SECURITIES AND FUTURES BILL - "MARKET MISCONDUCT"

The group of international financial institutions listed below (the "**Group**") previously commented on the Guides to Legislative Proposals issued by the SFC in July 1999. This paper sets out the Group's concerns in relation to the proposals in the Bill for wide-ranging criminal liability for "market misconduct", the jurisdiction of the Market Misconduct Tribunal, and the civil right of action which may arise in respect of "market misconduct" and certain other activities. Detailed comments are attached.

In summary, the Group's main concerns are as follows:

Overlapping criminal/civil/regulatory jurisdiction

The current proposals are for a series of widely defined categories of "market misconduct", each of which would constitute a criminal offence or result in the case being brought before the Market Misconduct Tribunal. In addition, in the case of a regulated person, disciplinary action (including fines and pecuniary penalties) could be brought by the SFC. Any adverse finding by the Tribunal, or conviction of a criminal offence, could lead to investors exercising the new statutory right of action for compensation. While action cannot be brought against the same person for the same conduct by both the criminal courts and the Tribunal, there is still scope for a single incident to lead to multiple criminal, civil and disciplinary actions against the same person or group of persons in a manner which would be oppressive because of the overlapping nature of the actions.

In addition to the wide-ranging criminal and civil sanctions in Part XIII and Part XIV of the Bill, there are other (overlapping) criminal and civil penalties in the Bill for various types of misrepresentation (see Sections 107, 106 and 200) and the Bill falls short of achieving consolidation and streamlining of the existing legislation. Instead, it has created an unwieldy, confusing and largely duplicative set of provisions.

Scope of criminal liability

Part XIV of the Bill creates 12 broadly defined offences, the scope of some of which is extremely unclear. As regards false or misleading information, the offence is one of strict liability, subject to a defence for a person who can prove that he could not reasonably have been expected to know that the information was false or misleading. This will be a difficult matter to prove. If criminal liability is to be imposed, the scope of the offences should be more clearly and narrowly defined. Also, criminal sanctions should only apply in the case of deliberate misconduct or knowing or reckless misstatements.

Liability of companies and their management

Generally, the Group is concerned about the draconian penalties which may apply under the Bill to companies and their directors and officers. For example, if any employee does a wrongful act, his conduct is treated as that of the company. Hence the company can be prosecuted, as can all its officers if they are regarded as contributing to the wrongdoing through their "neglect". It is inappropriate to impose serious criminal and civil penalties on companies and their senior management in the absence of proof of deliberate misconduct at senior management level.

Overall effect

Such extensive "market misconduct" provisions, with the uncertainties as to their scope and the potential for strict liability for financial markets participants, is very likely to discourage legitimate market activities such as hedging and arbitrage that assist in supporting the efficiency of the market and facilitate market liquidity. If the scope of the market misconduct provisions is to remain widely drawn, extensive “safe harbours” will be required to protect financial markets participants, otherwise these provisions are likely to have a “chilling” effect on the development of Hong Kong as an international financial centre.

List of Submitting Group Members

Bear Stearns Asia Limited

Credit Suisse First Boston (Hong Kong) Limited

Donaldson Lufkin Jenrette Asia Limited

Goldman Sachs (Asia) L.L.C.

Jardine Fleming Securities Limited

J.P. Morgan Securities Asia Pte Ltd

Kleinwort Benson Securities Asia Limited

Merrill Lynch (Asia Pacific) Limited

Morgan Stanley Dean Witter Asia Limited

Salomon Smith Barney Hong Kong Limited

If you would like to discuss any of the above issues with the Group collectively, please contact Pauline Ashall/Jeremy Collard at Linklaters, 10th Floor, Alexandra House, Chater Road, Central, Hong Kong (Direct line: 2842 4819 /2901 5237).

Comments in relation to Market Misconduct

1 Scope of market misconduct

The Bill provides for ten different categories of “market misconduct”, together with two additional offences in Part XIV of the Bill. Notwithstanding that most of the offences are based on provisions in the Australian Corporations Law, the Group considers that many of the sections are ill-defined, and that it is unnecessary and inappropriate to create such a large number of categories of market misconduct, particularly as each of them is a criminal offence carrying substantial penalties.

As set out in our letter of 14 December 1999 to the Financial Services Bureau the Group considers that, in principle, any “market misconduct” provisions should be limited to the following three categories:

- insider dealing
- intentionally creating a false or misleading impression as to the market in particular securities or futures, for the purpose of inducing investors to deal in those securities or futures.
- knowingly or recklessly making false or misleading statements in order to, or being reckless as to whether the statements may, induce investment transactions.

This would be consistent with the position in other countries that are generally accepted as international financial centres, and where such draconian criminal sanctions for market misconduct do not apply. In the UK, under the new Financial Services and Markets Bill, the Financial Services Authority will have power to impose civil penalties in respect of “market abuse”, but “market abuse” is not a criminal offence. Instead, the criminal offences for misconduct under the FSMB fall within the three categories outlined above.

However, the proposed categories in the Bill are much more widely drawn, and may apply to conduct falling short of deliberate misconduct and/or knowing or reckless misstatements. A more restrictive approach should be adopted to defining the categories of “market misconduct”, which would also reduce the need for “safe harbours” to be provided for in rules made by the SFC. The various categories are discussed in detail in Section 2 below.

In view of the proposal to criminalise “market misconduct”, the extensive scope for penalising companies and their management for the wrongdoing of others, the significant potential civil liability exposure for companies, their senior officers and other employees and the lack of adequate defences, the overall impact of the proposed new regime for “market misconduct” is extremely troubling and may discourage firms from setting up new businesses or expanding existing businesses in Hong Kong. The new regime is very likely to discourage the conduct of legitimate financial markets activities, such as hedging and arbitrage, by international market participants in Hong Kong, which benefit the market as a whole.

2 Categories of market misconduct

As indicated above, the Group believes that substantial redrafting and streamlining of the proposed categories of market misconduct is essential. Generally, having separate sections on each category of market misconduct, and their associated definitions, set out separately in Parts XIII and XIV adds unnecessary length, complexity and confusion to the Bill.

On the other hand, if there are to be separate regimes for criminal liability and civil penalties, the threshold for criminal liability should be higher than under the present drafting of the Bill. We note that in Australia it is proposed that “market misconduct” should be capable of attracting civil penalties as well as criminal sanctions but that (as in Pt 9.4B of the current Corporations Law) a person should only be guilty of an offence if he contravened one of the provisions intentionally or recklessly and, in addition, either was dishonest and intended to gain an advantage for himself or another, or intended to defraud or deceive someone.

We are also concerned about the territorial scope of “market misconduct”. By extending the scope of these provisions to transactions on markets outside Hong Kong, the law is being expanded even beyond the equivalent Australian provisions on which Parts XIII and XIV of the Bill are based.

At the very least, activities which may create a false or misleading appearance with respect to a market outside Hong Kong should not be penalised in Hong Kong unless the conduct in question would have been criminal if carried out in the place where the market is situated. Sections 269(4)(b) and 296(4)(b) go some way to achieving this result, but the onus of proof is on the defendant to establish that the conduct would not have been a criminal offence outside Hong Kong. Also, if the investments are traded in a number of different markets, the defendant must prove that no offence would have been committed in any such market. This would be a very onerous requirement, particularly as most countries have some form of laws on market manipulation and the success of the defence in Hong Kong would be dependent on being able to prove that complex legal provisions of a foreign country did not apply in the particular circumstances of the case. Proving a negative in this way would be extremely difficult and the burden of proof should lie with the prosecution.

Furthermore, the provisions relating to “market misconduct” would apply to activities conducted outside Hong Kong that create a false or misleading appearance with respect to securities or futures traded on an ATS authorised in Hong Kong. The Government seems to want to require all international ATS to which Hong Kong investors have access to become authorised in Hong Kong. However, the majority of trading through the ATS will take place outside Hong Kong, and not involve Hong Kong investors. It therefore seems inappropriate to include trading on ATS within the scope of the “market misconduct” provisions in the Hong Kong legislation as currently proposed. A compromise would be to include false trading on an ATS only if the misconduct took place in Hong Kong, or it could be shown that a substantial number of investors in Hong Kong were misled.

Subject to these overriding comments, we set out below more specific comments on the categories proposed in the Bill.

2.1 Insider dealing

The Consultation Paper states that the current definition of insider dealing in the Securities (Insider Dealing) Ordinance is re-enacted with one change. In fact, it is proposed to expand the definition in a number of respects, with “relevant information” being extended to include information about a shareholder or officer of the corporation or about the listed securities of the corporation or their derivatives. The definition of “listed securities” is also extended to include securities not yet issued, or issued but not yet listed, as long as it was reasonably foreseeable that they would be listed and they subsequently are listed. This goes beyond the position in most countries and may be of concern. We note that, even if the relevant securities are not issued or listed at the time of the “dealing”, insider dealing is only committed if at that time the prospective issuer is a “listed corporation” i.e. has other securities listed on the Stock Exchange. However, this could apply if the corporation only has debt securities listed. Where an IPO is contemplated, this amendment to the law could constrain the ability of the company and its substantial shareholders to secure commitments from strategic investors based on information not yet in the public domain but which will be disclosed in the prospectus. We also have the following comments:

- It is highly confusing and inconvenient that, within Part XIII and Part XIV of the Bill, "insider dealing" is defined in Sections 253 and 279, but many of the definitions relevant to insider dealing are set out in the general interpretation section at the beginning of Part XIII, Section 229 and Part XIV, Section 273. Other definitions are set out in Sections 230-233 and Sections 274-276, making particular definitions somewhat difficult to find.
- Sections 254(4) and 280(4) (defence for agents) are somewhat confusing. An agent who does not himself possess inside information would not be an insider dealer in any event, even if his client had inside information. We assume that these defences are intended to apply where the agent has inside information, but is simply executing an order on his client's instructions, and is therefore not using the inside information.
- The drafting of the new "defence" in Sections 254(7) and 280(7) appears defective. It would make more sense if sub-section (6) was amended so that it applied where a person enters into a transaction <u>or</u> counsels or procures another party to enter a transaction, where the counterparty to the transaction knew, or ought reasonably to have known, that it was transacting with a person connected with the relevant corporation or a related corporation.
- There should also be a specific exclusion (whether in the form of a defence or a safe harbour) for pledgees/mortgagees of shares selling those shares pursuant to their rights under a security arrangement upon the occurrence of a default by the pledgor/mortgagor in circumstances where the pledgor/mortgagor is the corporation or a connected person and such default may be material but has not been made public. At present, it is not clear whether a bank in exercising its rights over the security will be engaging in insider dealing. With the introduction of Section 268, a bank's exposure to civil liability is increased and there should be an exclusion to guard against such danger.

