Paper No.12E/01

Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

Securities and Futures Bill
Part XIII - Civil liability for market misconduct

At the Bills Committee meeting on 21 September 2001, Members considered clause 272 of the Securities and Futures Bill (SF Bill) and asked the Administration to provide information on whether the courts in overseas jurisdictions would adopt the same common law principles set out in clause 272(2) (i.e. "fair, just and reasonable")[1] in deciding whether a person should be liable to pay compensation in an action similar to one initiated under clause 272.

2. Clauses 272 creates a right of civil action for a person who suffers pecuniary loss as a result of a contravention of the various market misconduct provisions of Part XIII. Clause 296 is its mirror image under the criminal regime in Part XIV[2].

3. The Securities and Futures Commission (SFC) has researched into the positions in the US, the UK and Australia, and the findings are summarized at the **Annex A**.

4. It can be seen from the research findings that the courts in the above overseas jurisdictions are prepared to adopt such common law principles as are appropriate in determining liability and the extent thereof. We expect no exception in the case of Hong Kong. We also note from the research that nothing in these jurisdictions departs from the "fair, just and reasonable" formula adopted for clauses 272 and 296, though their respective statutes do not carry any express provisions to this effect.

5. We had considered the alternative of remaining silent in the law on "fair, just and reasonable" in finalising the Blue Bill. On balance, we decided to accept the views expressed during consultation on the White Bill that it would be better if we could give some guidance to the court to allay concerns that the claims may be overly wide. We recognize that this is the first time we write in the law that a claimant may rely on

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[1] Clause 272(2) provides that "[n]o person shall be liable to pay compensation under subsection (1) unless it is fair, just and reasonable in the circumstances of the case that he should be so liable."

[2] The right of civil action created by clause 296 also extends to those who suffer loss caused by a contravention of the criminal offences in clauses 292 to 294 which are not mirrored in Part XIII.

rely on probative evidence from Market Misconduct Tribunal findings and determinations in pursuing claims for damages. It is reasonable that the market and the investing public are looking for some guidance as to what may be pursued under the law.

6. On the advice of our legal advisers, we have chosen to include the common law principle of "fair, just and reasonable". According to them, this principle appears to be the appropriate test to determine whether a defendant should be liable and to what extent he should be liable under clauses 272 and 296 of the SF Bill. There are also a number of court cases which adopt the same test as the moral criterion or benchmark for civil liability (see **Annex B**). Although we are not aware of any case authority directly applicable, this moral criterion has been adopted in cases involving damage to property, psychiatric injury as well as pure economic loss which arises from the acts or omissions of auditors, accountants, building and ship surveyors, building contractors, solicitors, psychologists, ambulance services and schools. The same principle applies to brokers, doctors and expert advisers for reward. We cannot see any reason why this moral criterion should not be applied in cases against financial intermediaries and financial services companies involving market misconduct. It was also well received by the market and the legal profession when the Blue Bill was exposed.

7. However, if Members take the view that in light of the latest research on the Australian and US position, the same result would have been achieved without clause 272(2) (and also clause 296(2)), we have no objection to leaving the matters entirely to the court. This, we believe, would not undermine the protection that clauses 272 and 296 intend to provide to the investors.

Securities and Futures Commission
Financial Services Bureau
3 December 2001

Securities and Futures Bill
International comparison of civil liability
Regimes for market misconduct

Background

1. Clause 272 creates a right of civil action for anyone who suffers pecuniary loss as a result of a contravention of the various market misconduct provisions of Part XIII[2]. Clause 296 is its mirror image under the criminal regime in Part XIV. The principles applicable to the right of action are:

   - compensation is not payable unless it is fair, just and reasonable in the circumstances
   - the loss must be a result of the contravention[3]
   - the loss is recoverable whether or not the plaintiff dealt in, refrained from dealing in or continued to hold a financial product affected by the contravention
   - an action may be brought even if the defendant has not been the subject of state brought proceedings in relation to the contravention
   - the findings of MMT proceedings or criminal proceedings are admissible in evidence in civil proceedings
   - the right of action does not affect any other rights of action available to the plaintiff or the defendant's liability under other laws including the common law which the right of action does not limit or affect.

2. Under the existing law, a person who suffers loss as a result of market misconduct under the Securities Ordinance (SO) has a right of civil action.[4] But, there is no equivalent provision in the Commodities Trading Ordinance (CTO) for similar conduct in relation to futures contracts or in the Securities (Insider Dealing) Ordinance (SIDO) for insider dealing. People affected by such conduct have to rely on their common law or equitable rights. This inconsistency has no sound policy justification. It is considered that a person who suffers pecuniary loss because of any form of market misconduct should have a clear right to take civil action to be compensated for their loss. There are two main means of doing this. The first is giving the regulator or other public body the power to apply to court for compensation or restitution for

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[2] The right of civil action created by 296 also extends to those who suffer loss caused by a contravention of the criminal offences in cl 292-4 which are not mirrored in Part XIII.

