Letterhead of HONG KONG BAR ASSOCIATION

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Your Ref: CB1/HS/1/98

22nd September 2000

Legislative Council
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Attn: Ms. Leung Siu-kum
Clerk to Subcommittee

Dear Ms. Leung,

Re: Consultation Paper on Securities and Futures Bill

Thank you for your letter dated 8th April 2000 inviting the comments of the Bar Association on the Consultation Paper on Securities and Futures Bill.

Enclosed please find the Bar's comments thereon for your consideration.

Yours sincerely,

Ronny Tong, SC
Chairman

Encl.

GL/al

'HONG KONG BAR ASSOCIATION 15TH SEPT. 2000

COMMENTS ON THE SECURITIES AND FUTURES BILL

General

1. The proposal to modernise and consolidate the legislative framework for the securities and futures markets is to be welcomed.

Part IV: Offers of Investments

2. We believe that the introduction of the new term of "collective investment schemes" and "investment arrangements", with power for the Financial Secretary to specify any class of arrangements as not constituting "investment arrangements" (clauses 100(1) & 101(2)), is an improvement in that it can cater for the ever increasing number and range of new products being launched in the market.

3. The provisions relating to the SFC's power to authorise advertisements, invitations or documents or the investment products themselves (clause 103) are unobjectionable. We note that according to Part 2 of Schedule 7, the relevant decisions of the SFC to give authorisation or to withdrawal authorisation are subject to review by the Securities and Futures Appeal Tribunal.

Part VIII: Supervision and Investigations

4. Part VIII of the Bill covers production of books and records, supervision of intermediaries and their associated entities, information relating to transactions, investigations and a miscellaneous division addressing matter such as certification to the Court of First Instance in relation to non-compliance with the foregoing provisions, assistance to foreign regulators, liens on documents, production of computerised information, inspection of records or documents seized and

magistrates warrants.

5. The current law allows the SFC to seek the production of books and records when the SFC has reason to suspect fraud, misfeasance or other misconduct in the management of a listed company. Part VIII expands upon those powers by broadening the circumstances in which the SFC may seek production of documents and by introducing additional powers by which the SFC may check the veracity of the books and records produced and/or place them in context. Subject to certain safeguards (such as the inadmissibility of statements which may tend to incriminate in any criminal proceedings) under the new provisions the SFC is empowered to require an explanation in respect of any record or document produced, from the various parties, including the company itself, an associated company, an authorised financial institution, an auditor or any other person.

6. These additional powers will significantly enhance the SFC's investigatory powers in cases of abuse, and as such are to be welcomed. The new provisions set out a clear code and provide the SFC with "teeth" to enforce it.

Part X: Powers of Intervention and Proceedings

7. The Bar supports the extension of the powers of the SFC to seek orders from the Court under clause 198 of the Bill, so that orders may be obtained against persons who have assisted in contravention of any relevant law or regulation, and so that a wider range of orders may be made.

8. As to Clause 200, which is a provision not included in the consultation in July 1999, the Consultation Document (§8.18) states that the clause seeks to recognise the duty of care owed by a person responsible for making any public statement to all those who may reasonably rely on it. However, as presently drafted, it appears

that the effect of the clause is to create a new cause of action which bears quite different features from the common law tort of negligent misstatement. Some of these features are:-

(1) The liability is *prima facie* established if the statement is materially false or misleading (clause 200(1)) and it is for the defendant to prove in defence that he acted in good faith and had reasonable grounds to believe that it was not false or misleading, or did not know, and could not reasonably have been expected to know, that it was false or misleading (clause 200(7)). In other words, there is a reversal of the burden of proof or a presumption of negligence.

This is not the case at common law, where the burden is on the plaintiff to prove negligence. While section 3 of the Misrepresentation Ordinance (Cap. 284) similarly reverses the burden, that provision is available only to a contractor induced to contract by a misrepresentation, and is in any event not without its critics: see e.g. Weir, A Casebook on Tort (7th edn), p.551.

Further, a defendant who fails to discharge the burden of proving good faith can have been only negligent but not fraudulent. Yet in the context of the Misrepresentation Act in the UK it has been held that the test of remoteness of damage is the same as fraud: Royscot Trust v Rogerson [1991] 3 All ER 294. This unfortunate result may repeat itself in the light of the wording of Clause 200.

