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(These minutes have been seen by the Administration and cleared by the Chairman)

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Subcommittee on
Securities and Futures Bill

Minutes of meeting
held on Friday, 28 April 2000, at 8:30 am
in Conference Room A of the Legislative Council Building

Members present : Hon Ronald ARCULLI, JP (Chairman)
Hon SIN Chung-kai
Dr Hon Philip WONG Yu-hong
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin

Members absent : Hon Eric LI Ka-cheung, JP
Hon Albert HO Chun-yan (Deputy Chairman)
Hon Ambrose LAU Hon-chuen, JP

Public officers attending : Miss AU King-chi, JP
Deputy Secretary for Financial Services

Miss Vivian LAU
Principal Assistant Secretary for Financial Services

Mr Frank TSANG
Assistant Secretary for Financial Services

Attendance by invitation : Mr Mark DICKENS
Executive Director, Securities and Futures Commission

Mrs Alexa LAM
Chief Counsel, Securities and Futures Commission

Mr Stephen TISDALL
Legal Consultant, Securities and Futures Commission

Clerk in attendance : Ms LEUNG Siu-kum, Chief Assistant Secretary (1)4

Staff in attendance : Mr KAU Kin-wah, Assistant Legal Adviser 6
Ms Rosalind MA, Senior Assistant Secretary (1)6

I Meeting with the Administration

Part XIV of the Securities and Futures Bill (the Bill) - Offences relating to Dealings in Securities and Futures Contracts

Mr FUNG Chi-kin referred to paragraphs 12.14 and 12.15 of the Consultation Document on the Bill (the Consultation Document) and sought clarification on the application of the provisions concerning market misconduct activities outside Hong Kong with respect to Hong Kong traded securities and futures and such activities in Hong Kong with respect to foreign traded securities and futures. He was concerned about how the enforcement actions would be taken against these types of market misconduct.

2. The Deputy Secretary for Financial Services (DS/FS) said that these provisions were drafted with reference to the practices in other international financial markets such as the markets in the United Kingdom (UK), the United States (US) and Australia. She advised that market misconduct activities were defined in the Bill. In the event that such activities were carried out in overseas jurisdictions affecting the securities market in Hong Kong, enforcement actions would be taken based on the "Memorandum of Understanding" (MOU) between the Securities and Futures Commission (SFC) and the financial markets regulators of the relevant jurisdictions. The Executive Director/Securities and Futures Commission (ED/SFC) added that clause 286 (1) and (2) of the Bill contained the provisions on offence of stock market manipulation in Hong Kong or elsewhere affecting the local or overseas stock markets. He illustrated with an example of market manipulation planned in London, executed in Hong Kong and affecting the stock market in Australia. The regulators of these three jurisdictions would carry out investigation, share information and collect evidence so as to take appropriate enforcement actions against the offenders in accordance with the MOU among these jurisdictions.

3. Mr FUNG Chi-kin sought clarification on the possibility of investigating and taking action against an offence of market misconduct carried out outside Hong Kong in the absence of a MOU with the jurisdiction involved. DS/FS replied that investigation and enforcement actions involving market misconduct in overseas jurisdictions could not be carried out in the absence of MOU. This was a problem also faced by regulators in other jurisdictions. ED/SFC said that SFC had signed MOUs with around 40 jurisdictions including all the major securities markets as well as some minor markets. These arrangements enabled SFC and its counterparts to carry out investigation, share evidence and take appropriate disciplinary actions against cross-border market misconduct activities.

4. In response to Mr SIN Chung-kai's concern about the practice of overseas jurisdictions in the handling of cross-border market misconduct activities, DS/FS said that the UK law would apply to all such activities provided that the markets where these activities were carried out were electronically accessible by investors in UK. The US criminalized both the acts of those abroad that affected US markets and those in the US that affected foreign markets. ED/SFC said that in Australia, all market misconduct activities which affected the Australian stock market were covered by the securities related legal provisions.