[3] Or a "relevant act" in relation to market misconduct in Part XIII, which includes: (i) engaging in market misconduct directly; (ii) knowingly assisting or conniving in another's market misconduct; and (iii) an officer of a corporation that is guilty of market misconduct who has consented to or connived in that misconduct.

[4] Section 141 gives a person who has suffered pecuniary loss as a result of a breach of ss 135-139 of the SO a right of civil action.

those who suffer loss because of market misconduct. The other is to give the people who suffer loss a right to act themselves. It is generally considered the latter is preferable as the SFC and other government agencies have limited resources and cannot act in every instance. Also, the decision about when to act can involve the SFC or other government agency in controversial decisions as to whom to assist and when. It is generally considered that it is better to give those affected rights that empower them to act for themselves. To this end, clauses 272 and 296 of the Bill will give those who suffer pecuniary loss because of market misconduct a clear right of civil action to seek compensation.

3. Given the lower civil sanctions that will be available under the Bill for market misconduct owing to human rights concerns and the difficulties of successful criminal prosecution, it is important that the deterrent effect of the market misconduct regime as a whole be strengthened. Private civil actions also serve the secondary function of deterring misconduct, as a person who commits market misconduct will also face the possible cost of compensating those who suffer pecuniary loss as a result. The proposal to make the findings of the MMT or a criminal court in relation to market misconduct admissible evidence in a civil suit should help in this regard. This will make it easier to bring a civil action for market misconduct, increasing the likelihood that a person found guilty of market misconduct will have to pay damages and so better deter market misconduct.

4. Nevertheless, in granting rights of civil action, it is important to guard against excessive claims. The means chosen to do this under cl 272 and 296 was to make loss only recoverable when it is fair, just and reasonable. We are advised that this reflects the prevailing Hong Kong and UK authority on when a duty of care will be implied at common law. We also expect that, in line with the experience overseas, questions of breach of duty, causation, remoteness and so on will be decided by analogy with common law tortious principles. Indeed, even though the US and Australian provisions do not include express references to a principle like “fair, just and reasonable”, the courts have read principles that limit recovery into the provisions from the common law. In so much as questions of breach of duty, remoteness and so on are at common law all bound up together with the question of when a duty exists, we feel that the adoption of the fair, just and reasonable rubric will help reinforce this tortious analogy. We expect the courts will sensibly read in other common law principles, eg causation and the measure of damages, as they have in other jurisdictions.

5. In developing the proposed rights of civil action in cl 272 and 296, regimes in similar jurisdictions were considered. We considered the US, the UK and Australia.

Australia

6. By comparison, with the US and UK, Australia is a small financial market although approximately the same size as Hong Kong. But, it has a well regarded regulatory system modelled on the US system and Hong Kong has historically taken much of its securities and futures laws from there, so it provides a measure of continuity with existing laws.

7. The present Australian rights of civil action for market misconduct related to securities are found in ss 1005, 1013-5 of the *Corporations Act* 2001 (CA) and for market misconduct related to futures in s 1265. The provisions will be changed by the *Financial Sector Reform Act* 2001 (FSRA) which will become effective in March 2002.

8. Section 1005(1) is basically quite similar to cl 272 and 296:

   - a person who suffers loss or damage by another's conduct that is a contravention of the market misconduct provisions has a right of action
   - the right of action does not depend on there being a criminal conviction
   - a person who contravenes the law or is involved in a contravention[5] is liable.[6]

9. Section 1005(3) provides that the right of action under s 1005(1) does not affect the liability of a person under any other law.

10. Section 1013 CA elaborates on who may recover compensation for insider dealing and how much they may recover and s 1014 CA does so for other forms of market misconduct.

11. Section 1013 CA is detailed. It gives a right of action to:

    - the corporation in cases of subscription by an insider
    - the seller in cases of purchase by an insider
    - the buyer in cases of sale by an insider.

    These people may recover compensation from the insider, any person the insider procured or any other person involved in the contravention, if they did not know the inside information. Further, in cases of sale or purchase by an insider, the corporation whose securities were bought or sold can also take

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[5] Under s 79 CA, a person is involved in a contravention if the person is a party to the contravention, has induced it, been directly or indirectly knowingly concerned in it or has conspired to bring it about.