(2) Liability attaches to any person who is "responsible for" a statement, including any person who makes or issues it and any person who assisted or participated in or approved the making or issuing of it (clause 200(6)). Two specific classes of persons are exempted: printers and broadcasters

(clause 200(3) & (4)).

It is unclear who is a person who assisted or participated in or approved the making of a statement. For example, is a person who provided information to a listed company, which was then used in a public announcement by the company, a person who assisted or participated in the making of the public announcement? Are all executive and non-executive directors of listed companies to be taken to have approved the making of public statements by the companies?

At common law, mechanical publishers of the relevant statement such as printers or broadcasters cannot conceivably be liable, unless they disseminate the statement knowingly it to be false. The fact that specific exceptions are required to cover their position shows that Clause 200 has cast the net very widely indeed.

(3) The defendant is potentially liable to any member of the public who has suffered pecuniary loss as a result of relying on the statement (clause 200(1)). The emphasis is on the plaintiff's reliance on the statement to his detriment. However, the clause as drafted does not discriminate as to the nature of the act of reliance and whether that act is related to the purpose for which the statement is made.

At common law, liability depends on the statement-maker's actual or presumed knowledge as to the purpose of the information: BCCI v Price Waterhouse (No.2) [1998] PNLR 564 at 588.

(4) As drafted, the control mechanism in an otherwise very wide clause appears to be the general criterion imposed by Clause 200(2): that no

person is to be held liable to pay compensation unless it is "fair, just and reasonable" in the circumstances of the case.

The rubric of "fair, just and reasonable" is apparently no longer the touchstone at common law. In Henderson v Merrett [1995] 2 AC 145, Lord Goff stated that once a case had been identified as falling within the "assumption of responsibility" principle, "there should be no need to embark on any further inquiry whether it is fair, just and reasonable" to impose liability for economic loss. This has since been endorsed by the House of Lords in Williams v Natural Life Health Foods Ltd [1998] 1 WLR 830 (*per* Lord Steyn).

Accordingly, the clause as drafted would cast the net very widely and leave it to the courts to grapple with a concept which is arguably outdated in the equivalent area at common law. We doubt whether this is conducive to the development of a consistent body of jurisprudence.

9. It can be seen, therefore, that the clause as drafted departs substantially from the common law position. Insofar as it is expected that "in determining questions of proximity ..... the common law principles applicable to negligent misstatements are intended to apply to [the] statutory action created under Clause 200" (Consultation Document §8.19), the clause has in our view gone too far.

10. This proposed provision potentially makes issuers of relevant statements, e.g. auditors of listed companies, liable "in an indeterminate amount for an indeterminate time to an indeterminate class", subject only to the rubric of what

is "fair, just and reasonable".[2] While the object of protecting investors is to be supported, one may question whether Clause 200 strikes the right balance.

11. The feature of any statement made publicly is that it is difficult to show that the maker of the statement intended that it to be relied upon by the plaintiff in question as a specific person or class of persons. Perhaps an alternative approach to Clause 200 is to provide a deeming provision that certain types of public statements if made in a certain manner will be deemed to be intended to be relied upon by a certain class of persons within a certain period of time. The rest may then be governed by common law principles relating to negligent misstatement.

Part XI: Securities and Futures Appeal Tribunal

12. Part XI of the Bill establishes a statutory tribunal for the purposes of hearing and determining applications for review under that Part and Schedule 7. Under the provisions, the Chairman of the Tribunal will be a judge and there will be 2 other members who will not be public officers. The tribunal will review certain decisions made by the SFC. The provisions prescribe a procedure, a timetable and provide for the powers of the tribunal.

13. Clause 205 empowers the Tribunal to consider any form of evidence, even if the material would not be admissible in evidence in a court of law. The Tribunal may punish for contempt as if it were a court of first instance and is empowered to award costs. Further, the Tribunal may register its orders in the Court of First Instance whereupon it becomes an order of the court.

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[2] For example, would Clause 200 have the effect of overruling Caparo v Dickman [1990] 2 AC 605? If so, is that the intended consequence?