Parts X and XVI of the Bill

5. DS/FS highlighted new provisions in Parts X and XVI of the Bill for members' consideration -

(i) Clause 192 conferred upon the SFC a new power to issue notices which required certain persons to transfer custody of certain property to the SFC or to any person appointed by the SFC for such purpose;

(ii) Clause 360 provided auditors of listed corporations with a statutory immunity from liability under the common law, if they voluntarily reported to SFC suspected fraud and other improper practices detected in the course of their auditing work.

(iii) Clause 362 gave SFC power to intervene in civil proceedings between third parties in appropriate cases to provide its regulatory perspective and expert opinion. The Administration had taken on broad comments received during the July 1999 consultation and included safeguards in clause 362 to ensure that this power of intervention would only be exercised if it was in the public interest to do so and subject to the challenge of parties to the litigation.

Part XV of the Bill - Disclosure of Interests

6. ED/SFC briefed members on the technical aspects of the Bill concerning disclosure of interests. He advised that the principal objectives of this part of the Bill included bringing Hong Kong's disclosure regime in line with international disclosure standards, enhancing transparency in the Hong Kong market and reducing burden of compliance. To achieve the aforesaid objectives, a number of new proposals were made under the new disclosure regime as follows-

(i) To meet international standards, the Bill proposed to reduce substantial shareholding disclosure threshold from 10% to 5% (clause 306) and to shorten the notification period for disclosure from five days to three business days (clause 308).

(ii) To increase market transparency, the following proposals on disclosure requirement were made in the Bill:

(a) A substantial shareholder or a director was required to disclose the consideration payable or receivable by him in acquiring or disposing of interests in shares;

(b) An unlisted corporate substantial shareholder was required to disclose details of any person in accordance with whose directions or instructions its directors were accustomed to act; and

(c) A "settlor" of a discretionary trust was required to disclose his interests in the shares held by the trust.

As regards the scope of disclosure, under the Bill, the scopes of concert party agreements and equity derivatives were expanded. Apart from disclosing a change in the level of an interest in shares, clause 304 of the Bill also required a substantial shareholder to disclose any change in the nature of his interest in shares. The exemption currently made available to SFC registered investment managers and to trust companies under the existing legislation would also be removed under the new disclosure regime so as to create a level playing field for all market participants. There were also provisions in clause 22 of Schedule 9 which clarified when interests in shares pledged to a lender ceased to be exempted from disclosure.

(iii) To reduce compliance burden for disclosure, several proposals were made in the Bill. These included removing requirements to disclose particulars of registered shareholders and changes in

those particulars; exempting substantial shareholders from disclosing small changes in their interests in shares; introducing more structured notification forms; and disaggregating the group interests for investment managers, custodians and trustees to reduce the compliance burden of the holding company concerned.

Discussion with members

Disclosure of interests involving offshore transactions

7. The Chairman sought clarification on comparison of the proposed disclosure regime with the international standard. He expressed concern about the practicability of enforcing the disclosure requirements by SFC in Hong Kong in the event that securities transactions were carried out in overseas financial markets.

8. ED/SFC said that the proposed regime would bring Hong Kong in line with the international standard in the majority aspects of the regulatory framework. It would be more comprehensive in respect of disclosure of interests in derivatives. Under the Bill, all interests in derivatives would be required to be disclosed. Nevertheless, in response to market views expressed during the consultation, information concerning pricing or price sensitive terms of options would not be required. On the question of enforcement of the disclosure requirements for offshore transactions, ED/SFC said that parties to the transactions had legal obligations to meet the disclosure requirements in Hong Kong if they were trading in shares registered in Hong Kong. There were similar provisions in relation to disclosure of interests in securities in overseas jurisdictions such as the UK, the US and Australia. Therefore, parties involved in the securities transactions, regardless of whether these transactions were made through professional dealers, should be aware of their legal obligation in disclosure.

9. The Chairman raised concern about the effectiveness of the disclosure requirements in relation to offshore transactions as one could intentionally carry out such transactions off-exchange to avoid disclosing his interests in shares. ED/SFC agreed that certain deficiency existed in the legislation in catching all the offshore transactions. Nevertheless, those who did not meet the disclosure requirements were running high risk because their shares could be subject to restriction orders served by the Financial Secretary upon inquiry into the listed company concerned. They could be deprived of certain rights such as free transfer of their shares. As similar provisions were commonly in place in other jurisdictions, it would be rather difficult for anyone with substantial interests in the shares of a listed company to claim ignorance of these disclosure requirements.