[6] *Section 1005(1) CA*
Subject to the following sections of this Division, a person who suffers loss or damage by conduct of another person that was engaged in contravention of a provision of this Part may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention, whether or not that other person or any person involved in the contravention has been convicted of an offence in respect of the contravention.

action. In general, s 1013 CA provides that the person seeking compensation can recover the difference between the price at which the trade did occur and the likely price at which the trade would have occurred if the inside information were generally known.

12. In relation to other forms of market misconduct, s 1014 CA provides that, without limiting s 1005, a person who entered into a transaction for the sale or purchase of securities with a person who contravened the relevant law, or who entered into such a transaction with a person acting on that person's behalf, may recover the amount of any loss they suffer because of the difference between the price of the securities in the transaction and the price that would have been likely if there was no contravention.

13. The wording of ss 1005, 1013 and 1014 suggests that each should grant separate rights of action.[7] But, it has been held that a civil right of cause of action for insider dealing or other forms of market misconduct does not exist under s 1005 independent of the elements of ss 1013 or 1014 respectively.[8] Whether this decision will withstand further rulings is not apparent.

14. The assessment of damages under the provision on which s 1005 CA is modelled has generally been on tortious principles,[9] involving "in general, a comparison between what the position of a party was, or would have been, without the contraventions and what it was because of the contravention".[10] (Sections 1013 and 1014 reflect this.) But, one judge has said that, although the tortious rules about damages were a useful guide, there was no justification for confining the damages which are recovered under such provisions by reference to the common law tests.[11]

15. One commentator said this about s 1014, which is just as applicable to ss 1005 or 1013:

> The assessment of damages in relation to manipulation occurring on market gives rise to particular difficulties, which are analogous to those which arise in quantifying damages for insider trading. There is little justification in principle for limiting recovery of damages for market manipulation to persons who by chance trade with the manipulator in a public market, since the manipulative activity will have affected the price at which all trades have taken place in that market with in the relevant time period. On the other hand, if damages can be recovered by all other persons who traded within the relevant period, those damages

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[7] Section 1013(9) CA provides that: "Any right of action that a person has by virtue of this section *is in addition* to any right that any other person has under section 1005."; and s 1014 is worded "*without limiting the generality of section 1005*".
[8] *Ampolex Ltd v Perpetual Trustee Company (Canberra) & Ors (No 2)* (1996) 14 ACLC 1,514 per Rolfe J.
[9] *Hubbards Pty Ltd v Simpson Ltd* (1982) ATPR ¶40-295 at 43, 675 per Lockhart J.
[10] *O' Brien Glass Industries Ltd v Cool & Sons Pty Ltd* (1983) ATPR ¶40-339 at 44,459 per Fox J (Sheppard J agreeing).
[11] *Frith v Gold Coast Mineral Springs Pty Ltd & Ors* (1983) ATPR ¶40-339.

> may be quite out of proportion to the scale of the manipulation or the profits which the manipulator has made. It will also be necessary to determine the point at which the effect of any manipulative activity on market prices has been dissipated, since traders after that point should have no entitlement to compensation.[12]

16. In the context of an action to void share sale and purchase contracts executed on the stock market after the disclosure of false or misleading information, the courts seem to have favoured a liberal policy of broad recovery:

> Transactions which take place in a misinformed market should be set aside provided that this can be done with a minimum of injustice to innocent parties ..it was not in the public interest that numerous persons should be forced to bear losses as a result of deliberate public misinformation or fraud.[13]

17. Another commentator has made the following remarks on s 1013 CA about principles governing recovery.

> There is a contemporaneous requirement in the US.[179] Presumably it is implied here, but in complex and technical legislation such as this, such an implication is a big stretch ..At common law a plaintiff who purchases shares 4½months before remedial disclosure of the inside information ..fails to prove contemporaneity.[182] Even a two week gap may not be contemporaneous. The plaintiff's trading must be at the same time as the insider dealing or for some short period thereafter. A reasonable period of liability may be a few days but not as long as a month.[183] *The US adopts the fraud on the market theory, meaning that the individual need not prove he or she is defrauded, but conversely also meaning that if the market is informed, then individual "fraud" is irrelevant. This theory also subsumes the plaintiff's need to prove materiality, causation and damages.* Of course, the theory is balanced by the contemporaneity requirement, but note this was also a common law requirement anyway.[184]
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> [179] 15 USC §78t-1.
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> [182] *Alfus v Pyramid Technology Corp* 745 F Supp 1511; ie this case is before 79t-1.
> [183] *Re Verifone Securities Litigation* 784 F Supp 1471, affirmed 11 F 3d 865; this is a §78t-1 case.
> [183] *Re Verifone Securities Litigation*; see also *Chanoff v US Surgical Corp* 857 F Supp 1011, affirmed 31 F 3d 66; cert den 130 L Ed 2d 601, affirmed 33 F 3d 50.

