

We strongly invite the Commission to reconsider the basic elements of short selling, particularly the elements of mens rea and the question of strict liability without losing sight of the fact that the Bill of Rights has a general application. Section 7(1) of Part I of the said Bill provides: "This Ordinance binds only –

(a) the government and all public authorities; and

(b) any person acting on behalf of the Government or a public authority."

Section 166

The requirements to confirm a short selling order as set out in this section are so cumbersome and so complicated to follow that most market practitioners are of the consensus that short selling or hedging as a mode of investment protection shall be stifled. Both leading brokerage houses and local brokers have expressed the feeling that with these provisions they would be most reluctant to undertake short selling on behalf of clients. It is believed the net result is to exile this sort of transactions to other jurisdictions. Again, for reason given above, we do not believe that the criminal penalty provided for under subsection (12) is justified in principle, nor a necessity for our present market atmosphere.

Section 167 requires an exchange participant or its representative to notify parties concerned that the order executed by him is a short selling order. That is all very well. However, this information of short selling has a presumed effect on the market in that its magnitude either in general or in respect of a particular stock may be gauged as a barometer on the future behaviour of the market or of the stock concerned. Therefore, if a short selling order has been bought back shortly after execution, in the present mechanism, the market has no way to know immediately. With a series of executed short selling orders cumulating to a sizable proportion, which had in fact been bought back, the market may be misinformed and misled. Market practitioners observed that a "short selling" button on the trading system is only one side of the coin. But without a "buy-back" button, the market can never have an up-to-date complete picture of what is happening on the other side until sometime later. We do not suggest for a moment that this result is intentional but the possibility that this information can create an immediate false impression on the market by those who try to attach some importance to it which may turn out to be deceptive, and is rendering the process elusive of its purpose.

Section 169 Unsolicited calls

We are of the opinion that unsolicited calls may create a nuisance in some cases to the receiving party and should not be encouraged. However, we are equally of the opinion that one should not reap a benefit as a result of someone's contravention. Our comments on the White Bill in this regard are applicable except the part relating to the penalty which has been redrafted.

Subsection (6) of this section provides that if the person who received the unsolicited call subsequently entered into an agreement, he can rescind the same within 28 days after the date when he becomes aware of the contravention. It is suggested that 5 business days (equivalent to a week) would be ample time for the person to decide whether it is in his favour to rescind the agreement after the same has been made. 28 days would just allow him to take advantage of 4 weeks of market development to make a profit if there is profit to be made and avoid a loss if it is subsequently not in his favour. We believe that the law only intends to be fair to a party aggrieved in this respect and not to guarantee an opportunity for him to make a profit out of someone's contravention."

It is noted under subsection (2)(b) an authorized financial institution is excepted from the provisions of unsolicited calls on another person with reference to providing securities margin financing. We see no particular reason that such institutions should be exempt from the law in the unpopular practice of making "cold calls". We do not advocate this unwelcome behaviour but do not see that the exception is a good example of a level playing field.

Further, subsection (4) provides: "… the Commission may in the rules prescribe that calls made by an authorized financial institution in compliance with such requirements under any guidelines published under section 7(3) of the Banking Ordinance (Cap. 155) that apply to it shall be within a class of calls to which this section does not apply." Again, we see no particular reasons that the authorized financial institutions should be exempt from this provision, neither is it conducive to a level playing field.

Part VIII

Section 173 subsection (1) empowers the Commission to appoint an authorized person who may make inquires of the intermediary or a related corporation and failing satisfaction, can make inquires of any other person whether connected with the intermediary or not. Subsection (3) empowers the authorized person to require any other person to produce within the time and at the place specified record or document which the authorized person believes to be in his possession and answer any question relating to them. Any person who fails to comply without reasonable excuse, such requirement imposed on him by an authorized person, commits an offence with criminal punishment. We believe this power to create a criminal offence is too wide. It does not only affects the intermediaries but extends to "any person" whether or not related to them.

Further we note that the "authorized person" is not statutorily restricted to a certain level of senior officers of the government or people with proper qualifications but is loosely defined as any person whom the Commission may authorize in writing (subsection (11) of section 172). We expect some safe-guards and checks and balances should be established here to protect the use of these wide powers. The effect goes beyond the securities industry and affects the rights of people in Hong Kong in general.