In the Consultation Paper, the Government invites comments on whether insider dealing should be extended to dealings in Hong Kong in foreign securities which are not listed in Hong Kong. The Group do not believe that the law should be extended in this way, especially as, while most countries have laws on insider dealing, those laws vary considerably in their scope and interpretation of the laws may be a matter of some complexity. Extending the Hong Kong law in this way may give rise to difficult conflicts of law issues with respect to the country where the securities are listed.

2.2 False trading in securities

The existing Section 135 of the Securities Ordinance applies where a person <u>intentionally</u> creates a false market, or acts <u>with the intention of</u> creating a false market. This is consistent with the law in other international markets - for example, in the United Kingdom an offence is only committed if a person engages in manipulative conduct for the purpose of creating a false or misleading impression and of thereby inducing others to deal in securities.

However, based on Australian legislation, the new definition in Sections 257(1) and (2) (and Sections 283(1) and (2)) would cover a person who acts intentionally <u>or recklessly</u>, or who does anything that is <u>likely</u> to create a false or misleading appearance with respect to the market for securities or futures. Therefore, if a court or Tribunal concluded that a person had done something that was likely to create a false or misleading appearance, he would be guilty of "false trading" even though he did not believe that his conduct would mislead the market, and even if in fact that market was not misled. The Section should be restricted to persons who had the intention or purpose of creating the false or misleading appearance in the market.

Sections 257(3) and (4) (and Sections 283(3) and (4)) further expand the definition of “false trading” to a person who intentionally or recklessly carries out a transaction that is likely to have the effect of creating or maintaining an artificial price for dealings in securities. Again, this appears to be a strict liability offence since it is not necessary to prove that the person acted for the purpose of creating or maintaining an artificial price.

The Group is very concerned that the concept of an “artificial price” for dealings in securities is too uncertain to be an appropriate threshold for criminal or civil liability. Arguably where a person buys securities and the price is pushed up as a result, the market price is “artificial” if (for example) the transaction was effected to hedge a short position rather than to create a “long” interest in the stock. If such a wide concept were used in the legislation, it would be essential to have safe harbours for hedging, programme trading, market making, arbitrage and other legitimate trading activities which might be alleged to create artificialities in the market. In the light of the Australian case of Fenwick v Jeffries Industries, a safe harbour should be introduced for genuine market transactions in securities which were effected because of the person’s interest in other classes of securities of the same issuer or an associate.

A partial definition of conduct creating a false or misleading appearance is set out in Section 257(5) (and Section 283(5)). Section 257(6) (and Section 283(6)) create a “defence” if a person can prove that the purposes for which he committed an act did not include the purpose of creating a false or misleading appearance. However, the defence only applies in respect of acts falling within Section 257(5) or Section 283(5), and not (as the Group considers it should) to other conduct which is alleged to constitute “false trading” within Sections 257(1), (2), (3) or (4) or Sections 283(1), (2), (3) or (4). Furthermore, the burden of proof should not be shifted to the defendant in this way.

In the Consultation Paper, the Government seeks to justify its stance on the basis that such conduct is “blatantly manipulative.” However, the various categories are defined in such wide terms that this assertion is not necessarily correct. In the case of “blatantly manipulative” conduct, the prosecution should not find it difficult to establish that the defendant had the relevant intention or purpose to have committed the misconduct.

2.3 Price rigging

Sections 258 and 285 of the Bill apply to fictitious or artificial transactions or devices relating to securities, and to transactions not involving a change in the beneficial ownership of securities. They overlap very significantly with the “false trading” categories of misconduct, and we see no justification for the separate category of “price rigging” in the legislation. Again, we are concerned that the concept of an “artificial” transaction is too open-ended to form the basis of liability, and could potentially affect arbitrage, programme trading, stabilisation, hedging and other legitimate market activities.

This category is also drafted as a strict liability offence, subject to a defence for a person who can prove he did not have the purpose of creating a false or misleading appearance. Again, it seems inappropriate for the burden of proof to be shifted to the defendant in this way, whether in respect of criminal proceedings or proceedings before the Tribunal. Also, the defence only applies in respect of sales or purchases of securities that did not involve a change in beneficial ownership, and not in respect of any other form of transaction which is alleged to be artificial.

The same comments apply in respect of “price rigging” in futures, in Sections 263 and 289 of the Bill.

2.4 Dissemination of information about prohibited transactions

The reason for including these provisions in the legislation (Sections 259 and 285 in respect of securities and Sections 264 and 290 in respect of futures), and the circumstances in which they are likely to apply, is unclear. If a person has engaged in "prohibited transactions", this will constitute market misconduct by itself, and a further category of market misconduct in respect of disclosure of information about such transactions seems unnecessary. It is highly unsatisfactory to introduce a new provision attracting substantial criminal and civil penalties where the "mischief" at which the provision is addressed is obscure.

Although these sections are based on Sections 1001 and 1263 of the Australian Corporations Law, there does not appear to be any instance of prosecutions in Australia under those sections.

2.5 Stock market manipulation

The scope of this category (Sections 260 and 286) is of serious concern. It is not restricted to false or artificial transactions, but would apply to any transaction that is likely to increase, decrease or stabilise the market price of securities, if done with the intention of inducing other persons to buy, sell or refrain from dealing in, as the case may be, those securities or securities of a related corporation. (It goes wider than the equivalent Australian provision (Section 998 of the Corporations Law) which applies to two or more such transactions).

A person who carries out a substantial transaction in securities will know that the transaction is likely to move the price and, thereby, affect the investment decisions of third parties. It may therefore be arguable that he "intended" his actions to have that consequence.

The introduction of such a widely defined category could greatly affect the index arbitrage business of securities firms. To hedge certain index-linked derivatives, traders have to buy and sell the stocks that constitute the index. In a market where there is little or no liquidity, the hedging transactions themselves when executed will have a market-moving effect. In cases where the firm stands to gain from such movement in the index, it could be very difficult to argue that the trade was not intended to induce others to buy/sell or hold stocks. Although such effects may be known to the trader, it is certainly not his intended purpose and there is often no other alternative for executing the hedging transaction. If the transaction is a genuine transaction which does not create a false or misleading appearance in the market, the fact that it moves the market and influences dealings by third parties should not mean that it is a criminal offence and/or market misconduct.

Transactions effected <u>for the purpose</u> of inflating or depressing the market price would already fall within the "false trading" category, and there seems no justification for this additional category of market misconduct.

2.6 False or misleading information

Sections 261, 265, 287 and 291 apply to anyone who is concerned in the dissemination of false or misleading information which is likely to induce transactions in securities or futures in Hong Kong, or to influence market prices of securities or futures in Hong Kong. It is not necessary to show that the person concerned was aware that information was false or misleading. Instead, the person would need to prove that he had acted in good faith, and did not know and could not in the circumstances of the case reasonably have known, or reasonably have been expected to know, that the information was false or misleading. This defence does not recognise the existence of "Chinese Walls", so if a corporation has issued false information in circumstances where the true facts were known to persons on the other side of a Chinese Wall within the corporation, it is arguable that the corporation “knew” that the information was false, even though the individuals responsible for issuing the information had no access to the true facts.

These Sections are very unsatisfactory. In effect, any statement (written or oral) which may influence the investment decisions of another person would have to be verified to prospectus standards, otherwise there is a risk of committing market misconduct (and a criminal offence punishable with up to 10 years imprisonment) if the statement turns out to be inaccurate. Producing inaccurate information, even if careless, should not be a criminal offence and/or market misconduct unless the person acted knowingly or recklessly.

In addition to the provisions on “false or misleading” information in Parts XIII and XIV, Section 107 of the Bill also imposes civil liability in respect of false or misleading information, as does Section 200. Section 200 is a new provision which has not previously been exposed for consultation, and is particularly troubling. We assume that it is intended to apply to announcements issued by a listed company in respect (for example) of movements in its share price. It imposes liability equivalent to that for false or misleading statements in a prospectus.

Section 200 is drafted extremely widely. It is not limited to announcements by listed companies but seems capable of covering any communication made to the public, in written form or verbally, which concerns securities or futures contracts. This would appear to cover research reports, statements made by analysts during press interviews and comments made by governmental or regulatory officials or staff of the exchanges. At least, it should be limited to statements made in documentary form and it should be clarified that a document distributed to a limited group (e.g. a research report sent to customers) is not to be regarded as a communication made or issued to the public.

Section 200 may apply to anyone who “in any material manner assisted or participated in, or approved the making or issuing” of the statement. This is unduly wide and vague, and if there is to be such a cause of action it would be better to specify (as is done in Section 40 of the Companies Ordinance on prospectuses) the categories of person who may be sued. Also, it should be limited in its territorial scope, to statements made to the public in Hong Kong. Even if it is restricted in these ways, we do not accept that it is appropriate to impose “prospectus liability” on all public communications in respect of securities and futures contracts.

Insofar as these provisions create civil liability, we propose (as discussed in 5 below) that they be deleted since Section 107, with some amendments, sets a more appropriate test for civil liability. As regards criminal liability (Sections 287 and 291) these sections could be replaced by a slightly modified version of Section 106, which is another criminal offence for fraudulently or recklessly inducing persons to invest money.

3 Other Offences

As indicated earlier, Part XIV of the Bill largely replicates all the categories of “market misconduct”, creating criminal offences for each of them. There are, in addition, two further criminal offences, in Sections 292-293 of the Bill, relating to fraudulent or deceptive devices and “bucketing” of futures contracts. The first of these largely duplicates various categories of market misconduct. We have no objection to Section 292(1)(a), which requires “intent to defraud or deceive”, however (b) sets a purely objective standard, and (c), like the market misconduct category of false or misleading information, creates a strict liability offence subject to a narrow defence, the burden of proof of which lies with the defendant.

The rationale for introducing the second offence, relating to failure to execute a trade on a recognised futures exchange when required to do so, is unclear. Does the Government have evidence of “bucketing” taking place in Hong Kong and which could not be dealt with under some other category? We note that there is only one reported case in Australia where bucketing was alleged (Commissioner for Corporate Affairs v Shintoh Shohin Pty Ltd).

As already mentioned, there is also another criminal offence in Section 106 of the Bill for fraudulently or recklessly inducing persons to invest money, which is also duplicative. The drafting approach results in very long and complex legislation, with Parts XIII and XIV of the Bill amounting to sixty-nine sections in all. A more streamlined approach to the drafting would be welcome.

4 Corporate and Senior Management Liability

Under Section 368 of the Bill, any act or omission of an individual acting or purporting to act for a corporation within, or apparently within, the scope of his office or employment is treated as the act or omission of the corporation. In the context of the market misconduct provisions and the criminal offences under the Bill, this substantially expands the normal circumstances in which a corporation can be penalised for the criminal conduct of an individual. Usually, this only arises where the individual was the “directing mind and will” of the company (Tesco v Nattrass) and the Bill should not extend the scope of corporate liability further than this.