18. Section 1015 CA provides a limit on the amount recoverable under ss 1013 or 1014: if a court has already ordered the person being sued to pay compensation under another provision of the CA in relation to the act or

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[12] A Black, "Regulating Market Manipulation: ss 997-999 Corporations Law" (1996) 70 *ALJ* 987 at 1004.
[13] *NCSC v Monarch Petroleum NL* (1984) 2 ACLC 256 at 261 per Nicholson J.

transaction in relation to which they are currently being sued, the person's liability is reduced by that amount.

19. Under s 1265(1) CA, any person with inside information in relation to a corporation, who deals in futures contracts in contravention of s 1253 CA, is liable to compensate any other party to the dealing who was not in possession of that information for any loss sustained because of any difference between the price at which the dealing took place and the price at which it would have taken place had the information been generally available.

20. Under s 1265(3) CA, any person who contravenes any of the other futures related market misconduct provisions in ss 1259-1264, whether convicted of an offence or not, will be liable to pay compensation to any other person who, by dealing in futures contracts, suffers loss because of any difference between the price at which the dealing took place and the price at which it would be likely to have taken place if the contravention had not occurred.

21. The amount of any compensation paid will be the amount of the loss sustained less any amount ordered payable under any relevant provision of the CA because of the same act or transaction.

22. Section 1324(1) CA is a general injunction power. It is very similar to cl 206(1) of the Bill. Like clause 206(9) of the Bill, s 1324(10) provides that a court may award damages in addition to or in substitution for an injunction. While s 1324 in theory provides an alternative right of action for any breach of the market misconduct provisions, there is some authority to the effect that it only allows for damages when pleadings also seek an injunction.[14]

23. Section 1318(1) provides for certain people (particularly corporate officers and auditors) to apply to court for total or partial relief from civil liabilities under the CA for negligence, default or breach of trust if the person has acted honestly and, in the circumstances, it is fair to excuse them from liability.

Law reform

24. The Australian parliament recently passed the FSRA, which commences in March 2002 and will amend the civil liability provisions for market misconduct.

25. Under s 1041I, a person who suffers loss or damage because of

- false or misleading information (equivalent to cl 268 and 290)
- false or misleading information inducing people

[14] *Executor Trustee v Deloitte Haskins & Sells* (1996) 14 ACLC 1,789 per Perry J. But cf *Permanent Trustee Australia Ltd v Perpetual Trustee Ltd* (1995) 13 ACLC 66 per Cohen J.

- dishonest conduct in relation to financial products or services and
- misleading or deceptive conduct in relation to financial products or services,

may recover the amount of loss or damage from the person who breached the law or any person involved in that breach, whether or not anyone has been convicted for the breach. The right of action does not affect liability under any other law. A person may apply to court to be relieved from liability under ss 1041I(4) and 1317S(2) on the same grounds as in s 1318 now.

26. Under s 1317HA, a court may order a person, who has contravened the provisions relating to market manipulation,[15] false trading and market rigging through creating a false or misleading appearance,[16] false trading and market rigging through artificially maintaining etc a trading price[17] and dissemination of information about illegal transactions,[18] compensation to be paid to a person (including a corporation) or collective investment scheme that suffered damage as a result. Damage includes profits made by anyone from the contravention and, for a collective investment scheme, diminution in the value of the property of the scheme. Under s 1317J, a person who suffers damage from a contravention, a corporation or collective investment scheme, etc. may apply for a compensation order.

27. Section 1043L elaborates on s 1317 HA in relation to insider dealing. Sections 1043L(2)-(5) effectively repeat the principles in s 1013, but extend them to other collective investment, retirement related or market traded financial products. Under s 1043L(7), a court may relieve a person from liability, in whole or in part, if the information the subject of the inside information came to their attention through being made available in a manner that would or would be likely to bring it to the attention of people who commonly invest in the financial products concerned.

Observations

28. The most recent Australian case on s 1005 damages actions provides a good example of how the courts approach actions under such provisions. In *Leadenhall Australia Ltd v Peptech Ltd*,[19] the appellants entered into a subscription agreement to buy a fixed number of shares and options in the respondent company which researched and developed peptides to develop and market human and veterinary drugs. Sometime later they entered into a modified subscription agreement. It was agreed that, in entering into the agreements, the appellants relied on the respondent's annual and quarterly

[15] Equivalent to cl 269 and 291 of the Bill.
[16] Equivalent to cl 265 and 287 of the Bill.
[17] Equivalent to cl 266 and 288 of the Bill
[18] Equivalent to cl 267 and 289 of the Bill.
[19] Supreme Court of New South Wales Court of Appeal, CA 40995/99 [2001] NWCA 272, Meagher, Handley and Giles JJA.