14. The Tribunal or a party to the review may refer the case to the Court of Appeal. Given that the Tribunal is empowered to consider evidence which is not admissible in a court of law, the position in relation to such evidence upon an appeal is not clear.

15. Schedule 7 to the Bill sets out those decisions of the SFC which are amenable to review, certain "excluded decisions" and deals with certain procedures. In addition, Clause 218 provides that the Chief Justice may make rules regulating the procedures. Clause 217 provides for a person aggrieved by an excluded decision made in respect of him to appeal to the Chief Executive in Council, whose decision shall be final.

16. By virtue of the more formal proceeding, a review may prove to be more costly and time consuming for the parties, which may deter some parties from pursuing their rights.

Part XIII: Market Misconduct Tribunal

Elimination of the Power to Impose Penalties of up to 3 Times the Profit Made or Loss Avoided

17. The civil sanctions for the MMT have been expanded to include a "cold shoulder" order where a person could be denied access to the market for up to 5 years (cl. 241(1)(b)), and a "cease and desist" order not to breach the market misconduct provisions (cl. 241(1)(a)). Although an order to disgorge the profit made or loss avoided has been retained (cl.241(1)(d)), the MMT would lose the power to impose financial penalties of up to 3 times the profit made and loss avoided.

18. The Government has decided not to retain the power to impose substantial

financial penalties on advice received to the effect that jurisprudence is developing before the European Court of Human Rights that such orders could be construed as "criminal" for human rights purposes (see paras. 11.9 to 11.12 of the Consultation Document).

19. To date, the prospect of substantial penalties has provided an effective deterrent to insider dealing in Hong Kong. As well, the IDT and Court of Appeal have accepted that proceedings before the Tribunal are not criminal. Changing the present regime so that insider dealing and other market misconduct would not attract substantial financial penalties may not be the way forward. The change is based upon an unpublished advice from counsel who is in all likelihood outside of Hong Kong. Such change will dramatically alter the effectiveness and deterrent value of proceedings before the MMT, especially for insider dealing, one of the most significant and prevalent forms of market misconduct. In addition, the change has no doubt influenced the Government to criminalize insider dealing. It is therefore recommended that the advice be publicized without disclosing the name of the counsel. Only then can the case law and arguments in the advice be properly addressed.

20. In the meantime it is recommended that the substantial financial penalty be retained under Part XIII of the Bill for the following additional reasons:

(1) Prosecutions under the Securities Ordinance for creating a false market and market manipulation have been rare.

(2) The SFC has had difficulty in gathering sufficient evidence to the criminal standard. One reason is s.33 of the SFC Ordinance which renders answers from a suspect to the SFC inadmissible in criminal proceedings if privilege is claimed. Normally, suspects are legally represented and privilege is

claimed. This sensible provision is continued under cl.170 of the Bill so that answers to the SFC will only be admissible for civil proceedings under Part XIII. It is therefore unlikely that the Bill will lead to more prosecutions for market misconduct.

(3) The lack of prosecutions under present legislation may have contributed to the decision to decriminalize market misconduct under Part XIII. However, only one route will be possible under the Bill. If the criminal route continues to be impractical, then most proceedings will take place before the MMT. In such case, an effective sanction of substantial financial penalties will not be available to the Tribunal.

(4) The new "cold Shoulder" and "cease and desist" orders together would not be as effective as substantial financial penalties.

The MMT and the Independence of the Presenting Officer

21. Under Cap. 395, the IDT conducts an "inquiry" concerning the matters referred to it by the Financial Secretary. Under Part XIII, the MMT will "have jurisdiction to hear and determine ... any question or issue ... in connection with the proceedings" instituted by the Financial Secretary with respect to alleged market misconduct (cl.235(1) and cl.236).

22. The Bill appears to signal a move away from an inquisitorial procedure by the removal of the term "inquiry" and the substitution of the more neutral expression "hear and determine". If this interpretation is correct, it is to be welcomed.

