

Bills Committee on Securities and Futures (Amendment) Bill 2016

Responses to Follow-up Actions Arising from the Discussion at the Meeting on 12 April 2016

This paper sets out the responses from the Government and the Securities and Futures Commission (“SFC”) to the issues raised by Members in relation to the Securities and Futures (Amendment) Bill 2016 (“the Bill”) at the meeting on 12 April 2016.

Regulatory framework over directors of an open-ended fund company

2. The proposed governance structure of an open-ended fund company (“OFC”) aims to enable the investment management functions of an OFC to be carried out by a qualified professional investment manager, which is licensed by or registered with the SFC; and the OFC board of directors to provide an additional layer of oversight for shareholders. This would help enhance the protection of the investors.

3. An OFC director will be subject to a range of eligibility requirements including that he/she has to be a natural person, of good repute and be experienced for the purpose of carrying out the business of the OFC, and not be an undischarged bankrupt. When considering an application for registration as an OFC, the SFC will take into account whether, among other things, the requirements relating to OFC directors will be met. In addition, OFC directors will be subject to a wide range of regulatory requirements and potential liabilities or offences under the Securities and Futures Ordinance (“SFO”), including the main legislation and subsidiary legislation (the OFC Rules). The overall proposed regulatory framework covering the directors of OFCs is substantial, and is more extensive than that for directors of ordinary companies.

Overarching duties, specific obligations and eligibility requirements

4. Under the Bill, an OFC director will be subject to the following overarching duties¹ which are key to the oversight of the OFC, including oversight of the activities of investment manager in relation to the OFC -

- (a) fiduciary duties imposed under the common law, such as the duty to act in good faith in the best interests of the

¹ The duties as set out under new section 112U.

company and its shareholders and the duty to exercise the directors' powers for proper purpose; and

- (b) the duty to exercise reasonable care, skill and diligence that is the same as that imposed under section 465 of the Companies Ordinance ("CO"), such as the duty to take all reasonable steps to ensure the suitability and competence of the investment manager appointed for the OFC and conduct ongoing monitoring of its performance.

5. An OFC director will further be subject to various operational requirements in the OFC Rules and the OFC Code. These include for example, holding of directors and shareholders meetings, preparation of financial statements, keeping of records and the conduct of corporate filings for transparency to investors.

Investigatory and enforcement powers

6. Under the Bill, the SFC's investigatory powers are specifically expanded to allow the SFC to investigate any suspected defalcation, fraud, misfeasance or other misconduct in relation to the management of an OFC (new section 182(1)(b)(viii)), or suspected non-compliance with any of the requirements for registration of an OFC (including requirements as to an OFC's directors) (new section 182(1)(fa)).

7. Where the SFC discovers that a director of an OFC has committed an offence under the relevant provisions in the SFO or engaged in defalcation, fraud, misfeasance or other misconduct, the SFC can exercise enforcement powers, including taking prosecution action and/or applying to the court for a wide range of remedial orders. It should be highlighted that where an investment manager of an OFC commits any contravention of the SFO, and a director consented to or was otherwise involved in (such as knowingly aided and abetted) such contraventions, the SFC can make an application to the court for an order against the director even if he/she is not directly engaged in such contraventions.

Remedies/Sanctions

8. A salient enforcement power in relation to OFCs has been newly added to the SFO under the Bill. Under the new section 214A, the SFC will be allowed to apply to the court for various court orders (which may be directed against a director of an OFC) if the business or affairs of the

OFC have been conducted in a manner which is oppressive or unfairly prejudicial to its shareholders, or involving defalcation, fraud, misfeasance or other misconduct. Such orders include an order for the OFC to bring proceedings against directors for *compensation* and an order to *disqualify directors* for up to 15 years.