reports. It was also agreed that these reports were unintentionally false and misleading in that they did not mention a large number of "restricted" securities required to be held, under the relevant stock market listing rules, in escrow for a fixed period. At the end of the escrow period, it was likely that some or all of those holding the shares would sell them, putting downward pressure on the company's share price. When the escrow period expired, the company's shares did decline quite substantially, but later recovered. The appellants alleged that they would not have entered into the subscription agreement had they known of the restricted securities. However, at trial the controller of the appellant companies said that, had he known of the restricted securities, he would have waited to see what would have happened and may have negotiated the agreements with different terms rather than saying that he would have not entered into the agreements at all. The appellants never produced evidence of what the terms of these alternative agreements might have been and there was insufficient evidence to suggest that the fall in the respondent's share price was because of the sale of the restricted securities and that, if part of the fall in the share price was because of the sale of the restricted securities, the effect was material (ie causation was not established). On these grounds, the judge at first instance found for the defendants. On appeal, the appeal court agreed with the trial judge's findings and dismissed the appeal.

29. Although rights of civil action in Australia for market misconduct are quite favourable for plaintiffs, the judiciary has shown themselves relatively adept at interpreting them in a balanced way. Further, Australian legal commentators show a mature awareness of the need to balance adequate compensation to plaintiffs without saddling defendants with improbable or excessive damages claims which seems to reflect that the Australian legal community is comfortable with the provisions and does not think them excessive.

United States

30. The US is an obvious market for comparison as it has the world's largest and most developed financial markets, which are widely regarded as the best regulated, especially in terms of investor protection.

31. Both the *Securities Act* 1933 (SA) and the *Securities Exchange Act* 1934 (SEA) provide express rights of action. Each of these express rights of action specifies, in varying degrees of detail, the measure of damages that a plaintiff may recover. Other elements of the cause of action (eg the defences available to the defendant, the applicable statute of limitation) are also spelled out in the statutes. However, the bulk of US private securities litigation involves claims based on the alleged filing by public companies of misleading financial statements, and these claims are normally brought under s 10(b) of the SEA and rule 10b-5, made by the US SEC under the authority of s 10. These are

general market misconduct provisions and do not expressly provide a private remedy.[20]

32. In a series of decisions since 1946, the US federal courts determined that s 10 and rule 10b-5 gave investors a private right of action to recover damages from those who breached s 10(b) and rule 10b-5.[21] All of the substantive and procedural elements of the implied cause of action were determined by court decisions, and they generally tended to be more favourable to plaintiffs than those provided in the express rights of action.

33. Rule 10b-5 itself effectively defines a material misstatement or omission as a "manipulative or deceptive device or contrivance" for the purposes of s 10(b).

34. So long as a misrepresentation or omission is material, a plaintiff generally does not have to prove that he or she specifically relied on it. In the case of an omission, the plaintiff does have to show that there was a duty to disclose the omitted information.

35. The US federal courts have generally held that the plaintiff must establish loss causation, ie that the misrepresentation or fraudulent act caused a loss to the plaintiff. However, it is sufficient to show that the misstatement or misconduct was a "substantial factor" in causing the loss. It is not necessary to demonstrate that the misstatement or omission was the exclusive cause of the loss, or that the plaintiff expressly relied on it.

36. The courts are not entirely consistent in determining the damages that may be recovered in a private action under rule 10b-5. As a general matter, recovery in a financial misstatement case is based on the difference between the market price at the time of a misrepresentation and the market price after the truth is disclosed. Historically, the courts were divided on the extent to which a defendant can reduce the amount of damages by establishing that other factors

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[20] *Section 10(b)*

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

…

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- ❖ to employ any device, scheme, or artifice to defraud,
- ❖ to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- ❖ to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

[21] Because s 10(b) does not provide a remedy independent of rule 10b-5, we will only refer to rule 10b-5.

partially caused the loss. While most courts follow this approach, some hold that the defendant is responsible for all of the damages once the plaintiff establishes that the misrepresentation or misconduct caused the plaintiff to make or hold an investment.

37. The SEA provides an express cause of action under s 20A against persons who violate rule 10b-5 by engaging in insider trading.[22] Under s 20A, contemporaneous traders on the other side of the market (ie people buying while the insider trader was selling, and vice versa) may bring an action for damages against the insider trader. In any such action, the damages recovered from a person who engages in insider trading may not exceed the profit gained or loss avoided by reason of the insider trading. This rule is premised on the concept that insider trading does not directly cause other investors to realise losses (the assumption being that a person trading on undisclosed information is not inducing other investors to trade).