Section 174 imposes a duty on people to supply information to an authorized person on transactions in securities with criminal liability for non-compliance. It is noted that this section not only applies to securities which are listed and traded in the market or related to licensed corporations. Subsection (1)(a) states: "a person registered as the holder of securities in a register of members kept under the Companies Ordinance;"

Under subsection (1) the information has to be furnished to the authorized person within "the time and in the form" specified by him. We consider this would be too strict an obligation for all shareholders of private companies or any company to perform with possible criminal punishments for failure to do so.

Subsection (2) lists the information required such as name, aliases, address telephone and facsimile numbers occupation and so on "in so far as applicable". It is not known what information is applicable in what circumstances which may be very varied. To clearly define the duty under this section we suggest since it is an obligation to furnish information already in possession by a person that this phrase be substituted by "in so far as available".

Apart from securities, subsection (2)(a) goes on to cover futures contract, leveraged foreign exchange contract and collective investment scheme. We wonder if it is the latter category of contracts or listed securities which are really important under the supervision of an authorized person in respect of intermediaries, there is no necessity to expand this power to cover all shareholders in Hong Kong. It imposes on all public as well as private company shareholders an obligation (with criminal punishments) which may sometimes be difficult or onerous to perform. In the interest of the investing public in respect of both public and private companies in Hong Kong we suggest that this provision be curtailed to securities or contracts which are absolutely necessary for the duty of the authorized person to supervise.

Under section 176 the power of the investigator is also very extensive. Subsection 176(1) provides that a person under investigation (who may not be limited to an intermediary) shall produce any record or document, give explanation or further particulars, answer any question and give all assistance in connection with the investigation to the investigator. We are of the opinion that the power of the investigator may be too extensive particularly in view that failure to do any of the above without reasonable excuse is a criminal offence under **section 177**

Section 180

The section provides that any answer, explanation or statement given by a person pursuant to a requirement by an authorized person under section 172 or to an investigator under section 176, even thought they might be self-incriminating and claimed to be so by the person, such answer or statement are still admissible against him in evidence in criminal proceedings. The same applies to proceedings under Part XIII of the Bill (subsection (2)(ii)).

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. This right is always observed by courts during criminal proceedings.

Furthermore, under Article 11 of the Bill of Rights Ordinance, it is provided that in the determination of any criminal charge against a person, he shall not be compelled to testify against himself or to confess guilt. Now, under this section a person under inquiry or investigation is exactly required by law to testify against himself. We earnest invite Council members to seriously consider whether the provisions is directly in conflict with the Bill of Rights and set a precedent in undermining the basic freedom of people in Hong Hong.

Part IX

Section 186

Subsection (1) provides " In this Part, unless the context otherwise requires –
"misconduct", in relation to a person, means—

….

(d) an act or omission relating to the carrying on of any regulated activity for which a person is licensed or exempt which, in the opinion of the Commission, is or is likely to be prejudicial to the interest of the investing public or to the public interest, and "guilty of misconduct" shall be construed accordingly;"

It is suggested that the Commission cannot and should not be the sole judge of what may be construed as likely to be prejudicial to the interest of the investing public or public interest. Similar provisions in Section 56 (5) of the Securities Ordinance does not provide to the effect that the determination of a misconduct lies in the opinion of the Commission. If it is so laid down by law as it is, then the opinion of the Commission is a fact which is beyond challenge and that fact alone is sufficient to find a person "guilty of misconduct" and trigger the rest of the disciplinary action in motion.

Moreover, it is noted that matters arising from section 186 are not within the ambit of review under Part 2 of Schedule 7. Therefore, for example, there is no redress at all to dispute the opinion of the Commission if it is conceived in error. We suggest the phrase “in the opinion of the Commission” can be removed without affecting the basic definition of misconduct.

Subsection 186 (2) provides that where any person is guilty of misconduct which occurred with the consent or connivance of, *or was attributable to any neglect* on the part of a responsible officer, or a person involved in management, then the latter is also regarded as guilty of the same misconduct. Here neglect is put in the same category as consent or connivance, a provision which disregards the element of intent in the mind of the person in question. Culpability may go to a responsible officer or a person involved in management. How do we pin-point an act of neglect in the management team to a certain person in each and every case or are they all jointly liable?

The phrase “a person involved in the management of the business” creates uncertainty as to its interpretation. It is not clear, apart from the board of directors, how far and down to what level would a person be construed as involved in the management of the business. Where disciplinary sanction is involved, it is only fair to distinctly identify those people who are responsible, and not to loosely make certain persons culpable, such as “a person involved in the management of the business”, which has not been defined.

