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24May 2001

Via e-mail – png@legco.gov.hk
Pauline Ng, Assistant Secretary General
Legislative Council
3/F Citibank Tower
3 Garden Road, Central
Hong Kong

Re: Follow-Up Discussion of False or Misleading Information Provision of Hong Kong Securities & Futures Bill

Dear Ms. Ng:

I was very pleased to meet you and the other members of the Legislative Council delegation in New York regarding certain provisions of the proposed Securities and Futures Bill (as revised in November 2000, the "Blue Bill"). In New York we discussed the importance of a "scienter" requirement for the market misconduct provisions of the Blue Bill generally. We also discussed, in particular, the importance of "scienter" for the false or misleading information provisions of clauses 268 and 290 both in terms of the knowledge that the information is false or misleading and in terms of the impact on the market or a transaction. I would like to take this opportunity to provide the information requested by the delegation regarding how "scienter" is established by courts in the United States under U.S. federal securities laws and place that information in the context of our views on clauses 268 and 290 of the Blue Bill.

Potential Remaining Impact Despite New Subparagraph. We at Schwab were pleased by the additional provision in the Blue Bill for the re-transmission of information, which could be applicable to securities firms in Hong Kong providing third-party news, analysis, and research. Nevertheless, we continue to have concerns that the revised language may not have addressed the creators of the news, analysis, and research whose information is being re-transmitted. This may, in turn, create an obstacle to the continued

growth of information (especially online information) about companies and markets, which we feel is critical to the development of more knowledgeable investors in Hong Kong and bringing information to the market.

Importance of Mental State. There are two elements of clauses 268 and 290 where we think the "mental state" requirements of the Blue Bill would be fairer by using a "scienter" level. First, the mental state requirement regarding the false or misleading character of the information may be unfair and include activities that should not be deemed market misconduct by setting mere negligence as the standard for liability. Second, we believe that the information's being "likely" to have a market or transactional impact is not enough to create liability. Instead, there should be a "mental state" requirement regarding the *impact* on the market or on a transaction. Both are critical to address the fairness of the clauses – especially where criminal sanctions could be incurred.

Establishing Mental States. A defendant's mental state (for example, "intent") is often an element that must be proven in court, whether in a civil or criminal context. A mental state may, of course, be established by some express statement or direct evidence. But where no such direct evidence of intent or recklessness exists, proof of a defendant's mental state in a securities case may need to be based upon circumstantial rather than direct evidence. Although we recognize that this creates an additional evidentiary burden, we believe that such a burden is fair and will help to ensure that only persons who act intentionally or recklessly are sanctioned.

U.S. Federal Securities Law. Where U.S. courts do not have direct evidence of "scienter" (intention or recklessness) in U.S. federal securities cases, they turn to a "strong inference" that a defendant acted with intent to deceive, manipulate, or defraud. They do so either by looking to strong circumstantial evidence of intent or recklessness or by looking to facts that show the defendant had a motive and opportunity to commit fraud. In this context, the U.S. Private Securities Litigation Reform Act of 1995[1] curtails the filing of meritless civil lawsuits by establishing a heightened burden of proof for securities fraud claims by requiring particularity of facts giving rise to a "strong inference" that the defendant acted with intent to deceive, manipulate, or defraud. Most U.S. courts look, where they are unable to establish strong circumstantial evidence of conscious misbehavior or recklessness, to facts where the defendants had both motive and opportunity to commit fraud.[2] For some U.S. courts, even showing motive and

[1] 15 United States Code §78u-4(b)(2).

[2] See, e.g., *Novak v. Kansas,* 216 F. 3rd 300, 307 (2nd Cir. 2000)(defendants intentionally issued financial statements that overstated the value of inventory they knew to be obsolete and nearly worthless). See also *Shields v. Citytrust Bancorp*, F 3rd 300 (2d Cir. 2000) (where in the case of public statements about the financial strength of bank, plaintiffs failed to allege sufficient opportunity for defendants to derive a financial benefit despite the decrease in the company's share price upon later disclosure of the bank's making significant charges against earnings).

opportunity may provide an inference but are not enough by themselves to show "intent" or "deliberate recklessness."[3]

Conclusion. The standards applied in the U.S. would not in civil cases, and certainly not in criminal cases, create liability for providers of market information where no scienter could be established by direct or indirect evidence with regard to the impact on the market or on transactions. We believe those standards to be fair and will not unnecessarily impede the growth and value of market information while protecting the market and individuals from true acts of misconduct.

If you would like other information or would like to discuss this further, please feel free to contact me at 415-636-1078.

Yours faithfully,

Carl Landauer
Vice President and Associate General Counsel

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[3] See, e.g., *Janus v. McKracken (in re Silicon Graphics, Inc. Securities Litigation)*, 183 F.3rd 970 (9th Cir. 1999)(despite the fact that the company publicly withheld information regarding receipt of defective chips, inflated announcements about productivity levels, and officers of the company sold up to 99.8% of their holdings just prior to announcement of company losses, the plaintiffs did not provide corroborating evidence about the authorship of internal reports and which officers received them).