Disclosure form and notification period of disclosure

10. In response to Mr SIN Chung-kai's question on the form of disclosure under the legislation, ED/SFC said that this would be specified in the subsidiary legislation. The SFC was in the process of consulting market participants on the design of the form which should be user-friendly to the industry. The subsidiary legislation would be subject to negative vetting by the Legislative Council.

11. Noting that the notification period for disclosure would be shortened from five days to three business days, Mr SIN Chung-kai sought information on the operation of this proposed "three-day rule". ED/SFC explained that from the date a person became aware of changes in his interests in shares which required to be disclosed, he had three business days to file the completed disclosure form to the Stock Exchange of Hong Kong (SEHK) and the relevant listed company. SEHK would make the disclosed information available to the public on its web site as soon as possible. The same information would be available for public inspection in the register of the listed company or its web site, if it had one. He informed members that consultation with representatives of listed companies was underway for the addition of a requirement in the SEHK Listing Rules for all listed companies to have their own web site. However, this consultation would be outside the ambit of the Bill.

12. In response to Dr Philip WONG's enquiry on the time allowed for the listed companies to publish the disclosed information in its register, ED/SFC said that no change had been brought about by the Bill in this regard. The Chairman opined that listed companies should be required to update their registers within a short period of time since it would be a rather mechanical process. In relation to the application of the "three-day rule", he sought clarification on the point at which an individual or corporation would have the obligation to disclose interests. He quoted an example of an individual A, whose percentage of shareholding in a listed company happened to exceed the 5% threshold as a result of his opting for new issued shares instead of cash dividend. He asked at what point the "three-day rule" would apply to A and whether it was practical to apply the rule in similar circumstances where the individual concerned might not be readily aware of the actual percentage of shares he had.

13. ED/SFC replied that the "three-day rule" would only be triggered at the point when the individual became aware of the change in his interests which required disclosure. In the above example, this might be the time when the listed company announced the change in its share capital. He pointed out that the situation quoted in the example might happen now even without the proposed "three-day rule". The primary obligations to disclose lay with the substantial shareholders. SFC would exercise its discretion in actions against

those failing to comply with disclosure requirements within the notification period. This normally ranged from a warning letter on the first failure and more serious sanctions on subsequent failures.

14. Mr SIN Chung-kai enquired about the rationale behind setting a "three-day rule" instead of two days which had been adopted in Australia and Singapore. Dr Philip WONG shared his concern and added that it should be reasonable to have a "two-day rule" for local transactions while allowing a more relaxed rule, i.e. three days, for offshore transactions.

15. ED/SFC explained that SFC had proposed a two days' notification period during the consultation in July 1999. However, taking into consideration the comments of local and international market participants that it would be difficult for them to meet the two days' limit, SFC had revised the proposal to allow three business days for disclosure. SFC believed that this revised proposal would balance the calls for more efficient updating and the compliance burden of market participants, in particular, those from the New York market. However, it was considered undesirable to have different notification periods for local and offshore transactions since standardized requirement for all market participants would provide clearer guidelines to them. DS/FS referred members to Annex E to the Consultation Document on comparison of disclosure regimes of overseas economies and added that the notification periods adopted in different economies ranged from one day to 14 days. The proposed period of three business days in the Consultation Document would be in line with the international standard. The Chairman agreed that Hong Kong should not follow the standards adopted in other jurisdictions without taking into account the differences between the financial markets of Hong Kong and other places.

Definition of derivatives

16. Mr FUNG Chi-kin enquired about the definition of derivatives in relation to the disclosure requirements. He asked whether products such as convertibles and stock futures would be classified as derivatives and whether interests in shares which constituted substantial percentage in the index futures would need to be disclosed by the shareholders.

17. ED/SFC said that convertibles and stock futures were classified as derivatives and interests in shares held through these derivatives had to be disclosed. As for index futures, although it was not caught in the disclosure regime, the market did have information about the level of open interests in the index futures and the proportion that different shares constituted the index. Therefore, the impact of interests in index futures on the market should be quite transparent even in the absence of statutory disclosure requirements.