Furthermore, where a corporation has committed a criminal offence under the Bill, if that offence was committed with the consent or connivance of, or attributable to any neglect on the part of, any officer of the corporation, that person is also guilty of the offence (Section 367(3)). In view of the extensive potential for criminal liability under the Bill, the Group does not believe that it is appropriate to create a risk of officers of a corporation being guilty of serious criminal offences unless they knowingly participated in the relevant conduct. Notwithstanding the similar provision in Section 147 of the Securities Ordinance, “neglect” is not a sufficient threshold for imposing serious criminal sanctions.

We note that the formulation in Section 367(3) is somewhat different from that for civil liability of officers for market misconduct, under Section 268 of the Bill. This extends civil liability to an officer of the corporation where the corporation has committed market misconduct which was directly or indirectly attributable to, or occurred with the knowledge, consent or connivance of that officer. Section 107(3) adopts yet another test for liability, stating that where a body corporate has acted in breach of the Section, any director is also presumed to have done so unless it is proved he did not authorise the making of the misrepresentation.

It would be more satisfactory to redraft Sections 268, 367(3) and 107(3) so that they only applied where the wrongful conduct had been committed with the person’s knowledge, consent or connivance.

Also, we note that the definition of “officer” is very wide. There are major discrepancies in the Ordinance as to responsibility of individuals for corporate misconduct, with some provisions applying to “officers”, others to “directors” and others to “executive officers”. There should be greater consistency, and the potential for individual liability should be narrowed in scope.

5 Liability to pay compensation

5.1 Range of different provisions in the Bill

Sections 268 and 295 of the Bill have the effect that a person who has engaged in "market misconduct" is liable to pay compensation by way of damages to any other person who has sustained pecuniary loss as a result, however that loss arose.

Also, as mentioned above, Section 107 of the Bill imposes civil liability for inducing others to invest money on the basis of false or misleading statements and Section 200 imposes civil liability for false or misleading misstatements to the public. As previously noted, the fact that many overlapping provisions that are scattered among different Parts of the Bill is unhelpful, causing the Bill to fall a significant way short of achieving the stated aim of streamlining and consolidating the pre-existing legislation.

5.2 Potential for unlimited exposure to litigation

There is a real danger of opening the floodgates for unmeritorious claims from investors. As an example of the potential scope of the cause of action, if a person is alleged to have dealt on the basis of inside information, there is a risk of actions being brought under Sections 268 or 295 by anyone who dealt in the market on that day (or even anyone who claims that he would have dealt if the information had been in the public domain). There is also a risk that anyone who had seen a research report (whether or not it had been sent to that person) which turned out to be inaccurate would bring an action. Even if frivolous claims are ultimately rejected, or the court exercises its discretion not to award damages, the defendant may have incurred substantial costs and reputational damage. Plaintiffs may be able to win out of court settlements, however unmeritorious their claims, because of the nuisance value of those claims.

In the Consultation Paper, it is noted that previous submissions argued that the statutory right of action should apply only if the plaintiff had an existing relationship with the defendant. The Government's response is that "this suggestion is taken". However, this does not seem to be the case. Any person can bring an action based on "market misconduct" by a third party, even though there was no prior relationship between them. The only limits are that the plaintiff would have to establish that his loss was caused by the defendant's conduct, and the court could determine that it was not "fair, just and reasonable" to require compensation to be paid. In our view, this degree of discretion for the court is of limited comfort, and may potentially lead to arbitrary results.

As set out in our letter of 14 December 1999, there is no comparable broad statutory right of action for "market misconduct" in jurisdictions such as the United Kingdom and the U.S. If there is to be a statutory right of action, then (as discussed above) it should be confined to the circumstances covered by Section 107 of the Bill.

Section 107 imposes civil liability for fraudulent, reckless or negligent misrepresentations which induce other persons to invest, where the loss was within the reasonable contemplation of the person making the misrepresentation at the time the statement was made. Subject to the fact that only the direct recipient of the statement should have a right of action, Section 107 sets a more appropriate standard for, and scope of, civil liability, and we see no justification for the wider provisions in Sections 200, 261 and 265. In our view , those provisions should be deleted, and Section 107 could be amended to include misrepresentations which induce people to deal in futures and/or refrain from dealing in securities or futures, to cover any gap that might otherwise be created. Section 107 should also be amended to restrict the potential for personal liability of directors of the company concerned.

6 Market Misconduct Tribunal

The Government is now proposing that, if "market misconduct" is alleged, a wide range of actions can be brought against persons involved: i.e. criminal prosecution, SFC disciplinary action (in the case of regulated persons) and civil actions pursuant to the statutory right of action. If "market misconduct" is to be criminalised (which we do not support unless the categories of criminal offence are much more narrowly defined than in the Bill at present) having a Market Misconduct Tribunal as well appears to be unnecessary. Such a Tribunal would be redundant, except where there is insufficient evidence to bring a criminal proceeding or for a civil cause of action to be pursued. Thus the Tribunal would appear to be a forum that would be used to pursue proceedings that currently could not be brought otherwise or in which the Government was unlikely to prevail. We find this troubling, particularly when the traditional safeguards that a person would have in a civil or criminal proceeding have been largely left to the discretion of the Tribunal. Among other things, a proceeding can be instituted if "it appears" to the Financial Secretary that misconduct has occurred. There is no requirement of a preliminary finding by the SFC. Moreover, because of the extensive civil compensation provision, actions in the Tribunal could give rise to significant potential exposure to market participants. Reliance on the judge to make compensation decisions in a fair, just and reasonable fashion does not give market participants sufficient comfort.

If there is to be a Tribunal to make determinations in respect of "market misconduct", we have the following comments on the proposed scope of its powers.

- although it is no longer proposed that the Tribunal has the power to fine, we note that it may order a person to contribute to the expenses of the SFC and the Government (which could be very substantial). We consider that if the Tribunal is to have this power it should be subject to strict safeguards, and a "cap" imposed.
- also, the Tribunal would have power to award payment of the amount of profit made or loss avoided, together with compound interest from the date of the market misconduct. An order to pay compound interest is generally viewed as penal in nature, and from the point of view of the defendant is tantamount to a pecuniary penalty, which can be very substantial.
- the Tribunal can make an order that a person shall not, without the leave of the court, deal in any securities, futures or collective investment schemes for a period of up to 5 years. This is described in the Consultation Paper as a "cold shoulder" order, but the drafting goes much wider than the normal concept of such an order. As an example of a "cold shoulder" order, the Takeovers Panel may direct that investment banks in Hong Kong do not provide corporate finance services to a person for a period of time. The Tribunal could make an order preventing a person from buying or selling any investments (which could for example prevent him from contributing to an MPF scheme, or continuing to deal with his existing securities portfolio). It would be very expensive and time consuming for a person to have to seek the leave of the court before he could make or unwind any investments held for his personal account. This provision should, at the very least, be redrafted to exclude assets held for personal savings and investment purposes.

7 Safe harbours

Scope of power to establish safe harbours

The Group considers, as discussed above, that the current categories of "market misconduct" are unduly wide. If they were redrafted and the number of categories reduced, there would be less need for "safe harbours". However, the inclusion of powers in Sections 269 and 296 for the SFC to create “safe harbours” is welcome. Those powers should extend to the creation of safe harbours in respect of any category of market misconduct - at present insider dealing and certain other categories are excluded. Instead, any safe harbour for price stabilising activities should create a defence in respect of insider dealing, as it does in other countries. Even if the SFC cannot at this stage foresee any circumstances in which it would wish to create safe harbours from some of the other categories of market misconduct, it is unhelpful to restrict the scope of the powers in this way.

Stabilisation activities

A safe harbour should be created in respect of stabilisation activities. This would bring Hong Kong in line with other developed securities markets, such as the United States and the UK. In Australia, which does not expressly permit stabilisation in its legislation, both the Australian Stock Exchange and the Australian Securities and Investments Commission have issued “no-action” letters in respect of stabilisation activities.

As regards the scope of activities which should be permitted, we suggest following the UK model, which is widely understood and followed in the international markets. As part of the overall reform of the regulation of financial markets in the United Kingdom, the Financial Services Authority has issued a consultation paper on the price stabilising rules. That paper does not propose any major changes to the existing rules. Instead it proposes greater flexibility in some areas and further guidance on a number of aspects of the rules.

Chinese Walls

There should also be an express safe harbour, as in the UK, in respect of activities conducted on different sides of a Chinese Wall (Section 48(6) of the Financial Services Act 1986). For example, if a research analyst at an investment bank issued a research report about a company in good faith, but, unknown to that analyst, staff in another part of the bank separated by a Chinese Wall had obtained confidential information about the company which indicated that some of the information was false, the investment bank should not be treated as having the requisite mental element that the research report contained false information so as to be guilty of market misconduct. This is similar to the “Chinese Walls” defence in Section 254(2) of the Bill, which applies in respect of insider dealing. Similar defences or safe harbours should be introduced for the other categories of market misconduct.

Other safe harbours

If the categories of “market misconduct” remain so widely drafted, it would be important, as discussed in Section 2 above, to create safe harbours for transactions such as arbitrage, hedging, programme trading and market making, which might otherwise be alleged to be “artificial” transactions or transactions which maintain an “artificial” price in the market.

22 May 2000

SECURITIES AND FUTURES BILL - DISCLOSURE OF INTERESTS IN SHARES

This paper sets out comments from the group of financial institutions listed below (the “Group”) on Part XV of the Bill. The main concerns of the Group can be summarised as follows.

Interests in shares

In respect of disclosures of interests in shares, the inclusion of interests in unissued share capital and equity derivatives (including cash settled derivatives), and the detailed information required to be disclosed, including changes in the nature of interests, would make calculation of the levels of “interests” held a matter of extreme complexity for financial institutions. Because interests in derivatives and unissued shares are included, the 5% disclosure threshold will often be exceeded. Therefore, daily disclosures are likely to be required, imposing a substantial compliance burden on financial institutions and listed corporations alike. The provision whereby “de minimis” changes of less than 0.5% may not need to be notified will not, in practice, alleviate the burden. The situation is made worse by the opacity of the drafting of this Part of the Bill. It is highly unsatisfactory to create criminal offences the scope of which is so difficult to understand.

We do not believe that the above changes to the scope of the disclosure obligation will result in materially greater transparency. Even if the law is strictly complied with, the listed corporation and the Exchange will receive large volumes of complex, confusing and potentially conflicting disclosures.