9. We have also proposed to expand the SFC's powers to apply for appropriate court orders under section 213 of the SFO where there is a contravention by the key operators² of an OFC (including OFC directors) of any provisions in the SFO. Such contraventions include failures by the directors to meet the eligibility requirements, and their statutory duties or requirements. In addition, orders may be sought against a director under section 213 in cases where the director is involved in, or aiding and abetting any contraventions by other persons such as the investment manager. Orders which may be sought under section 213 include *an order requiring a director to take steps to compensate or restore the affected parties (including investors) to any transaction to the position in which they were before the transaction was entered into.*

10. Moreover, *an OFC director would be criminally liable if he/she engages in any of the following fraudulent or deceptive activities, or has otherwise colluded with the investment manager in such contraventions -*

- (a) carrying on of any business of an OFC for any fraudulent purpose (new section 112ZT);
- (b) employing the use of fraudulent or deceptive devices, etc. in transactions in securities (which would include the shares of OFC) (section 300);
- (c) making any fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire an interest in or participate in a collective investment scheme (including shares in an OFC) (section 107); and
- (d) making false or misleading representations in applications to the SFC or when providing information in compliance with a requirement (sections 383 and 384).

² Including directors, investment manager and custodian of an OFC.

11. Furthermore, where any criminal offence is committed by an OFC, any director who, for example, has aided or abetted or consented to, or has been reckless as to, the commission of the offence is also guilty of the offence (section 390). This applies to all offence provisions under the SFO and the OFC Rules.

12. Details of the contraventions/offences and the corresponding remedies/sanctions under the SFO applicable to OFC directors, as well as examples of cases where orders were sought by the SFC under sections 213 and 214 of the SFO (the mirror provisions of the new sections 213(3A) and 214A) are provided at Annex.

Application of market misconduct provisions to OFC directors

13. Apart from the above, pursuant to the existing SFO provisions³, where a director of an OFC engages in *market misconduct*⁴, the SFC can bring actions against such a director. Under Part XIII of the SFO, the SFC may institute proceedings in the Market Misconduct Tribunal (“MMT”) against OFC directors. Pursuant to section 258 of the SFO, the MMT may impose sanctions against a director for any market misconduct attributable to him/her for breach of the duty under section 279 to take all reasonable measures to ensure that market misconduct is not perpetrated by the OFC. The orders that may be made by the MMT include orders for a director to pay to the Government the profit gained as a result of the market misconduct or prohibiting a person to continue to be a director or to deal in any securities specified in that order. Under section 281 of the SFO, the director could also be made subject to civil liability and to pay compensation by way of damages for any pecuniary loss sustained by another person as a result of the market misconduct.

³ The provisions refer to those under Parts XIII and XIV of the SFO. The market misconduct provisions are generally applicable to listed corporations and therefore would apply to listed OFCs which are also “listed corporations”. Depending on the facts, certain market misconduct provisions may also apply to unlisted OFCs. For example, disclosure of false or misleading information inducing transactions (sections 277 and 298 of the SFO). Separately, civil actions can also be brought against the director for compensation under section 305 of the SFO in addition to actions against offences for market misconduct under Part XIV of SFO.

⁴ As defined under section 245 of the SFO which means (a) insider dealing; (b) false trading within the meaning of section 274; (c) price rigging within the meaning of section 275; (d) disclosure of information about prohibited transactions within the meaning of section 276; (e) disclosure of false or misleading information inducing transactions within the meaning of section 277; or (f) stock market manipulation within the meaning of section 278, and includes attempting to engage in, or assisting, counselling, or procuring another person to engage in, any of the conduct referred to in paragraphs (a) to (f).

Other civil liabilities that directors are generally subject to, similar to directors of ordinary companies

14. Pursuant to the established common law, where a director of a company is in breach of his/her duties (in the case of a director of an OFC this would include the duty of reasonable care, skill and diligence in overseeing the investment manager's activities concerning the OFC), he/she may be subject to civil liabilities including the payment of damages, rescission (i.e. to unwind a transaction and restore the parties to their former position), or specific performance (i.e. to do or not to do something).

15. Notably, under the new section 112ZC to be added by the Bill, it specifically renders void any provision in the OFC's instrument of incorporation or any contract purporting to exempt a director for liability for misconduct (which is defined under the new section 112T to refer to negligence, default, breach of duty or breach of trust in the course of performing duties in relation to the OFC.)

Duties of OFC directors

16. Section 112U(3) as currently drafted refers to the duty of an OFC director as "the same fiduciary and other duties that are owed by a director of an ordinary company to the ordinary company". As explained in our earlier response (LP Paper No. CB(1)779/15-16(01)), not all operational obligations of the directors of an ordinary company, particularly those prescribed under the CO, are applicable to OFC directors (for example, obligations of directors in relation to distributions, capital maintenance, shares buy-back and redemptions, and financial assistance to acquire own shares). Accordingly, we propose to amend this section to convey the policy intention that such "other duties" refer specifically to the overarching duty of the OFC directors to exercise reasonable care, skill and diligence, which is expected to be observed at all times and the same as that which applies to directors of ordinary companies under section 465 of the CO, rather than the operational obligations.