Reduction of substantial shareholding disclosure threshold from 10% to 5%

18. Mr FUNG Chi-kin doubted whether a reduction of the substantial shareholding disclosure threshold from 10% to 5% would result in a tremendous increase in the volume of disclosure, giving excessive if not confusing information to investors. Moreover, he sought information on the reason for setting the threshold at 5%.

19. ED/SFC explained that the 5% threshold was the recommended standard for Asia by the Asian Development Bank. It was the level used in the US, Australia and the Mainland and was considered a reasonable level which was consistently adopted in the region. He said that there would not be a tremendous increase in the volume of disclosure because the additional volume of information would only come from those shareholders who held shares amounting between 5% to 10%. Taking into account that substantial shareholders holding over 10% of the shares of the listed companies were already included in the existing disclosure regime, the small number of additional shareholders to be included in the new regime should not give rise to problem of excessive information to investors.

Discretionary trusts

20. The Chairman raised concerns about the interpretation of the definition of "settlor" of a discretionary trust and sought clarification on the type of "settlor" who would not be included in the disclosure regime.

21. ED/SFC explained that the revised definition of "settlor" in clause 1 of Schedule 9 was drafted in response to market comments that the original definition was too wide. The present drafting would limit a "settlor" to someone providing property for a trust and retaining a power to influence the discretion of the trustee in the handling of the trust property. This revised definition aimed at making clear that a settlor who in effect "controlled" the listed shares through his influence on the trustee managing the discretionary trust holding the shares, should be subject to the same disclosure requirements as substantial shareholders. Any "settlor" of a discretionary trust should be able to decide whether he was included in the disclosure regime because he would surely know whether he had influence on the decision of the trustee in handling the trust property.

22. In relation to the Chairman's concern about the tax implication for a "settlor" who disclosed his interests, ED/SFC said that there should not be any tax implication brought about by the disclosure. He pointed out that the "settlor" of discretionary trust would only be required to disclose his interests in a listed company by stating the percentage of shares the discretionary trust held in the company. It would be the deemed interest rather than the real interest of the settlor and therefore should not attract any tax liability.

Disclosure of pledges of shares

23. On disclosure of pledges of shares, the Chairman expressed concern about the undesirable impact on the share prices of smaller size listed companies which defaulted their loans, if the banks chose to dispose of all the pledged shares. This might lead to a considerable drop in the share prices of the companies concerned. ED/SFC concurred that there were circumstances under which creditors dumped large quantity of shares rapidly, resulting in a drastic drop in share price to a point that they might have got a better price should they proceed for a more orderly unwinding of the business.

24. Mr FUNG Chi-kin pointed out that the timing of disclosure of interests in pledged shares could give rise to market volatility. If banks were required to disclose their interests in pledges of shares at the time when the loans, for which these shares had been pledged as security, became default and the banks started to dispose of the shares in large volume at a low price, investors would suffer loss as a result of the drop in price. He sought clarification on SFC's assessment of this kind of market volatility and its proposal to address the problem of disclosure of pledged shares.

25. ED/SFC said that investors would be better informed if disclosure was made when pledges of shares were accepted by banks as security for loans. Nevertheless, SFC had to strike a balance between protecting the privacy of shareholders and setting disclosure requirements which would enhance market transparency. Market views collected during previous consultation had shown that market participants strongly opposed the disclosure of pledges of shares by lenders. As to the disclosure by shareholders, market views were divided. Taking these views into consideration, SFC had decided to proceed with nothing more than clarifying that disclosure had to be made at the point when the banks started to take control of the shares. This provided a slight improvement to the present disclosure regime so that investors could better assess the risk involved and be aware of the source of the bulk selling of shares in the event that a bank had started to dispose of a large volume of shares they had taken over.

26. Dr Philip WONG enquired about the possible sanctions that might be imposed by SFC if a shareholder inadvertently made a mistake in his disclosure of interests. ED/SFC said that in practice, SFC had never imposed sanction on anyone who made inadvertent mistakes. SFC would either request the concerned party to submit a supplementary notice to rectify the error or to pay more attention in the future.