Greater transparency could have been achieved by reducing the disclosure threshold to 5%, shortening the disclosure period to 3 business days and making minor changes to streamline the disclosure regime (to which proposals we have no objection) without making the other changes mentioned above, which we believe will be damaging to the Hong Kong market. We do not believe that any increase in transparency is sufficient to justify the onerous burden imposed on market participants by those changes to the disclosure regime.

Short positions

The Group is opposed to the proposal for short positions to be disclosed. This imposes a very substantial compliance burden for listed companies, their directors and shareholders and financial institutions, and could seriously damage the equity derivatives market in Hong Kong. However, it is unlikely to provide useful market information. It will not capture all open short positions (since the disclosure obligation applies only to persons who have a long position of 5% or more).

Where a market participant makes public disclosure of a short position, this will create an incentive for others to engage in manipulative activities such as short squeezes, and make it difficult and costly to hedge the position. This will increase the costs of legitimate trading and hedging activities in Hong Kong equities.

Overall impact

The scope of the proposed disclosure obligations goes well beyond the requirements in other international financial markets. The disclosure regime would impose a substantial compliance burden on Hong Kong listed companies and their management, as well as on financial institutions. It could add significantly to the costs of trading in Hong Kong listed shares and discourage companies from seeking listing of their securities in Hong Kong.

Furthermore, the complexity of the provisions is likely to lead to erroneous disclosures by those who seek to comply with the provisions, and encourage others to disregard their disclosure obligations. The result may be that the market receives incomplete and misleading data.

List of Submitting Group Members

Bear Stearns Asia Limited

Credit Suisse First Boston (Hong Kong) Limited

Donaldson Lufkin Jenrette Asia Limited

Goldman Sachs (Asia) L.L.C.

Jardine Fleming Securities Limited

J.P. Morgan Securities Asia Pte Ltd

Kleinwort Benson Securities Asia Limited

Merrill Lynch (Asia Pacific) Limited

Morgan Stanley Dean Witter Asia Limited

Salomon Smith Barney Hong Kong Limited

If you would like to discuss any of the above issues with the Group collectively, please contact Pauline Ashall/Kelly Cheng at Linklaters, 10th Floor, Alexandra House, Chater Road, Central, Hong Kong (Direct line: 2842 4819 /2842 4867).

DISCLOSURE OF INTERESTS IN SHARES - GENERAL COMMENTS

The Government's Consultation Paper states that Part XV of the Bill "will bring the disclosure requirements in Hong Kong in line with international standards while minimising the costs of compliance".

If the law was simply amended to reduce the disclosure threshold to 5% and disclosure period to 3 business days, this would be in line with international standards, and we would have no objection. We also accept that there are a couple of minor respects in which the information to be disclosed is simplified (e.g. the identity of the registered shareholder need not be disclosed). However, further far reaching changes are proposed which are not in line with international standards, and which will make the disclosure regime in Hong Kong far more onerous to comply with than that under the laws of other jurisdictions. We believe that the new disclosure regime will discourage companies from listing their securities in Hong Kong and discourage international investors from participating in the Hong Kong market. It will also have a substantially adverse impact on the development of derivatives markets in Hong Kong, and make hedging transactions more costly.

We are also concerned that, if the disclosure requirements are intended to apply to dual-listed stocks, this will result in investors having to comply with two different disclosure regimes and, in view of the width of the Hong Kong regime, discourage foreign companies from seeking dual listing in Hong Kong.

Scope of "interest in shares"

The first major concern is the way in which the concept of an "interest in shares" which counts towards the disclosure threshold has been expanded, by including interests in unissued shares and interests arising under equity derivatives, including cash-settled derivatives. The definition of "interest" is already very wide and may result in a large number of people having an "interest" in the same stock. If the new changes take effect, the result will be that the amounts of "interests" requiring disclosure may exceed by a very significant multiple the amount of the company's issued capital.

The information disclosed will not be of benefit to the listed company, because the company will be interested in knowing who can exercise "control" in respect of its shares i.e. exercise voting rights at general meetings. However, interests in shares may arise under the extended definitions even though no control can be exercised over any of the company's shares. The concept of "interest" would be extremely wide, extending to unissued share capital and derivatives, but the disclosure threshold would be calculated based on the issued share capital of the company. In view of the relatively low market capitalisation of many Hong Kong listed companies, it therefore becomes highly likely that financial markets groups, which as part of their ordinary business, engage in transactions related to such companies (with no intention of building up a controlling stake or of affecting the market price of the company's shares) will easily reach the 5% disclosure threshold. This is particularly the case as interests of different companies in the group usually need to be aggregated.

Once the 5% threshold has been reached, it is likely that further disclosures will need to be made on virtually a daily basis, as the overall level of the interest fluctuates and/or there is a change in the <u>nature</u> of the interest, (for example, because options have been exercised). For a very simplistic example of how the disclosure obligations might work in practice, see Appendix II.

Again, the need to disclose the changes in the <u>nature</u> of an interest goes beyond international market practice. The (non-exhaustive) definition of when such a change occurs, in Section 304(7), is extremely obscure, creating an unduly wide and vague obligation that will be extremely onerous to try and comply with in practice. We understand that the SFC takes the view that a loan of securities results in a change of the nature of a lender's interest, which will require disclosure. This will be extremely difficult for institutional investors to comply with, since if they engage in a securities lending programme their custodian will have discretionary authority to lend out their stock without notifying the investor or its investment manager of the loan. Since the loan involves no change in the investor's economic interest in the shares (and the borrower will acquire an interest requiring disclosure), we do not see any reason to require disclosure by the lender of the loan and the subsequent return of the stock, particularly in view of the extensive new requirements for record-keeping by lenders and reporting of short sales by borrowers which will apply under the Securities (Amendment) Bill. Any such disclosure obligation is likely to lead to a significant reduction in the amount of Hong Kong stock available for borrowing, with adverse consequences for the liquidity of the market.

As a general comment, we do not believe that the extremely complex "de minimis" provisions in Section 304 will be of material assistance in relieving the compliance burden. The new regime would require fundamental changes to existing systems for recording interests and making reports, and would involve a huge investment in computer technology and manpower, adding considerably to the costs of doing business in Hong Kong.

The amount of information to be disclosed in respect of interests in shares is extensive, and includes:

- details on whether the interest relates to issued or unissued share capital
- details of equity derivatives under which the interest arises, and the exercise period of the derivative and its expiry date
- where the interest arises by attribution under s309, the name and address of each other person having an interest in the shares
- the consideration paid to acquire the interest and
- if notification is being made for the first time, the consideration paid to acquire interests over the preceding 4 months.

These obligations are very onerous, and involve the disclosure of commercially sensitive information. We are particularly opposed to the proposal to require disclosure of the consideration paid to acquire an interest in shares, especially "looking back" over a period of 4 months. This will create a significant additional workload. Whilst we understand that there may be cases where the SFC may need such information, in which case we would be most willing to provide it, requiring such disclosure as a matter of course is excessively onerous. For heavily traded shares, the simple task of assembling a summary report of 4 month trading activity would be labour intensive and could take a significant amount of time.

The heavy compliance burden is made worse by the immense complexity of the disclosure requirements. We agree with the comments of the Securities Law Committee of the Law Society in their response to the 1998 SFC Consultation Paper:

> "It is essential, as a matter of good law-making in the context of criminal law such as the Ordinance, that the law be comprehensible and compliable with in practice. If it becomes so complicated that even specialist regulators and lawyers have problems understanding it, then it becomes bad law. We believe

that some of the proposals will be so complicated to implement that they will cause major concerns in this respect."

Even where a financial institution incurs considerable expense on an on-going basis in committing resources to making disclosures, there is still a considerable risk of errors being made because of the complexity of the requirements and the complete lack of clarity of the provisions, potentially resulting in substantial criminal penalties. On the other hand, international investors, including fund managers, may well be unwilling to adhere to reporting requirements which are much wider in their scope and more complex in their application than rules applying in other international markets. This will provide a substantial disincentive to invest in Hong Kong securities. Furthermore, the law is so complex that a significant degree of non-compliance can be expected. This prejudices those reputable financial institutions who have made every effort to comply, and may result in an incomplete and misleading picture being giving to the market.

Disclosure of Short Positions

The proposals for disclosure of "short positions" also go beyond the disclosure regimes applicable in other international financial centres. In some markets, there is a requirement for brokers to make periodic disclosure to the exchange of their net open short interest. However, it is unprecedented to expect any investor (assuming he has a 5% "long" interest which, as discussed above, will not be a particularly substantial threshold) to disclose short positions. The requirements are particularly onerous because a person with a 5% "long" interest will have to disclose <u>any</u> short position, and subsequent fluctuations in the short position crossing any percentage threshold. This may require very frequent disclosures to be made.

In our view, the costs of compliance will be out of all proportion to any value that the information might have for the markets and the regulators. The definition of "short position" is very wide, including cash-settled positions, and transactions under which there is a conditional right or obligation which may never be performed, or only at some considerable time in the future. It should also be noted that short positions held by different companies in the group will need to be aggregated at holding company level. Therefore, a financial group may be reporting a substantial short position which appears to be out of line with the overall "long" position of the group. However, in economic terms, there may be no overall net short position.

Effects of provisions relating to equity derivatives

Generally, the disclosure requirements and the onerous administrative burden they impose are likely to undermine the development of the derivatives market in Hong Kong.

Where a person has entered into a long or short position and makes a disclosure, this may be sufficient to enable other market participants to identify that the person has a position which requires to be hedged in the market. This would give other market participants the opportunity to make it difficult, and more costly, for the position to be hedged. This will encourage financial institutions who enter into equity derivatives to carry out their hedging activities immediately, prior to making disclosure of the short position, rather than carrying out their hedging activities in an orderly manner over a period of time. This would increase the volatility in the market.

Investigations by listed companies

Under Section 317 of the Bill, a listed company may issue enquiries as to persons holding, or having held in the preceding 3 years, an "interest" in the company's shares. Disclosure of any "interest", including one falling below the 5% threshold, is required. The amount of detail required to be provided is extensive, and the exemptions from disclosure in Part 3 of Schedule 9 do not apply.

While Section 317 is similar to the existing Section 18 of the SDIO, the new expanded definition of “interest” in the Bill will apply, making compliance with any enquiries much more onerous. At present, with the disclosure threshold set at 10%, listed companies have a legitimate interest in enquiring as to whether someone is acquiring a stake in the company’s issued share capital. However, with the disclosure threshold reduced to 5% the need for a company to have these rights of enquiry is less compelling. In view of the expanded definition of “interest”, a company could use Section 317 enquiries as a powerful tool for hindering legitimate activities relating to its shares, by tying up substantial resources within financial intermediaries and other market participants.