23. "Counsel of the Tribunal" under Cap. 395 will be replaced by a "Presenting Officer" appointed by the Secretary for Justice. The Officer will "conduct the

proceedings" (cl.235(4)) and present to the MMT "such available evidence" to enable the Tribunal to reach an informed decision as to alleged market misconduct (para. 15, Schedule 8). This suggests that the Presenting Officer will be more independent than Counsel to the IDT under Cap. 395. However, under para. 15, the Presenting Officer is also required to present "any evidence which the Tribunal requests him to present to it." As well, under para. 12 of the Schedule 8, the MMT may "order the Presenting Officer to provide particulars of any additional market misconduct discovered during the proceedings by a person not included in the Notice from the Financial Secretary." Accordingly, the inquisitorial nature of the proceedings has not been removed; however, it could be said that the intent of Part XIII of the Bill is to make the proceedings more adversarial in character. With the court decisions in the *Paragon* case in mind, and the amendments in the Bill, the role of the Presenting Officer should be clear. Accordingly, no further amendments are required in this regard.

Preservation of Secrecy

24. Schedule 8 of the Bill relates to the appointment of members, the Presenting Officer, and various procedural matters concerning the MMT.

25. Para. 40 of Schedule B makes an ordinary member liable to pay compensation by way of damages to any person who brings an action for sustaining pecuniary loss by the member's failure to preserve secrecy. This provision does not apply to the Chairman and appears to address the problem which arose in the *Chee Shing* inquiry. This matter has not been discussed in the Consultation Document.

26. Although para. 41 of Schedule 8 indicates that no compensation shall be paid unless it is "fair, just, and reasonable in the circumstances," para. 40 should ensure that truly dedicated and competent people from the private sector will refuse to sit

as members of the MMT. The possibility of being found liable to pay compensation (even though such breaches should not occur), will not make serving as a member an attractive proposition.

27. It is recommended that para. 40 of Schedule 8 and any related provisions be removed. They are unnecessary. The Chairman will undoubtedly bring the provisions of Clause 358 to the attention of the members.

Part XIV: Offences Relating to Securities and Futures Contracts

Criminalization of Insider Dealing

28. The MMT will have an enlarged civil jurisdiction to hear proceedings concerning insider dealing, and conduct such as stock market manipulation (cl.260), false trading in securities or future contracts (cl. 257, 262) and disclosure of false or misleading information inducing transactions in securities or future contracts (cl. 261 and 265).

29. In addition, a dual system has been created so that all civil market misconduct under Part XIII, including insider dealing, will be covered by the criminal offence provisions in Part XIV. In fact, the civil market misconduct provision under Part XIII are identically worded to the market misconduct offences under Part XIV. The SFC will initially recommend a civil or criminal route, and later, the Financial Secretary or the Secretary for Justice will make the final decision as to the course of the proceedings.

30. The rationale for criminalizing insider dealing is set out at para. 11.14 of the Consultation Document, and is summarized as follows: other jurisdictions including the U.S., the U.K. and Australia have done so; the provisions have

become familiar to participants and the Hong Kong market is experienced; and it would be inconsistent to exclude insider dealing from the dual system. Accordingly, the document concluded that it is an "appropriate time to introduce criminal sanctions to send a clear message that insider dealing would not be tolerated."

31. These reasons do not justify the criminalization of insider dealing. That other jurisdictions have adopted a dual system should not determine the position in Hong Kong. It appears that criminalization flows more from the decision to remove the present substantial financial penalties (discussed below) than from the reasons stated in para. 11.14. To date, about 10 inquiries have been conducted by the IDT and substantial penalties have been imposed. A "clear message" has already been sent to market participants. There is no evidence that insider dealing has become more prevalent or that the orders imposed by the Tribunal have not had an appropriate deterrent effect. Finally, no message will be sent to the market if insider dealing cannot be effectively investigated by the SFC and evidence gathered to the high standard required in criminal prosecutions.

Part XVI: Miscellaneous

Section 362: Intervention in Proceedings

32. We note and welcome that the Bar's comments made in August 1999 on the Consultation Paper have been taken into account in the drafting of this section which now broadly follows the Bar's proposals. It is unclear, however, as to why this section now appears under Part XVI ("Miscellaneous") and not in Division 3 ("Other powers and proceedings") of Part X ("Powers of Intervention and Proceedings").