Part X of the Bill - Private action against false disclosure to market and market misconduct

27. The Chief Counsel/SFC (CC/SFC) briefed members on clause 200 of the Bill which created civil liability for false disclosure to market. The provisions in clause 200 were drafted with reference to section 40 of the Companies Ordinance. These provisions would make a person civilly liable for disclosing to the public materially false or misleading information concerning securities or futures contracts that might affect the price of the securities or futures contracts. Any person who had suffered loss as a result of relying on such disclosure could claim damages from the person who was responsible for the disclosure. The provisions would also provide a defence for persons acting in good faith, without knowledge and with due diligence. Separate defences were available for people acting as "conduits" of such disclosure.

28. CC/SFC also briefed members on the new provisions under clauses 268 and 295 which allowed private right of action against market misconduct. She pointed out that under the common law, a person who had suffered loss as a result of market misconduct might be able to seek redress through a civil action against the person responsible for the misconduct. However, the victim might encounter difficulties as he might not be able to fit his cause of action in an action in contract or tort, or he might not be aware of his legal position under common law. The Bill would put Hong Kong more in line with international practice, such as that in the US, by creating an express statutory right of civil action for damages or other remedies. The provisions would allow findings by the Market Misconduct Tribunal (MMT) and criminal convictions for market misconduct under Part XIV to be admitted as evidence in a civil action. Nevertheless, the victim would still need to prove that the MMT findings or criminal convictions were probative and relevant to his suit. This civil cause of action had been found to be rather effective in deterring market misconduct activities in the US and similar provisions had been proposed in the UK.

29. On clause 200 about the parties liable to civil proceedings for disclosing false or misleading information, the Chairman raised concern on whether SEHK and SFC would be liable to claims in these civil proceedings as they would assist the listed companies in the disclosure of information.

30. CC/SFC referred members to clause 200(6) stating that "a person responsible for an announcement, disclosure, statement or other communication being made or issued includes - (a) any person making or issuing it; and (b) any person who in a material manner assisted or participated in, or approved, the making or issuing of it". Taking into account these provisions, SEHK or SFC should not be considered responsible for the

disclosure of information. In addition, there were provisions in clauses 23 and 359 which gave immunity to SEHK and SFC respectively.

31. The Chairman queried whether the provisions for statutory private right of actions would benefit the majority of the investors, who might not have the resources to take their cases to the court. As legal proceedings would be costly and time-consuming, this statutory right might only be meaningful to large companies or institutional investors with the necessary resources to take legal actions for remedies. While supporting SFC's objective to improve the standard of disclosure, he expressed grave concern that the creation of statutory private right of action would upset the level playing field in the market since small and medium size listed companies would not have the same financial ability to meet claims for remedies. The Chairman also noted that the proposals under the new regime would impose additional civil sanctions on those people making false or misleading information to the public. Despite that similar provisions had been adopted in the US, he opined that this might not be equally applicable to Hong Kong.

32. ED/SFC said that the provision of statutory private right of action in the US aimed to improve the standard of disclosure and people making public statements would be more careful in releasing information when they knew that they would be liable to claims for remedies. Although individual investors who had limited resources might not be able to commence civil proceedings for remedies, they could still benefit from a more transparent market with a higher standard of disclosure. He pointed out that if someone suffered losses as a result of relying on misleading or false information, it would be fair to require those releasing the information to be responsible for compensating the losses. The statutory private right of action only served to clarify the responsibility in this regard.

II Any other business

33. Members noted that the Subcommittee had covered all major topics in the work schedule proposed by the Administration (LC Paper No CB(1)1346/99-00(01)). They agreed that the tenth and eleventh meetings should be scheduled for 19 and 20 June, 2000 at 8:30 am and 10:45 am respectively to consider the White Bill in the light of market views.

(*Post meeting note*: Upon request of Hon SIN Chung-kai, the meeting scheduled for 19 June 2000 was cancelled.)

34. There being no other business, the meeting adjourned at 10:35 am.

Legislative Council Secretariat
3 October 2000