38. Initially, US courts have interpreted the implied right of recovery under rule 10b-5 liberally, but over the past 10 years both the Supreme Court and Congress have tried in various ways to trim back this right.

39. Following the judicial creation of the rule 10b-5 private right of action, judicial decisions gradually began to limit its scope, including in the following ways:

- purchase or sale requirement: s 10(b) prohibits fraud or deception "in connection with" the purchase or sale of a security, and the courts have held that a plaintiff must have purchased or sold a security in reliance on the misrepresentation in order to recover damages. For example, if a company conceals its deteriorating performance by putting out false earnings releases, a shareholder who alleges that he would have sold the company's stock at a higher price but for the false release may not recover damages. On the other hand, an investor who alleges that he bought the stock at an inflated price can recover damages. The requirement to have bought or sold securities is not a strict requirement of the law, but was upheld by the Supreme Court[23] for two reasons:
- the first is very specific to US civil litigation culture owing to US federal civil discovery procedures. A person who does not intend to pursue a case to genuinely seek compensation, but rather for its settlement value can increase the settlement value of the case by threatening to seek discovery of a large number of documents or deposing many of the company's officers and staff wasting their time and distracting them from company business

[22] In the US, unlike in HK and the other jurisdictions surveyed, trading while in possession of material, nonpublic information is only insider dealing if using the information is in breach of a fiduciary duty or some other relationship of trust and confidence.
[23] *Blue Chip Stamps et al v Manor Drug Stores*, 421 US 723 (1975)

- the second was that it was thought that it would be difficult to decide whether a person had held securities or not purchased them because of a misrepresentation in a document other than on the testimony of the plaintiff, which would be difficult to disprove.
- reliance: the Supreme Court has likened an action under rule 10b-5 for false or misleading information to an action at common law for deceit and required proof of reliance on the information.[24] However, the courts have now conceded that reliance can be inferred in cases where misrepresentation is material.
- causation: the US federal courts have required proof of causation either in terms of the contravention complained of is a proximate cause[25] of, or substantial factor in,[26] the loss
- restrictive statute of limitations: the courts formerly tolled the statute of limitations in cases alleging violations of rule 10b-5, based on the common law doctrine of equitable tolling. In 1991, the Supreme Court held that plaintiffs must bring claims under rule 10b-5 within the earlier of three years after the violation occurred or one year after discovery of the violation. Because some variation of this 1-and-3-year structure applied to each of the express causes of action under the SEA, the Supreme Court ruled that it should also apply to the implied cause of action under rule 10b-5.
- treatment of projections: many cases under rule 10b-5 were filed by investors who sought to recover damages because a company made earnings projections that failed to materialize. The courts cut back on their ability to recover in such cases by developing the "bespeaks caution" doctrine, which essentially held that a plaintiff could not reasonably rely on projections or other predictive statements if the defendant included cautionary language describing the factors that could influence the projection. The US Congress later provided a similar defense to liability by enacting the safe harbor for forward-looking statements described below.

Law reform

40. In the *Private Securities Litigation Reform Act* (PSLRA) 1995, the US Congress enacted the following measures that limited the impact of rule 10b-5 securities claims:

    - safe harbor for forward-looking statements: liability may not be based on forward-looking statements if the statements are identified as such and are accompanied by meaningful cautionary language describing the

[24] *Huddleston v Herman & MacLean,* 640 F.2d 534 (1981).
[25] *Huddleston* n 23.
[26] *Bastian, et al v Petren Resources Corporation, et al,* 892 F 2d 680 (1990).

factors that may cause actual results to differ from those in the projection.

- fee shifting: although the US Congress declined to adopt an "English rule" governing the payment of legal fees, it created a rebuttable presumption that legal fees should be awarded as a sanction where a complaint fails to meet the pleading standards under rule 11 of the Federal Rules of Civil Procedure.
- calculation of damages: where damages are claimed based on the difference in the market price at the time of a misrepresentation and the market price after the truth is disclosed, the damages must be based on the mean trading price over a 90-day period after the truth is disclosed. This is intended to ensure that damages are not based on temporary price swings.
- class action reforms: various measures targeted at class action lawsuits which we will not discuss as class actions are not a feature of Hong Kong law.

Observations

41. The judiciary in the US has shown a great deal of sensitivity in developing the principles that govern private rights of action in the US, even in the absence under rule 10b-5 of any statutory guidance on what the appropriate principles should be. They have naturally turned to common law tort law principles to achieve a sensible balance between adequate rights to compensation and discouraging excessive or vexatious claims. The concern at the growth of private civil litigation reflected in the PSLRA stemmed in large part from certain features of the US legal system including very liberal procedural rules for class actions and very aggressive plaintiff law firms who specialised in bringing actions, some in the hope of extracting settlements of claims that were never to be brought to court. It might be thought that, the combination of the relatively low volume of private securities litigation in the US prior to the spread of class actions and the absence in the US of the "loser pays" rule on legal fees, strongly suggests that, as Hong Kong does not provide for class actions and retains the loser pays rule as to counsel fees, there should be relatively little reason to fear that the creation of a private right of action for market misconduct will result in an uncontrollable wave of private litigation.