Assuming that the right for companies to make enquiries is to remain, we see no justification for expanding this right beyond the right of enquiry in respect of voting rights in issued share capital of the company. Also, it would be helpful if Section 317 and the other provisions in Division 3 of Part XV were amended to clarify and delimit:

- the information a company may ask for;
- the time limit within which such information is to be provided (currently, it must be provided within such reasonable time as may be specified in the enquiry, and what is “reasonable” in this context is a matter of significant doubt).

Exemption from disclosure

In addition to the exemptions in Part 3 of Schedule 9 (which reflect the existing law), we believe that the reduction in the disclosure threshold and the expanded concept of “interests in shares” justify consideration of additional exemptions. While para 18(h) allows for new exemptions to be created by regulations, it would be helpful to introduce exemptions into Part 3 itself for long and short positions held for market making purposes, since we understand that market making is to be introduced in respect of Nasdaq/Hong Kong listed securities.

Other points

A number of drafting comments are set out in Appendix 1 to this document. Assuming that our interpretation of the legislation is correct, some of these are of considerable importance. The difficulties in interpreting the legislation demonstrate that the overall complexity and detail of the proposed legislation is unacceptable for a disclosure regime which financial markets participants need to comply with on an on-going basis as part of their ordinary business, and a breach of which attracts substantial penalties.

22 May 2000

APPENDIX 1

DISCLOSURE OF INTERESTS IN SHARES - DRAFTING COMMENTS

- Definition of “equity derivatives” in section 298(1) - the words “wholly or partly” in (b) appear to suggest that contracts linked to baskets of stocks or stock indices are treated as equity derivatives in respect of each stock in the basket or index. The SFC confirmed at its workshop on 8 May 2000 that this was not the intention, but the drafting should be amended.

- Definition of “listed corporation” - includes a company which only has warrants or debt securities listed on the Exchange. In practice, exemptions are often given by the SFC in respect of shareholders in such companies, but the exemption needs to be applied for and a fee paid. The definition should be confined to companies with share capital listed on the Exchange, and disclosure only required in respect of share capital which is listed.

- Definition of “relevant share capital” - in respect of issued share capital, this means shares of a particular class. It also includes unissued shares of any class. It would not make sense if a person with shares of Class A, and who holds convertible bonds in respect of Class B shares, would need to aggregate these to determine the amount of “relevant share capital” held. (The provision in Section 298(2) referring to separate classes does not assist, because this relates to the company’s <u>issued</u> equity share capital.)

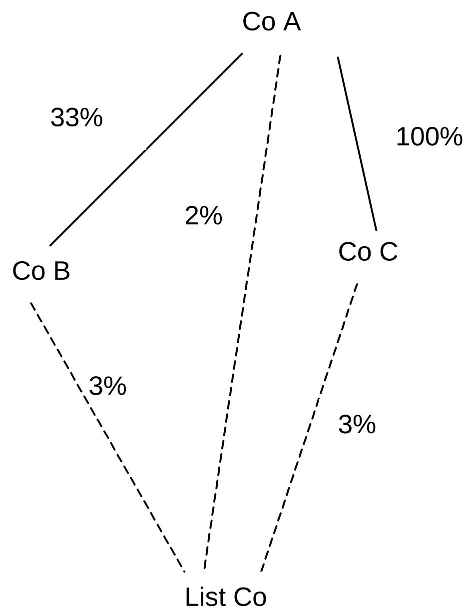
- Definition of “short position” - (b) would include a lender who has given a “hold notice” i.e. committed to lend shares but where the loan has not yet taken place. When the loan is made the lender would cease to have a short position. We assume this is not intended, and (b) should be expressly limited to stock borrowers.

- Some of the disclosure obligations in Section 300 expressly require knowledge or awareness of the relevant facts before a disclosure obligation is triggered, and others do not. Can the Government confirm that, despite the obscurity of the drafting, Section 302(2) and 303(3) are intended to, and do, have the effect that under no circumstances is a breach of disclosure obligations committed where the person is not aware that he has the relevant level of interest in the shares or relevant short position, as the case may be?

- Section 305(1) appears to have the effect that if a person holds 10% of the issued shares of Class A shares, and the company has issued 1m Class A shares and more than 1m Class B shares, the person would not have a notifiable interest, because his interest in the entire issued share capital is less than 5%. We assume that this change from the current position under the SDIO is intended.

- Section 305(2) appears to have the effect that if a person holds 10% of the issued share capital, and the company issues more shares through a rights issue that the person does not take up, no disclosure obligation is triggered even though the holding is diluted below 10%. However, if the person had taken up his pro rata entitlement, the effect would be that he would have to calculate his prior holding based on the new issued share capital, i.e. as being less than 10%, which would appear to trigger a disclosure obligation even though in reality his percentage interest remains at 10%. This does not seem to make sense.

- In the following example, Section 309(6) appears to deem Co B and Co C “interested” in shares of List Co in which Co A has an interest (including shares in which Co A is interested by attribution). Since Cos B and C cannot only control the voting rights over the particular shares they hold in any way, and the aggregate interest of Co A already requires disclosure, this imposes a completely unnecessary and misleading disclosure obligation on Co B. The effects are compounded by the fact that Co A is, in turn, treated as interested in all the List Co shares in which B is interested.



Co A has aggregate interest of 8%. Co B and Co C are deemed by s309(6) to have an 8% interest (resulting in Co A having an 18% interest, and so on ….).

- Section 310 - the extended test for concert parties in Section 310(1)(b) includes agreements to make loans for the acquisition of shares in a target corporation. To create a "level playing field" the exemption in Section 310(6) should apply not just to Hong Kong-licensed lenders but to anyone who lends the money in the ordinary course of his business.

- Schedule 9 para 11(b) provides that a person is regarded as ceasing to be interested in shares if another person fails to deliver the shares to him in breach of a contractual obligation. It should be clarified that this does not apply simply because of a delay in delivery of shares. It would not make sense if a purchaser, having acquired an "interest" at the time of agreeing to purchase, had to notify that his interest had ceased (and then notify that his interest had revived) if the seller was late in settling the purchase.

- Schedule 9 para 18 creates an exemption for holders in, and trustees and custodians of, collective investment schemes authorised by the SFC. There seems no justification for restricting this exemption to authorised schemes - foreign schemes which invest in Hong Kong shares should also be entitled to the exemption.

  Also, an interest should be an "exempt security interest" under para 21 if it is held by way of security in the ordinary course of business by any bank or securities dealer, whether or not licensed in Hong Kong.

APPENDIX 2

X Co is a HK listed company. Group A is an international financial services group with operations in a large number of different operating entities internationally.

X Co has issued share capital of 50m ordinary shares and an affiliate has issued 10m long-dated bonds convertible (in 5 years time) into X Co shares, 10% of which are held by a Group A company. A number of issues of cash-settled call warrants relating to X Co shares have been issued by different investment banks, and are listed on the SEHK or in Luxembourg. One of the issuers (in respect of warrants relating to 3m x shares) is a Group A company, which has delta-hedged its exposure to price movements in X Co's shares by buying stock futures in respect of 0.5m X Co shares on the HKFE, by an OTC call option in respect of 1m shares with another investment bank, and

A Group A company in London has lent money to a client secured against a portfolio of securities that includes 0.5m X Co shares. The company has the right to use the portfolio, and has lent out the X Co shares. Group A in New York regularly buys and sells X Co ADRs for its clients, and has today bought 1m in the market, for settlement on T+2.

Group A's "long" interests in X Co shares

X Co bonds	1m
Stock futures	0.5m
OTC call option	1m
Portfolio held as security	0.5m
ADR position	1m
Total	4m
i.e.	8% of the issued share capital

Group A's "short positions" in X Co shares

Warrants	3m
Total	6% of the issued share capital

In these examples, Group A only has the right to control 0.5m x Co shares, and then only under a security interest that would be an exempt security interest if held by a Group A company in Hong Kong. For Group A to have to disclose an 8% interest may give a misleading picture to the market, even though very detailed disclosures need to be made as to how the interest arises.

<u>Day 2</u>

Group A buys back 0.5m warrants, which are cancelled.

Group A's short position is reduced to 5%. Disclosure required.

<u>Day 3</u>

Purchases of ADRs settle and ADRs are transferred to clients.

Group A's long position is reduced to 6%. Disclosure required.

Day 4

Borrower returns X shares to Group A on maturity of loan. Disclosure needed of change in nature of Group A's interest in 0.5m shares.

Day 5

Since warrants issue is over-hedged, some 0.3m stock futures are sold. Group A's long interest falls to 5.4%. Disclosure is required.

Day 6

X Co has repurchased 1m shares in the market. A's long interest increases to over 5.5% and its short interest increases to over 5.1%. In this particular case no disclosure obligations will arise, however if the change in issued share capital had resulted in Group A crossing a percentage threshold, disclosure would have been required.

Securities and Futures Bill - Licensing Regime

The group of international financial institutions listed below (the "**Group**") previously commented on the SFC's Consultation Paper on Review of Licensing Regime published in July 1999. This paper sets out the Group's comments on the licensing provisions set out in Part V of the Bill.

We also comment on the various provisions throughout the Bill that impose criminal, civil or disciplinary sanctions on licensed individuals, and others involved in the management of a licensed corporation or exempt persons.

The main concerns can be summarised as follows:

Licensing of Executive Directors

The SFC is proposing that <u>all</u> executive directors of a licensed corporation should be approved as "responsible officers". In addition, all "responsible officers" are also required to be licensed with the SFC as licensed representatives. This would mean that they must have passed specific Hong Kong professional examinations, as well as being able to demonstrate management skill and experience, and would be subject to on-going training requirements.

This proposal may cause problems for licensed entities incorporated outside Hong Kong, or which are part of an international group. The entity may well have executive directors who are based outside Hong Kong and who are not currently registered as "dealing directors" or "investment advisers". It is not practical to expect them to pass Hong Kong-related examinations or to undergo on-going professional training to satisfy Hong Kong rules. We suggest that the SFC should only apply its requirements to executive directors based in Hong Kong. Although other directors would still need to be "fit and proper", they would not require to be approved by the SFC as responsible officers and registered as a licensed representative with the SFC.

Criminal Liability

Under the Bill, a large number of offences may be committed by licensed corporations, directors, officers and licensed representatives. A licensed corporation and its management may be held criminally liable for acts of a "rogue trader", or for breach of conduct of business rules made by the SFC. Many offences can be committed inadvertently or through negligence yet carry very serious penalties. For example, if a licensed corporation fails to comply with SFC rules, the rules may provide that a breach amounts to a criminal offence for the licensed corporation <u>and</u> each of its executive officers. The Bill is unduly draconian and the penalties excessive.

Senior Management Responsibility

Under the Bill, senior management of licensed corporations are at risk of criminal, civil and disciplinary sanctions, not just where they have been personally involved in the wrongdoing but also if the misconduct is regarded as having arisen through their lack of supervision, or other neglect. As mentioned above, strict liability offences may also be created without even the need to prove negligence.

