

# The Securities and Futures Ordinance, 2002

## — Continuity and Change

Legal Services Division<sup>1</sup>

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[1] *This article is intended to be an overview of the SFO and should only be used as a general guide. We suggest that it be read together with the detailed provisions set out in the Ordinance. If you require advice regarding any of the provisions in the SFO, you should consult your professional adviser.*

## Introduction

The Securities and Futures Ordinance (Cap.571) ("SFO") is one of the most important and comprehensive pieces of legislation to be enacted in Hong Kong for many years. It is also one of the largest and because of its sheer size and coverage, and the ever-increasing sophistication of the markets it regulates, a very complex piece of legislation. With the commencement of the SFO later this year will come many important changes but the regulatory framework will also be very familiar for market participants and their advisers. In this article we aim to provide you with a road map so that you can find your way around the SFO.

Our approach in formulating this guide has been to deal with each of the major features of the legislation according to its layout in the SFO. We take you through each Part of the SFO indicating where the existing law has been incorporated and what new features have been included. In dealing with each Part we have adopted a consistent theme in its treatment - "continuity" - by summarizing how the existing law is continued; and "change" - by summarizing the changes brought about by the SFO. We list the key provisions of each Part, focusing on the new.

### The laws we know

The SFO absorbs the ten Ordinances that currently regulate the securities and futures industry in Hong Kong.<sup>2</sup> A detailed derivation table illustrating where the subject matter of many of the provisions of the

existing Ordinances is dealt with in the new SFO is available on the SFC's website. You will find most of the existing provisions (or provisions resembling them to a degree) in the SFO. Some of the more detailed or technical matters such as the provisions for regulating the handling of client assets and the keeping of accounts and records by intermediaries which are currently to be found in primary legislation in the Securities Ordinance (Cap.333) ("SO"), the Commodities Trading Ordinance (Cap. 250) ("CTO") and the Leveraged Foreign Exchange Trading Ordinance (Cap.451) ("LFETO") will be contained in subsidiary legislation under the SFO.

### All in one book

The SFO takes stock of the past, addresses the changes in the markets over the past generation and has built-in flexibility to embrace future developments. The current patchwork of laws governing the securities industry is a product of history often made in response to developments long after they had emerged. One of the underlying aims in drafting the SFO was to make it flexible to cater for the rapidly developing environment in which the markets operate and the increasingly sophisticated expectations of those who use the markets. With this in mind, many of the parts of the SFO provide a framework leaving the detail to be included in schedules or in subsidiary legislation that can be more efficiently and quickly amended to cater for market changes.

There has been some criticism that the legislation is not easy to navigate around but we say that the

[2] *Securities and Futures Commission Ordinance (Cap.24)*  
*Commodities Trading Ordinance (Cap.250)*  
*Securities Ordinance (Cap 333)*  
*Protection of Investors Ordinance (Cap.335)*  
*Stock Exchanges Unification Ordinance (Cap.361)*

*Securities and Futures (Insider Dealing) Ordinance (Cap.395)*  
*Securities and Futures (Disclosure of Interests) Ordinance (Cap.396)*  
*Securities and Futures (Clearing Houses) Ordinance (Cap.420)*  
*Leveraged Foreign Exchange Trading Ordinance (Cap.451)*  
*Exchanges and Clearing Houses (Merger) Ordinance (Cap.555)*

SFO will simplify matters for users. It locates the securities laws in a single statute giving greater accessibility, clarity and consistency.

## The layout

The SFO is divided into 17 Parts and 10 Schedules. It can be divided up broadly according to the subject of regulation as follows -

- Regulating the Commission itself - the establishment of the SFC, its regulatory objectives, functions and powers, duties, delegation and its accounting and financial arrangements - Part II
- Regulating the market operators (exchange controllers, exchange companies and clearing houses), investor compensation companies and automated trading services - Part III
- Regulating investment products and collective investment schemes - Part IV
- Regulating intermediaries -
  - (i) Licensing and registration, licensed persons, registered institutions, fitness and properness - Part V
  - (ii) Capital requirements (financial resources), client assets, keeping of accounts and records and audit relating to intermediaries and associated entities - Part VI
  - (iii) Business conduct of intermediaries, restrictions on short selling and regulating unsolicited calls - Part VII
- Monitoring and disciplining intermediaries and their representatives and listed companies -
  - (i) Supervision and investigations by the SFC - into listed companies and intermediaries and their associated entities - Part VIII
  - (ii) Discipline of licensed persons and registered persons - Part IX
  - (iii) Intervention powers and powers to initiate proceedings including applications injunctions and other orders and remedies to protect the interests of members of listed corporations - Part X
- Appeals from SFC decisions - the Securities and Futures Appeals Tribunal - Part XI
- The establishment and management of the Investor Compensation Fund - Part XII
- Taking action against market misconduct -
  - (i) The Market Misconduct Tribunal - establishment of a civil tribunal to hear cases of market misconduct and to impose civil sanctions - Part XIII
  - (ii) Market Misconduct Offences - provisions defining criminal offences and imposing criminal penalties for market misconduct which mirror the civil wrongs dealt with by the Market Misconduct Tribunal - Part XIV
- Disclosure of Interests in Listed Companies - Part XV
- Miscellaneous provisions relating to the SFC's powers - secrecy, fees and levies, statutory immunity and general rule - making power - Part XVI

The schedules help to cut down on bulk or detail in the main provisions. The Interpretation and General provisions which have universal application throughout the SFO are set out in Schedule 1. The procedural provisions for the Tribunals (the Securities and Futures Tribunal and the Market Misconduct Tribunal) established by the SFO are contained in schedules (8 and 9 respectively) as are the provisions relating to the membership and meetings of the Commission in schedule 2.