United Kingdom

42. After the US, the UK is the second largest world financial market and reputedly the most international constituting in part a large offshore market for Europe and even the US in some financial products. The UK regulatory system is about to undergo revolutionary change with the commencement of the *Financial Services and Markets Act* 2000 (FSMA).

43. The most notable feature of the UK system is that the FSMA does not give a general right of civil action for conduct equivalent to what amounts to market misconduct under the Bill. Rather, it gives the Financial Services Authority (FSA) and the Secretary for State powers to apply to court for restitution or for the FSA to order restitution.

44. Under s 382 of the FSMA, the FSA or the Secretary of State may apply to court for an order for restitution if:

- a person has breached a "relevant requirement" or been knowingly involved in a breach; and
- profits have accrued to him or one or more people have suffered loss or otherwise been adversely affected as a result of the breach.

45. "[R]elevant requirement" is defined in s 382(9) to mean:

- in relation to an application by the FSA, means a requirement which is imposed by or under the FSMA or which is imposed by or under any other Act and whose contravention constitutes an offence which the FSA has power to prosecute
- in relation to an application by the Secretary of State, means a requirement which is imposed by or under the FSMA and whose contravention constitutes an offence which the Secretary of State has power to prosecute under the FSMA.

46. The FSA and Secretary of State may prosecute the crimes of disseminating false or misleading information[27] and market manipulation[28] under s 397 FSMA. The FSA may also prosecute[29] insider dealing under Pt V of the Criminal Justice Act 1993. [30]

47. Under s 382(2) the court may order the person concerned to pay to the FSA a just sum having regard to the accrued profit, or the extent of the loss or other adverse effect, or both. One commentator has said that the provision gives the court a "broad discretion as to the amount which may be awarded".[31]

48. Under s 382(3), the FSA must pay restitution to those who appear to the court to be someone to whom the profits are attributable or who have suffered the loss or adverse effect (s 382(8)).

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[27] Loosely similar to cl 106 of the Bill.
[28] Loosely similar to cl 287(1) of the Bill.
[29] Section 402(1) FSMA.
[30] The CJA is an evolution of the *Company Securities (Insider Dealing) Act 1985* on which the Hong Kong Securities (Insider Dealing) Ordinance was based.
[31] L Minghella, *Blackstone's Guide to the Financial Services & Markets Act 2000*, 2001, London, Blackstone Press Ltd, p 264.

49. Nothing in s 382 affects a private person's right to seek civil proceedings (s 382(7)).

50. Under s 383, a court may make a restitution order on the FSA's application if it is satisfied that a person:

- has engaged in "market abuse"[32] which is similar to market misconduct or
- by some action has required or encouraged another person to engage in behaviour, which, if the first person engaged in it, would be market abuse.

51. Under s 383(3), the court may not make a restitution order if it is satisfied that:

- the person concerned believed, on reasonable grounds, that his behaviour was not market abuse or that he was not requiring or encouraging another to engage in behaviour which if he himself engaged in would be market abuse or
- he took all reasonable precautions and exercised all due diligence to avoid behaving in such a manner.

52. The requirements for profit, loss or other adverse effect, the amount that can be ordered to be paid, to whom it is to be paid and how is the same as under s 382.

53. Under s 384(1), the FSA may itself order an authorised person, basically equivalent to a licensed or registered intermediary,[33] to pay restitution in either of the circumstances that ss 382 allow a court to order restitution. Under s 384(2), the FSA may also order any person to pay restitution in any of the circumstances that s 383 allows a court to order restitution. The FSA must give those concerned natural justice and they then have a right of appeal to the Financial Services and Market Tribunal.

54. Section 150(1) creates a right of civil action for a private person who suffers loss as a result of a breach by an authorised person of a rule made under the FSMA subject to the defences and other incidents applying to actions for breach of statutory duty**.** What a private person is may be prescribed and a person who is not a private person may have a right of civil action in prescribed circumstances. Under s 150(4), rules do not include the listing rules or rules concerning financial resources. But, under ss 138-147, the FSA has broad powers to make rules about:

- the activities an authorised person conducts to protect consumers

[32] Under s 118 market abuse broadly speaking consists of three kinds of behaviour which correspond to insider dealing, forms of market manipulation and the dissemination of false or misleading information.
[33] Sections 31(2) and 417 FSMA.