Whilst other international markets do impose significant responsibilities on senior management, the range of sanctions and the severity of the penalties provided for under the Bill are greater than in other jurisdictions and, the Group believes, will act as a serious disincentive for international financial markets participants to assume management responsibilities in the Hong Kong market.

List of Submitting Group Members

Bear Stearns Asia Limited

Credit Suisse First Boston (Hong Kong) Limited

Donaldson Lufkin Jenrette Asia Limited

Goldman Sachs (Asia) L.L.C.

Jardine Fleming Securities Limited

J.P. Morgan Securities Asia Pte Ltd

Kleinwort Benson Securities Asia Limited

Merrill Lynch (Asia Pacific) Limited

Morgan Stanley Dean Witter Asia Limited

Salomon Smith Barney Hong Kong Limited

If you would like to discuss any of the above issues with the Group collectively, please contact Pauline Ashall/Kelly Cheng at Linklaters, 10th Floor, Alexandra House, Chater Road, Central, Hong Kong (Direct line: 2842 4819 /2842 4867).

Comments in relation to the Licensing Regime

1 Scope of activities requiring a licence

Part 1 of Schedule 6 contains the list, and definitions of, the regulated activities for which a licence will be required. The Group's comments on particular regulated activities are set out below.

1.1 "Dealing in securities"

The definition of "securities" in Schedule 1 to the Bill is similar to that currently in Section 2 of the Securities Ordinance, however there is a "catch all" provision that includes (or excludes) from the definition "any interests, rights or property, whether in the form of an instrument or otherwise, prescribed by the Financial Secretary as being (or not being) securities". There is a concern that when developing new products which do not fall within the definition of securities in the Bill, it would be necessary to apply for a ruling from the Financial Secretary on the status of that product. This appears unduly burdensome and a restriction on the development of new products in Hong Kong.

The definition of securities includes shares in mutual fund corporations and other types of "funds". However, as under the existing law, it is difficult to determine whether interests under a limited partnership are "securities" and, if so, in what circumstances this arises.

The second limb of the definition of "dealing in securities" - "providing a facility for bringing together on a regular basis sellers and purchasers of securities, or for negotiating or concluding sales and purchases of securities" - appears to overlap with the definition of "automated trading services". There is no exemption from the definition of "dealing in securities" for a person licensed under Part V to provide automated trading services, or vice versa.

The Group supports the continued exemption for inter-professional dealings but is disappointed that the current "professionals" definition (that is, a person whose business involves the acquisition, disposal or holding of securities, either as principal or agent) has been maintained for all purposes in the Bill, including the marketing regime in Part IV of the Bill. The Group wrote to the SFC in November 1999 proposing a wider definition of "Qualified Investor", which it was hoped would be used for the purposes of the Bill and in the context of the conduct of business rules and codes to be made by the SFC (to provide for a lighter regulatory regime where licensed persons were dealing with "Qualified Investors"). This definition is attached as an Annex to this paper.

1.2 "Dealing in futures contracts"

As with the definition of "securities" there is a right for the Financial Secretary to determine whether or not a product is a futures contract. Our comments above in relation to securities apply equally to futures contracts.

It is unclear from the definition of "futures contract" in the Bill whether "an option on a contract made under the rules or conventions of a futures market" is meant to cover only exchange traded options, or also includes OTC contracts.

In the definition of "futures market" in Part III of the Bill we see no reason for the reference to "commodities" or for the Bill to continue to include a (non-exhaustive) definition of "commodity". We note that the definitions (in Part 3 of Schedule 3) simply reflect the contracts currently traded on the Hong Kong Futures Exchange ("**HKFE**"), none of which relate to "commodities" in the normal sense of that term anyway. The definition covers all futures business whether relating to commodities or not and it simply adds to the length and complexity of the Bill to retain the definition.

A more significant point is that the definition of "futures market" may be wide enough to include inter-professional computer dealing/settlement systems that enable professionals to trade in OTC products such as swaps, at least if the system operator is regarded as maintaining a place at which facilities are provided for bringing together the swap counterparties. Not only would this mean that the system operator would need to be licensed under Part V or registered under Part III as an ATS provider, but professionals who dealt in swaps for their own account through the system would be regarded as dealing in "futures contracts" and would therefore need to be licensed. This should be addressed by creating a general exemption in the definition of "futures market" for professionals-only markets, where the professionals in the market are dealing for their own account and not engaging in dealings with or for clients.

The definition of "dealing in futures contracts" is similar to the definition of "trading in commodity futures contracts" in the Commodities Trading Ordinance ("**CTO**") but no longer contains the requirement that the person with whom the dealing is taking place be in Hong Kong. This is a significant change in scope.

There should be an exemption for inter-professional dealings in futures, equivalent to that applying in respect of securities, which should apply to professionals dealing for their own account and not engaging in dealings with or for clients, and not being participants on a specified futures exchange.

1.3 "Trading in leveraged foreign exchange contracts"

Although Part I of Schedule 6 refers to "trading in leveraged foreign exchange contracts" this is not a defined term. There are definitions of "foreign exchange trading", "leveraged foreign exchange contract" and "leveraged foreign exchange trading". In essence these are the same as the existing definitions contained in the Leveraged Foreign Exchange Trading Ordinance with the addition of an exemption for transactions done by "an individual through a trader". "Trader" is defined to mean a person licensed to trade in leveraged foreign exchange contracts or an authorised institution.

It seems unduly narrow that such transactions are exempted only if conducted through a "trader" and not other persons. The definition of "trader" should also include a person exempt from the definition of leveraged foreign exchange trading under any rules made by the SFC. Also, the exemption in paragraph (ii) of the definition, for hedging contracts, is too narrow, as it only applies to contracts effected between two parties, each of which is a Hong Kong-incorporated company.

There is also a provision permitting the SFC to make rules to exclude other persons from the definition of leveraged foreign exchange trading. It is extremely important that the existing exemptions in the Leveraged Foreign Exchange Trading (Exemption) Rules are retained, and in our view, they should also be expanded. Otherwise, onerous registration, reporting, documentation and prudential requirements may apply in respect of foreign exchange business, even if carried out with professionals only. This would have a significant impact on the conduct of this business and potentially on the decision to continue to conduct this business in Hong Kong.

Thus we would suggest that the SFC introduces an exemption from the licensing requirement for all foreign exchange transactions between "professionals", whether or not effected for hedging purposes, and whether or not one or both parties has a qualifying credit rating, and also for all transactions effected through a trader.

1.4 "Advising on corporate finance"

This definition seems unduly wide in a number of respects:

- paragraph b(iii) extends to advice concerning acceptance of a take-over offer or tender offer. This should only apply in respect of advice given generally to shareholders. Otherwise, if a person is the investment adviser to an individual investor, and the investor seeks advice on whether or not to accept a take-over offer in respect of shares in the investor's portfolio, the investment adviser could not give that advice without being licensed as a corporate finance adviser.
- paragraph (c) extends to any advice concerning the restructuring of a corporation or any of its assets or liabilities. This would appear to cover matters such as rescheduling of debt obligations, not relating in any way to securities issued by the company and should be restricted in scope.

1.5 "Providing automated trading services"

This definition includes "services provided by means of electronic facilities provided by a person ….. by which offers to purchase or sell securities or futures are regularly made, communicated or accepted."

It seems unclear how this definition is intended to apply. If a securities dealer in Hong Kong offers its customers the ability to place orders on-line, using computer technology licensed to it by a software house, is the dealer and/or the software house caught? If the order relates to U.S. securities, and the dealer in Hong Kong can electronically place those orders with a number of different exchanges and ECNs in the U.S., is that exchange or ECN itself regarded as conducting a regulated activity (and, if so, is it conducting that activity in Hong Kong?)

To provide automated trading services, an entity must be licensed under Part V or authorised under Part III of the Bill. If seeking a licence under Part V to provide automated trading services, Sections 115(4) and 117(1)(c) have the effect that if that service constitutes operating a stock market then the licensed corporation must be an Exchange participant of the Stock Exchange. This is somewhat circular, because the office of an exchange participant is exempted from the definition of "stock market" anyway. Also there is duplication between Sections 115 and 117.

More importantly, it should be made clear that these Sections only apply to the operation of a stock market in Hong Kong. The same comment applies to Section 19 of the Bill. Alternatively, it would be very helpful to amend the definition of "stock market" so that it only applies to a place in Hong Kong.

It is unclear what types of business will be caught by the definition of "stock market" in Part III of the Bill, which includes "a place at which facilities are provided for bringing together sellers and purchases of securities". Can the Government confirm that this is not intended to apply to on-line brokers which take orders from their clients for execution through an exchange or ECN? Can the Government also confirm that this is not intended to require exchanges and ECNs which operate outside Hong Kong to become Exchange participants?

It is a matter of concern that an ATS provider (including an overseas exchange) can only operate a "stock market" if it is an Exchange participant. As such it will be subject to the rules of the Exchange, and those rules could restrict the ability of an Exchange participant to use or provide trading systems other than those of the Exchange.

1.6 "Providing securities margin financing"

The definition covers someone who provides "financial accommodation" for the acquisition of securities. "Financial accommodation" is very widely defined and includes an arrangement under which a person is to be provided with credit, whether directly or through a third party. During the passage of the Securities (Margin Finance) (Amendment) Ordinance, concern was expressed that this would extend to a person in Hong Kong who arranges for an investor to open a margin financing account with an affiliated securities dealer outside Hong Kong. The Government confirmed that this was not the intention and that the person in Hong Kong would not be regarded as "providing" the financial accommodation. It would be better therefore to make this clearer in the drafting of the definition in the Bill.

1.7 "Providing asset management"

Unlike the definition of "investment adviser" in Section 2 of the Securities Ordinance, there are no exemptions from this regulated activity. It would be useful to make clear that the definition is only intended to cover discretionary investment managers and not, for example, trustees or custodians who administer a portfolio but where investment management authority has been delegated to an investment manager who is appropriately licensed, whether or not in Hong Kong.

2 The new licensing regime

2.1 Corporations

Only a company which is incorporated in Hong Kong or an overseas corporation which has registered a branch in Hong Kong under Part XI of the Companies Ordinance, and not a partnership or individual, will be eligible to be licensed. The position of limited partnerships that have separate legal personality is unclear. Arguably, such a partnership may be regarded as a "corporation" in any event and the Group would like confirmation from the SFC (and the Registrar of Companies) that a limited partnership can be regarded as a corporation for this purpose.

We note that, in the definition of "corporation" in Schedule 1 to the Bill, the SFC may exempt an entity from being treated as a "corporation" but there is no provision for the SFC to make rules to include additional entities within the definition.