We suggest subsection (2) be amended to read as follows:

“ In this Part, where any person is, or was at any time, guilty of misconduct, within the meaning of paragraph (a), (b), (c) or (d) of the definition of “misconduct” in subsection (1) as a result of the commission of any conduct which occurred with the consent or connivance of another person as a responsible officer of a licensed person, the conduct shall also be regarded as misconduct on the part of that other person, and “guilty of misconduct” shall also be construed accordingly.”

Section 187

Section 187(1) provides that if the Commission is of the opinion that a person is not a fit and proper person to be or to remain licensed or to be or remain a responsible officer, or a person in the management of a licensed corporation, the Commission may exercise the following powers:

(i) revoke or suspend his licence; (ii) revoke or suspend his approval as a responsible officer; (iii) publicly or privately reprimand him; (iv) prohibit the person from applying for a licensed or to be a responsible officer for such period as the Commission may specify.

Under subsection (2), the Commission may also order the person to pay a pecuniary penalty of up to $ 10 Million or 3 times the amount of profit obtained as a result of his misconduct.

Thus the Commission (whoever acting on its behalf) may form its own opinion and pass penalty including the revocation of licence / approval and a heavy fine. This is an example where the Commission plays the role of prosecution, jury and judge at the same time, with a wide range of administrative sanctions in addition to its power to make a heavy fine.

Under subsection (7), the Commission shall publish guidelines to indicate the manner in which to perform these functions. The statutory effect of these guidelines is that they shall not be binding on the Commission as legislation and any departure from them shall not make the Commission answerable in a court of law. Subsection (8) seems to confirm this, that such guidelines are not subsidiary legislation.

The Commission, being the executive arm of the government, is already the investigator as well as prosecutor. In its opinion alone, if a person is not guilty of anything in law, he can be guilty of misconduct by the opinion of the Commission under the previous section, so it is jury as well. In this section, it performs the part of a judge to pass penalty. We do not believe that this will be conducive to impartiality and fairness if we leave everything in one authority, from prosecution to jury to judge. It goes to the root of the principle of separation of powers within a government. Any merger of the duties of the administration with that of the judiciary must be avoided. We are strongly of the opinion that the power to order a pecuniary penalty by the Commission should be removed to the courts of law in Hong Kong.

Section 188 provides for the revocation of a licence of a licensed corporation in certain events. The points at issue are paragraphs (vi) and (vii) of subsection (1)(b) where a director's mental incapacity or conviction of an offence may result in the revocation of licence for the licensed corporation. Argument has been advanced that if a director is mentally deficient, he should not be fit to remain a director anyway and the licensed corporation should thus remove him and so could have avoided the revocation happening. We suggest that this is a faulty argument. If this is the real intention of the law, it should be written specifically in respect of the disqualification of a director and not in a way as to confuse the issue with an entirely different matter concerning the licence of a licensed corporation which is a legal entity quite separate from the individual. If a separate section on disqualification of directors is considered appropriate, these paragraphs should be removed there.

Section 189(1) provides that the Commission shall not exercise its power to revoke a licence or order a fine etc., without first giving the person an opportunity of being heard.

When the Commission plays the parts of prosecution, jury and judge at the same time, there is definitely a conflict of interests. How can it "hear" a case impartially as a jury and as a judge when it acts as the informant as well as prosecutor at the same time within the same Commission with a unified consensus on certain policies? This conflict in the duplicity of roles goes to the root of the matter and does not inspire confidence or increase the transparency that justice will be done.

Section 193 subsection (1) provides that in reaching a decision for taking disciplinary actions in the Commission may have regard to any information or material in its possession which is relevant, regardless of how the information or material has come into its possession. We do not view that this provision is helping the Commission to promote its image that decisions are reached with transparency nor is it part of a fair and open government. If all the information and material in

its possession are validly obtained and authentic, bearing no doubt as to their truthfulness, there is no reason to be secretive about their source.

Section 194 is in connection with the transfer of records upon revocation of licence. This is a replica of section 187 of the White Bill with the exception of subsection (3) therein. For ease of reference, that subsection (3) is reproduced here:

"(3) Where a person is charged under subsection (2) for failure to comply with a requirement imposed under subsection (1), it is a defence to the charge for the person to prove that, in the circumstances of the case, he acted reasonably in purported compliance with the requirement."

Since the requirement mentioned in subsection (1) is such that the Commission may direct the transfer of records "in such manner" as reasonably specified, there is always a possibility that the requirement cannot be complied with in some circumstances. Therefore the provision for a defence is appropriate. We suggest that subsection (3) as contained in the White Bill be reinstated.