17. The proposed amendment to section 112U(3) is not intended to impose upon a director of an OFC any duty that is not falling within section 112U(3)(a) or (3)(b). It has always been the intention of section 112U(3) to impose upon the director the overarching duties of (a) fiduciary duties under the common law; and (b) the duty to exercise

reasonable care, skill and diligence (which is to be identical to that under section 465 of the CO). Such overarching duties are expected to be complied with by the director of the OFC at all times in relation to all of his/her acts.

18. It should be highlighted that, as far as the OFC is concerned, the CO will not apply to OFC directors, but only the SFO (including the Bill and the OFC Rules). Specific operational matters of the OFC that the directors have to assist with will be specifically set out in the OFC Rules. These include, for example, the appointment of first director, the use of the common seal, maintenance of registers, books and records, reporting obligations, and winding up processes.

Publication of particulars of open-ended fund company under section 112G

19. As explained in our earlier response to the questions raised by the Legal Adviser of the Legislative Council (LP Paper No. CB(1)773/15-16(01)), similar to the existing practice regarding authorization of investment products, the SFC in general will publish on its website the names of registered OFCs and the date of registration as soon as practicable after the registration takes effect. It should nonetheless be noted that under the proposed arrangement for the OFC regime, the Companies Registry (“CR”) will be responsible for maintaining the statutory corporate filings of the OFC. Notably, the OFC will be required to file documents and forms with the CR which could be searched online. These include, for example, the instrument of incorporation, notice of change of company name, director or address of registered office, etc. Maintaining the word “may” in section 112G would allow flexibility to be retained with regard to the publication of the OFC’s particulars by the SFC, where appropriate. For example, the SFC may provide a link to the CR’s website for accessing the information kept by the CR. On the contrary, if the SFC is required mandatorily to publish the particulars of the OFCs, it may result in duplication with the functions of the CR.

Drafting issues

20. We have reviewed the Chinese text of the new sections 112ZK(4)(ga) and 214A(5) as set out in the proposed Committee Stage Amendments.

21. Regarding section 112ZK(4)(ga), we are of the view that the proposed formulation (“.....違反原訟法庭根據有關規則(即根據(g)段訂立的規則)作出的命令；”) is accurate in reflecting the meaning of the provision. The relevant part of section 112ZK(4)(ga) refers to the contravention of an order made by the Court of First Instance. The order is so made under certain rules (“根據[若干規則]作出的命令”), and those rules are made under paragraph (g) (“根據(g)段訂立的規則”). The proposed formulation uses the label “有關規則” to refer to those rules first and then explains what those rules are in brackets. Otherwise, the provision will have to read “違反原訟法庭根據根據(g)段訂立的規則作出的命令”, with two consecutive “根據”, where the first “根據” refers to the fact that the order is made under the rules and the second refers to the fact that the rules are made under paragraph (g). The proposed formulation has been carefully devised to avoid this undesirable wording, which could be difficult to understand or lead readers to think that there is a typographical error. It is also clear from section 112ZK(1) that the rules are made by the SFC. We consider that the proposed formulation is sufficiently clear with the use of the label and brackets.

22. Regarding section 214A(5), the definition of “controller” as currently drafted follows an identical definition in the existing section 214(9). That said, we agree that the bilingual texts of the definition could be simplified as follows –

“控制人(controller)指屬《銀行業條例》(第155章)第2(1)條所界定的間接控權人或大股東控權人的人。”

“controller (控制人) means ~~a person who is~~ an indirect controller or a majority shareholder controller as defined by section 2(1) of the Banking Ordinance (Cap. 155).”