2.2 Individual registrations

2.2.1 Responsible officers

Every executive director of a licensed corporation must be approved as a responsible officer of that corporation. Unfortunately there is no definition in the Bill of what is meant by an executive director. (We assume that by "executive directors" the SFC means statutory directors. Many financial institutions include the word "director" in titles given to employees who are not appointed to the board, and they should not be regarded as "executive directors" for the purposes of the Bill.) This is a very important point that should be clarified.

In order to become a responsible officer, a person must also be registered with the SFC as a licensed representative. We see no reason for this "dual" registration, at least not where the person is not actively engaging in regulated activities in Hong Kong. To become a licensed representative, a person must have passed specific Hong Kong professional examinations, as well as being able to demonstrate management skill and experience, and would be subject to on-going training requirements.

This may make it difficult to transfer, or discourage the transfer to Hong Kong of, experienced personnel based outside Hong Kong from other affiliated companies because such personnel will not have local experience (if required by the SFC) and will not have satisfied the examination requirements in order to obtain registration and thus cannot take up their responsibilities immediately. The Hong Kong market would undoubtedly benefit from the participation of such persons and their skills, insight and experience.

This proposal may also cause problems for licensed entities that have executive directors who are based outside Hong Kong. It is not practical to expect them to pass Hong Kong-related examinations or to undergo on-going professional training to satisfy Hong Kong rules. The requirements for registration of directors may discourage senior persons from becoming the head company or one of the overseas affiliated companies from becoming a director of the Hong Kong registered person. These senior persons may not be involved in day-to-day decisions but would be generally knowledgeable about the business of the registered person. Possible candidates will not want to be locally licensed, even if they could meet the requisite Hong Kong requirements.

If the requirement for registration applies to overseas directors, Hong Kong licensed persons may well lose the involvement on their boards of senior overseas people, leaving these boards to consist of largely local personnel, without the depth and breadth of experience of the overseas directors.

This proposal may also cause problems for executive directors who are involved in areas such as legal compliance, settlement and risk management who may not have the requisite financial markets experience to be registered as licensed representatives but still make a valuable contribution to the board of directors. It would be very damaging if it became the practice not to appoint such persons to the board, because of the licensing requirements that would arise.

We suggest that the SFC should only apply the licensing requirements to executive directors based in Hong Kong but require that at least two executive directors are based in Hong Kong and approved as responsible officers. Although other directors would still need to be "fit and proper", they would not require to be approved by the SFC as responsible officers and registered as licensed representatives with the SFC.

We note that the SFC has power to grant waivers from the approval requirements for individuals, but this does not afford sufficient comfort, in the absence of a clear written policy on when waivers will be granted, and a rapid turn-around of waiver applications. There is a concern that considerable costs and delays would be incurred in making waiver applications, and that potentially arbitrary and inconsistent decisions will be made by the SFC.

In approving an applicant as a responsible officer the SFC must be satisfied that the applicant has "sufficient authority" within the licensed corporation. It is unclear how the SFC would assess this in practice, and guidance is needed on what is meant by "sufficient authority".

There is also a requirement in Section 123(2)(c) that there must be at least one responsible officer in Hong Kong at all times. So long as the responsible officers are capable of adequately supervising the business in Hong Kong, it should not be necessary for them to be physically present in Hong Kong at all times. There may be circumstances, such as global senior management meetings, where all responsible officers have to be absent from Hong Kong.

It is very draconian that breach of the requirement for a licensed corporation to have at least two responsible officers, and for at least one to be in Hong Kong at all times, is a criminal offence for the corporation and each responsible officer, punishable with imprisonment for 2 years, a fine of HK$1 million and a daily default fine of HK$10,000. It seems that an offence would be committed if, for example, there were two responsible officers and one resigned, was dismissed or died. An offence would also be committed if each responsible officer happened to be out of Hong Kong on a short business trip at the same time. If there is to be criminal liability, it should only apply where a licensed corporation has operated without any responsible officer in Hong Kong for a significant period of time.

2.2.2 Other individuals

Licensing as a representative is required to perform or take part in any act which constitutes a regulated activity, unless the individual performs only clerical duties (Section 112(2)). The scope of the licensing requirement is therefore potentially very wide and the scope of the "safe harbour" for clerical duties is very unclear. Breach of this licensing requirement is a criminal offence punishable with 2-year imprisonment, a fine of HK$1 million and a daily default fine of HK$100,000. It is therefore essential that there be greater clarity as to the scope of the activities requiring an individual to be licensed. It is also suggested that the penalties for breach are excessive.

2.2.3 Substantial shareholders

Section 26A of the Securities and Futures Commission Ordinance already requires that substantial shareholders obtain the prior approval of the SFC. Section 128 of the Bill reflects this provision but with various drafting changes, including the 14-day period for notification where a person becomes aware of being a substantial shareholder being reduced to 2 business days. This is an unreasonably short timescale.

2.3 Criteria for registrations of entities and individuals

Members of the Group have already set out their concerns on the SFC's proposals for Criteria in Assessing the Competence of Licensees and a copy of the earlier submission to the SFC is attached.

In relation to licensed corporations, those proposals will result in detailed guidelines on standards of management, supervision and internal controls being set out in both:

- the Fit and Proper Criteria; and
- the Management, Supervision and Internal Control Guidelines.

This is confusing, since both sets of guidelines are intended to apply on an ongoing basis. They overlap very considerably and, where there is overlap, there are differences between them. In the case of entities, rather than introduce new requirements in the Fit and Proper

Criteria, it would be far more satisfactory to require applicants for registration to meet the standards in the MSIC Guidelines.

While it is accepted that there should be overall management and oversight of the Hong Kong licensed entity, the standards should clearly recognise that supervisory, management and risk control functions can be exercised at group level, whether within Hong Kong or from overseas.

It should also be clarified that management oversight can be exercised through committees or other bodies that are not necessarily committees of the board of directors of the company. Very often, the board will only meet infrequently for formal business, but directors and others will participate in regular meetings of committees such as a regional or global risk management committee that represents the global group.

In relation to individual applicants, it is essential that experience gained outside Hong Kong and qualifications from overseas are recognised in assessing competence to be registered with the SFC.

2.4 Provisional and temporary licences

2.4.1 Individuals

The Bill contains provisions allowing representatives to be granted provisional or temporary licences. The Group supports the formalisation of arrangements which are currently adopted by the SFC.

There is no indication of how long the SFC will take to approve such provisional licence, but hopefully it should be a matter of days. If so, this would solve the current problem of having to employ personnel for up to several months before they are able to conduct licensed activities in Hong Kong.

The SFC may grant a temporary licence for a period not exceeding 3 months if the SFC is satisfied that the applicant is fit and proper, competent to carry out his duties to the requisite standard and that:

- he seeks to be licensed solely for undertaking a regulated activity that is incidental to the activity being carried on by his principal;
- he is authorised to carry on a regulated activity outside Hong Kong and such authorisation is granted by an authority that performs functions similar to the SFC, and that authority confirms that the applicant is so authorised and that the authority is empowered by the law of its jurisdiction to take disciplinary action against the applicant for his conduct in Hong Kong;
- in the 24 months immediately preceding the date of application, the applicant has not carried on that regulated activity in Hong Kong for a period of more than 6 months.

It would be useful if the SFC could clarify what is meant by “incidental” since the activities for which a licence is sought are likely to be the “mainstream” activities carried out by the individual and his employer. It would also be useful to clarify what would be required by means of confirmation by the overseas authority that the applicant is authorised to carry on a regulated activity. As temporary licences are often required at short notice it could prove problematic if the SFC requires information other than a copy of the applicant's overseas licence. It may take a considerable time to obtain information from the overseas regulator.

The Group suggests that the time period after which further temporary licences will not be granted is extended to 9 months in the preceding 24 months. Also, only licences previously granted while working for the same organisation or group should be counted for this purpose.

2.4.2 Institutions

In order for an individual to be granted a temporary licence, the institution he works for outside Hong Kong must also be granted a temporary licence. This is an additional requirement which has not been required in the past and appears unnecessary as an individual applicant for the temporary licence would normally work in Hong Kong, not on behalf of his overseas employer, but for a Hong Kong regulated affiliate of the overseas employer.

The granting of a temporary licence to the overseas employer would appear to indicate that it is carrying on a business in Hong Kong which would make it liable to register in Hong Kong for company law and taxation purposes and could have significant implications under other Hong Kong laws and regulations. Since a temporary licence will only be granted to an employer which is a corporation, it would cause problems for overseas institutions, such as limited partnerships, that may not fall within the definition of "corporation" in the Bill.

The proposal for temporary licensing for institutions as well as individuals appears misconceived and the Group urges the Government to reconsider this matter.

2.5 Trainees

In view of the examination requirements which are being imposed, it may be necessary to allow persons who have not yet passed the examinations to engage in some registrable activities, under appropriate supervision. Otherwise, it will be very difficult for new entrants to join the industry. We would suggest a restricted registration that permits them to conduct business subject to oversight by a designated registered person.

2.6 Notification requirements

Section 122 requires that, where an individual ceases to act as a licensed representative, he has to return his licence, and his principal has to notify the SFC within 2 business days. Failure to do so is a criminal offence punishable with a fine of HK$200,000, imprisonment for 6 months and a daily default fine of HK$10,000. This timescale is unreasonably short, and it seems unduly draconian to impose serious criminal penalties for delays in compliance. If there is to be any criminal sanction, this should only apply where a person has ceased to be a licensed representative but continues to hold himself out as being licensed.

The relationship between Section 122 and 130 is unsatisfactory as regards licensed representatives. Sections 130(1) and (2) would appear to require an individual to give prior notice to the SFC before resigning, or before the firm for which he works changes its address. Sections 130(1)-(2) should only apply to licensed corporations. Also Section 130(4) requires the appointment or resignation of a director to be notified to the SFC both by the licensed corporation and the individual. This is duplicative and unnecessarily bureaucratic.

We comment in 5.2 below on Section 130(5) (“whistle blowing”), which is also unsatisfactory.

3 Waivers

Under Clause 129 of the Bill the SFC will have power to grant a modification or waiver in respect of any condition specified or imposed by the Bill in relation to a licence. Although the Group supports the flexibility that this gives the SFC, it believes that there should be transparency in the licensing process and that if modifications or waivers are granted, the reasons for and details of such modifications or waivers should be published by the SFC.

4 Transitional arrangements

We note that Part I Schedule 10 contains transitional arrangements in respect of existing registered persons (both corporations and individuals), whereby such registered persons will be regarded as being licensed to do particular regulated activities for a period of 2 years from the date of commencement of Part V, but that within the 2 year period the registered person must apply to be licensed for each regulated activity it wishes to undertake. Persons who are currently registered as securities dealers will be regarded as licensed for dealing in securities, advising on securities, advising on corporate finance and providing asset management. The Group believes that they should also be regarded as being licensed to provide automated trading services as many financial institutions are currently providing Internet based or other electronic trading services which would appear to fall within the definition of automated trading services.