- the handling of clients' money by authorised persons
- authorised persons who are managers of authorised unit trusts carrying out activities
- authorised persons who are authorised to conduct insurance business from carrying out activities
- endorsing the Takeovers Code and Substantial Shareholders' Rules
- price stabilisation rules
- the communication by authorised persons or their approval of communication by others of invitations or inducements to engage in investment activity or participate in a collective investment scheme
- the prevention and detection of money laundering in connection with authorised persons business
- the disclosure and use of information held by an authorised person.

55. The test of causation under UK law for such a right of action is that the breach must be a major or substantial factor in bringing about the loss, which the plaintiff must prove.[34] In determining what type of loss is recoverable, the courts have usually tended to explore what types of loss the legislation is intended to prevent. The courts have tended to take a purposive approach in this regard.[35] The principle of remoteness of damage seems not to have been regarded as less important than the harm the legislature intended to prevent.

56. The defences that apply to breaches of statutory duty are:

    - the plaintiff as author of his own misfortune
    - contributory negligence
    - voluntary assumption of risk
    - intervention of a third person
    - acts of god and
    - delegation of duty.

    However, it is difficult to see how most of these defences other than the first two could be argued in most instances of market misconduct.

Observations

57. Reservations have already been expressed above in relation to empowering the regulator or another government body to take action on behalf of private individuals as a general substitute for private rights of action. It is thought

[34] *Wilsher v Essex Area Health Authority* [1988] 2 WLR 557
[35] *Grant v National Coal Board* [1956] AAC 649

inappropriate to follow the UK model and thought better to emulate the Australian and US models of giving people more extensive private rights of civil action. The Australian model is thought preferable to the US model as the rules in the US under rule 10b-5 are entirely judge made and it would be difficult to codify them in a form that would gain universal acceptance. Rule 10b-5 is also expressed in a very broad manner which is different to the more precise categories of market misconduct adopted in Parts XIII and XIV. Provisions broadly similar to the Australian provisions are thought to be clearer and more predictable, to fit better with the proposed market misconduct regime and to be more historically consistent with those rights of civil action already in Hong Kong's securities laws. However, we do not favour the elaboration in ss 1013 or 1014 of the CA, which the new Australian amendments largely abandon.

Securities and Futures Commission
3 December 2001

Annex B

Judicial Application of "Fair, Just and Reasonable" as the test for establishing liability

Whether auditors owed a duty of care to another company intending to take over/acquire the shares in the subject company – *Caparo v Dickman* ([1990] 2 A.C. 605); *James McNaughton Paper Group Ltd v Hicks Anderson & Co* ([1991] 2 Q.B. 113); *Yue Xiu Finance Co Ltd. & Anor v Agnew & Ors (formerly t/a Deloitte Haskins & Sells & Anor)* (1996) 2HKC 122

Whether auditors owed the Law Society a duty of care – *Law Society v KPMG Peat Marwick and others* ([2000] 1 All ER 515)

Whether auditors owed a duty of care to the liquidators of companies whose accounts the auditors had audited – *Bank of Credit and Commerce International (Overseas) Ltd. (In Liquidation) v Price Waterhouse (No.2)* ([1998] P.N.L.R. 564)

Whether solicitors owed a duty of care to a non-client – *White v Jones* ([1993] 3 W.L.R. 730; *Dean Allin & Watts* (23 May 2001)

Whether a surveyor valuing a house for a building society owes a duty of care to the potential purchaser – *Smith v Bush* ([1990] 2 A.C. 831)

Whether a ship surveyor who recommended that a damaged ship should continue its voyage was liable to the owner of the cargo which was lost when the ship sank – *Marc Rich & Co. AG v. Bishop Rock Marine Co. Ltd.* ([1995] 3 All ER 307)

Whether an educational psychologist owed a duty of care to a child whom she diagnosed – *Phelps v Hillingdon London Borough Council* ([1999] 1 All ER 421)

Whether a sub-contractor owed a duty of care to the employer – *British Telecommunications plc v. James Thomson & Sons (Engineers) Ltd.* ([1999] 2 All ER 241)

Whether an ambulance service owed a duty of care to a member of the public on whose behalf a 999 call had been made – *Kent v Griffiths and Others (No. 2)* ([2000] 2 All ER 474)

Whether a victim of self-inflicted injuries owed a duty of care towards a secondary

party who suffered only psychiatric illness as a result of having witnessed the event causing the injuries – *Greatorex v Greatorex and Others* (The Times, June 5, 2000)

Whether a school owed a duty of care to a pupil who was being bullied while at school and who suffered only psychiatric injury – *Bradford-Smart v West Sussex County Council* (The Times, December 5, 2000)