**Financial Services and the Treasury Bureau
Securities and Futures Commission
April 2016**

Securities and Futures (Amendment) Bill 2016 (“the Bill”)

**Contraventions/offences and remedies/sanctions under
the Securities and Futures Ordinance (“SFO”)
applicable to directors of an open-ended fund company (“OFC”)**

Provisions under the Bill/SFO	Contraventions/Offences	<i>Remedies/Sanctions</i>
213(1) and new 213(3A)	Any contraventions by an OFC director of (a) any relevant provisions; (b) any of the conditions of any registration; or (c) if a director is knowingly involved in, or aiding and abetting any such contraventions by other persons (e.g. investment manager), the Securities and Futures Commission (“SFC”) may apply to the Court of First Instance (“CFI”) for a range of remedial orders.	The orders include, in summary – (a) an order requiring a <i>director</i> to take steps to compensate or restore the affected parties (including investors) to any transaction to the position in which they were before the transaction was entered into (section 213(2)(b)) ¹ ; (b) an order to freeze the assets of the <i>director</i> (section 213(2)(c)) ² ; (c) an order restraining a <i>director</i> from continuing the contravention (section 213(2)(a)) ³ ;

¹ On 12 December 2013, the CFI ordered Du Jun, former director of Morgan Stanley Asia Limited to pay \$23.9 million to investors as restoration for insider dealing.

² On 18 July 2014, the CFI granted an interim order to restrain Gu Chujun, a former chairman and chief executive officer of Greencool Technology Holdings Limited (“Greencool”), from disposing of his assets. The purpose was to preserve assets allegedly held for the benefit of Gu pending a trial in which the SFC was seeking remedial orders for more than 1,300 minority shareholders who purchased Greencool shares during the period the SFC alleged Greencool’s disclosed financial position was grossly overstated.

³ On 28 March 2014, the CFI granted an order to appoint interim receivers and managers over Qunxing Paper Holdings Company Limited. The immediate effect of the appointment was to suspend the powers of the then current board of directors over the management of the company’s affairs and place administrative control over the company in the hands of the interim receivers and managers.

Provisions under the Bill/SFO	Contraventions/Offences	<i>Remedies/Sanctions</i>
		(d) an order removing a <i>director</i> (new section 213(3B)(a)(i)).
New 214A	Where directors of an OFC have been involved in oppressive or fraudulent conduct of the OFC's business or other misconduct involving the affairs of the OFC, which results in unfair prejudice to the interests of shareholders of the OFC, the SFC may apply to the CFI for the relevant orders.	The orders include, in summary – (a) an order that the <i>OFC</i> to bring proceedings against a <i>director in question (including for compensation)</i> (new section 214A(2)(b)) ⁴ ; (b) an order <i>disqualifying a director</i> for up to 15 years (new section 214A(2)(d)) ⁵ .
New 112ZT	Any person (including OFC directors) involved in carrying on of any business of an OFC for any fraudulent purpose commits an offence.	<i>Liable to a maximum fine of \$10 million and imprisonment of up to 10 years.</i>
300	Any person (including OFC directors), directly or indirectly, employing the use of fraudulent or deceptive devices or engages in any act which is fraudulent or deceptive in transactions involving securities (e.g. shares of OFCs) commits an offence.	<i>Liable to a maximum fine of \$10 million and imprisonment of up to 10 years.</i>
107	Any person (including OFC directors) making any fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire an interest in or participate in a collective	<i>Liable to a maximum fine of \$1 million and imprisonment of up to 7 years.</i>

⁴ Pursuant to a petition by the SFC under the existing section 214, being a mirror provision of section 214A of the Bill, on 16 January 2015 the CFI ordered for the directors of First China Financial Network Holdings Ltd to pay RMB18,692,000 to the company as compensation for misconduct (breach of their duties).

⁵ Pursuant to a petition by the SFC under the existing section 214, being a mirror provision of section 214A of the Bill, on 26 September 2012, the CFI ordered Li Wo Hing, former CEO of Medical China Limited to pay \$10.7 million in compensation to the company for his misconduct and he was disqualified as a director of any company for 7 years.

Provisions under the Bill/SFO	Contraventions/Offences	<i>Remedies/Sanctions</i>
	investment scheme commits an offence.	
383 & 384	Any person (including OFC directors) who knows that, or is reckless as to whether the representation in applications to the SFC (section 383), or provision of information to the SFC in purported compliance with a requirement under the SFO (section 384), is false or misleading in a material particular commits an offence.	<i>Liable to a fine of \$1 million and imprisonment for 2 years.</i>
390	Where any criminal offence is committed by an OFC, any director who has aided or abetted or consented to, or has been reckless as to, the commission of the offence is also guilty of the offence. This applies to all offence provisions under the SFO and the OFC Rules.	