The transitional arrangements do not take into account exemptions that are available under the existing regime. For example, the current position, as confirmed by the SFC, is that under the CTO a person based in Hong Kong can enter into commodity futures contracts with a person outside Hong Kong in relation to offshore commodity futures contracts without being registered as a commodities dealer. However, the new definition of “dealing in futures contracts” does not include the requirement that the person with whom the dealing takes place be in Hong Kong, so it appears that during the transitional period certain types of existing exempted business will not be able to be carried out. It would be preferable if during the transitional period registered persons were able to carry on all business currently carried out by them under the existing regime, whether by virtue of being registered or because an exemption applies (either implicit or explicit).

It is not clear what an application to be licensed will involve for existing registered persons and exempt dealers. If it requires submitting fresh applications, this would be a major exercise for the industry, and we doubt that the SFC would have sufficient resources to process all the applications on a timely basis. Also, existing licensed individuals (and those currently working for an exempt dealer) should not be required to take additional examinations in order to be licensed under the new regime. There should be a “grandfathering” procedure for such persons.

We believe that there should also be “grandfathering” for directors of licensed persons or exempt dealers who are not currently registered, but will need to become registered as “responsible officers” under the new regime.

5 Responsibility of Senior Management and Corporations

Under the Bill an "executive officer" (which includes a "responsible officer" of a licensed corporation) is exposed to a number of potential criminal, civil and disciplinary liabilities. Also, various provisions impose criminal and civil liability on "directors" or "officers", and greater consistency in the drafting would have been welcome.

Whilst other international markets also impose significant responsibilities on senior management of regulated entities, the range of sanctions, the basis on which liability is imposed and the severity of the penalties provided for under the Bill are greater than in other jurisdictions, and may act as a serious disincentive for international financial markets participants to assume management responsibilities in the Hong Kong market.

5.1 Capital requirements, client assets and records, and conduct of business rules

Part VI of the Bill includes provisions concerning the SFC's power to make financial resources rules, client assets rules, client money rules, record-keeping rules and rules relating to contract notes and statements of accounts. The rules may provide that if a licensed corporation (or, except in relation to financial resources rules and client money rules, an exempt person) fails to comply with such rules, the entity and each of its executive officers commit an offence punishable by 2 years' imprisonment and a fine.

Part VII of the Bill gives the SFC power to issue rules and codes of conduct relating to the conduct of business for clients. Again, such rules may provide that a breach of the rules amounts to a criminal offence by the dealer and each of its executive officers.

Although there is a similar provision in the existing law in Section 146 of the Securities Ordinance (which, so far as we are aware, has not been used) the Group considers that power to create offences punishable with imprisonment should not be delegated to the SFC in this way, and that any penalty for breach of the rules should not automatically extend to executive officers of the licensed corporation.

In respect of the offences under Parts VI and VII of the Bill, a limited defence may apply under Section 367. It would be a defence if the executive officer proves that he honestly and reasonably believed that the failure by the corporation to comply with the rules would not occur. However the Group believes such a defence will in practice be extremely difficult to prove. As a general matter, it is wrong in principle to place the burden of proof on the defendant and it is not appropriate to impose criminal liability except where the individual knowingly participates in the wrongdoing.

5.2 Whistle blowing

Under Section 130(5), an executive officer also has an obligation to "whistle blow". He must report to the SFC if anyone attempts to prevent him from properly discharging his supervisory responsibilities. Any failure to comply with this reporting requirement without reasonable excuse would amount to a criminal offence punishable by imprisonment for 6 months.

Generally, laws should protect a "whistle blower" from adverse consequences such as dismissal from employment. There are no such express protections in Hong Kong, and the creation of this offence creates an intolerable dilemma (for example) for a compliance director who does not feel that he has sufficient support from another member of senior management.

5.3 Disciplinary action

Under Section 180, the SFC may take disciplinary actions against any responsible officer or other regulated person for misconduct or lack of fitness and properness. In addition to revocation/suspension of his licence, the relevant responsible officer may be liable to a fine of up to HK$10 million and/or required to pay a penalty of 3 times the profit made or loss avoided as a result of the misconduct.

Section 179(2) specifically provides that if "misconduct" occurs as a result of the consent or connivance of, or was attributable to any neglect on the part of, a responsible officer, the responsible officer shall also be guilty of the misconduct. In our view, the onus should be on the SFC to show that the acts or omissions of the responsible officer were sufficient of themselves to constitute "misconduct" and Section 179(2) extends the scope of liability too far.

It should also be noted that the SFC's disciplinary powers also extend to anyone involved in the management of the business of a licensed corporation, no matter whether that person is licensed by the SFC or not. This is very widely and vaguely drafted, and the scope of the SFC's disciplinary powers should, in our view, be more clearly and narrowly defined.

5.4 Market Misconduct Tribunal

Section 266 of the Bill requires <u>every</u> officer of a corporation to take reasonable measures to ensure that proper safeguards exist to prevent the corporation from engaging in market misconduct (e.g. insider dealing, market manipulation and issuing false or misleading statements).

Under Section 242, where the Market Misconduct Tribunal (the "**Tribunal**") determines that a corporation is guilty of market misconduct which is attributable to a failure of any person to take the measures required by Section 266, the Tribunal can make any order against that person that it could make against the corporation.

In view of the width of the "market misconduct" provisions of the Bill, the burden on officers of showing that they took reasonable measures would be very great, since market misconduct could potentially arise in any area of the firm's business and take many different forms.

5.5 Criminal Liability

We have already commented on the unsatisfactory criminal offence for corporations and their executive officers which is created under Section 123 of the Bill (see 2.2.1 above) and the offence under Section 130(5) (see 5.2 above).

Under Parts VI and VII of the Bill, the SFC may make prudential and conduct of business rules a breach of which is automatically a criminal offence for the corporation and its executive officers. The power to create criminal offences should not be delegated to the SFC in this way. The Group notes that a limited defence may apply under Section 367, that is, if the executive officer proves he honestly and reasonably believed that failure by the corporation to comply with the rules would not occur. However, the Group believes such a defence will in practice be extremely difficult to prove. In the Group's opinion, only executives who have actual knowledge of the breach should be disciplined.

Various other criminal offences are created under the Bill, for example for "market misconduct". By Section 367(3) of the Bill, where a corporation has committed a criminal offence with the consent or connivance of, or attributable to any neglect on the part of any officer of the corporation, that officer is also guilty of the offence.

In view of the severity of the penalties for the various offences under the Bill the Group does not accept that "neglect" should be sufficient to make a responsible officer guilty of such offences. The Group does not believe that it is appropriate to create a risk of responsible officers of a corporation being guilty of serious criminal offences unless they knowingly participated in the relevant conduct. Notwithstanding the similar provision in Section 147 of the Securities Ordinance, "neglect" is not a sufficient threshold for imposing serious criminal sanctions.

Of course, the risk of criminal liability for corporations and their senior management will be much increased under the Bill as compared with the existing law, because of the multitude of new criminal offences under the Bill. By Section 368 an act or omission of an employee or other person purporting to act for or on behalf of a corporation within or apparently within the scope of his employment is deemed to be the act or omission of the corporation. This substantially expands the normal circumstances in which a corporation can be penalised for the criminal conduct of an individual, and would mean that, in the event of (for example) of an employee defrauding a client, the company as well as the individual would be guilty of an offence under Section 106 of the Bill, and if the fraud is regarded as attributable to "neglect" of an officer of the company, that officer would also be guilty of an offence (punishable with up to 7 years imprisonment and a fine of HK$1 million).

Generally, the risk of serious criminal penalties is likely to be a considerable deterrent to conducting regulated activities in Hong Kong at all, and is likely to make it difficult to persuade senior personnel to assume management responsibility in Hong Kong.

5.6 Civil Liability

The Bill creates a statutory right of action for investors who have suffered loss as a result of market misconduct. However, if an officer is penalised by the Tribunal or the criminal courts in respect of misconduct attributed to his lack of supervision, investors should not thereby have a right of action against that officer as well as against the corporation.

In addition to the statutory right of action for "market misconduct", the Bill creates other rights of action, in respect of false or misleading statements. Under Section 107(3), where a company has made any fraudulent, reckless or negligent misrepresentation, every director is presumed also to be liable to compensate investors unless the director can prove that he did not authorise the making of the misrepresentation. It is wrong to shift the burden of proof to the directors in this way.

ANNEX

"**Qualified Investor**" means any person, whether acting as principal or as agent, who can reasonably be regarded as having sufficient experience and/or financial standing and/or understanding of the financial markets or products so as to make it unnecessary, in dealing with or for that person, to apply all of the rules applicable to dealings for other investors. A Qualified Investor includes, but is not limited to, the following:

(a) any person registered as a dealer or investment adviser, whether with the SFC or with an overseas securities or futures regulator

(b) an institution authorised as a bank or deposit-taking company under the Banking Ordinance, or by an overseas banking regulator

(c) insurance companies

(d) multilateral agencies, governmental entities and governmental-controlled entities

(e) unit trusts and mutual funds

(f) a corporation which has share capital or net assets of not less than HK$• or its equivalent in foreign currencies, or any corporation which is a member of a group which includes such a corporation *

(g) an individual whose net personal assets are not less than HK$• or its equivalent in foreign currencies or whose income in the last 12 months is not less than HK$• or its equivalent in foreign currencies *

(h) a partnership, trust or other organisation which has net assets of not less than HK$• or its equivalent in foreign currencies *

(i) any other person whose business involves the acquisition and disposal, or the holding of securities (whether as principal or as agent).

In determining whether an entity falls within paragraphs (f), (g), (h) or (i), it will be sufficient to show a reasonable belief that such entity fell within those paragraphs. "Reasonable belief" can be established, inter alia, from obtaining the audited financial statements for the latest accounting period, bank statements, or confirmation from the entity.

* The Group would welcome the opportunity to discuss with the SFC the appropriate limits to be inserted. As guidance, attached as Appendix I, are examples of corresponding limits used in other jurisdictions

Appendix I

UK

Corporation - share capital or net assets of £5 million or more

Partnership or unincorporated association - net assets of £5 million or more

Trust - cash and investments is £10 million or more

US

Corporation - total assets in excess of US$5,000,000

Individual - net worth US$1,000,000 or income in excess of US$200,000 in last two years

Trust - total assets in excess of US$5,000,000

Malaysia

Corporation - total net assets exceed RM10 million

Individual - total net personal assets exceed RM3 million

Singapore

Corporation - net assets exceed S$10 million

Individual - net personal assets exceed S$5 million