## Consolidation and Amendment

The long title of the SFO embodies the twin themes of consolidation and amendment of the network of securities laws that has developed rather haphazardly in Hong Kong over the last quarter of a century.

*"An Ordinance to consolidate and amend the law relating to financial products, the securities and futures market and the securities and futures industry, the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry, the protection of investors, and other matters incidental thereto or connected therewith, and for connected purposes"*

Keeping in mind these themes, this article will take you through the legislation and point out where the existing laws have been slotted into the new law and explain the major changes that have been adopted.

## Roadmap

### Part I - Preliminary

#### Commencement of the SFO

The SFO will come into operation once the subsidiary legislation that underpins it is enacted. We expect this to happen by the end of the year.

*Schedule 1* - all the interpretation provisions which have general application throughout the Ordinance are found in Schedule 1. Specific definitions, which apply to a particular part of the SFO, are set out in that Part. In addition, certain definitions, which apply only to a specific section, appear in that section.

## Part II - The SFC - its Constitution, Objectives, Functions, Powers and Duties

### The regulator

#### *Continuity*

This Part provides for the continuing existence of the SFC, which was established by the Securities and Futures Commission Ordinance (Cap. 24) ("SFCO"). The detailed provisions relating to the constitution and proceedings of the Commission are set out in Schedule 2. As in existing law, provision is made for the power to establish committees, the establishment of the Advisory Committee, delegation of the Commission's powers, the power of the Chief Executive to direct the SFC and the SFC's reporting and financial and accounting arrangements.

#### *Change*

For the first time the regulatory objectives of the Commission are enshrined in legislation. They are set out in section 4 -

- (a) *to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;*
- (b) *to promote understanding by the public of the operation and functioning of the securities and futures industry;*
- (c) *to provide protection for members of the public investing in or holding financial products;*
- (d) *to minimize crime and misconduct in the securities and futures industry;*
- (e) *to reduce systemic risks in the securities and futures industry; and*
- (f) *to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.*

Also new is section 6 which sets out the general duties of the Commission. This provision places an obligation on the Commission to perform its functions in a way that is compatible with and appropriate for the purpose of meeting its regulatory objectives.

### Part III - Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and ATS

#### The market operators

##### *Continuity*

The Ordinance does not change significantly the existing arrangements for the exchanges and clearing houses. The monopoly of the Stock Exchange Company of Hong Kong under the Stock Exchanges Unification Ordinance (Cap. 361) ("SEUO") is preserved.

##### *Change*

In line with technological advances, providers of automated trading services ("ATS") which are operated as a trading network along the lines of an exchange, will in the future be able to apply for authorization under this Part. ATS providers whose activities are more akin to dealing will be regulated under Part V.

Provision is made for the recognition and regulation of a new Investor Compensation Company which will administer a new investor compensation scheme to be established under Part XII of the SFO.

#### *Key Provisions*

##### Exchange Companies - Division 2

- *Who can operate an exchange*

Section 19 prohibits a person from operating a stock market unless it is the Stock Exchange Company, a recognized exchange company controlled by the same exchange controller<sup>3</sup> controlling the Stock Exchange Company, or that controller where it is itself a recognized exchange company. No one may operate a futures market unless the person is a recognized exchange company. In section 5 of Schedule 10 it is provided that both the Stock Exchange Company and the Futures Exchange Company are deemed to be recognized under section 19.

- *Duties and immunity*

This division sets out the duties of a recognized exchange company and confers immunity on such a company and persons acting on its behalf in respect of anything done or omitted to be done in good faith in the discharge or purported discharge of its duties.<sup>4</sup> There is also provision for withdrawal of recognition in certain circumstances.<sup>5</sup>

- *Listing Rules*

The recognized exchange company is given the power to make non-statutory rules relating to the listing of securities on the stock market operated by it but these and any amendments to them are subject to the approval of the SFC.<sup>6</sup>

- *Rules by the SFC on listing and the exchanges*

The SFC may also make rules in respect of the listing of securities, exchange participants and certain

[3] *Hong Kong Exchanges and Clearing Limited ("HKEx")*

[4] *Section 22*

[5] *Section 28*

[6] *Sections 23 and 24*

matters regarding the discharge of their functions by a recognized exchange company.<sup>7</sup> These provisions are derived from the SEUO and the CTO, in relation to the futures market.

#### Clearing Houses - Division 3

- *Recognition*

This Division contains provision for recognition of a company as a clearing house by the SFC<sup>8</sup> and withdrawal of this recognition in certain circumstances,<sup>9</sup> the company's duties and immunity in the performance of those duties<sup>10</sup> and a power to make rules, subject to the approval of the SFC.<sup>11</sup> These are drawn from the Securities and Futures (Clearing Houses) Ordinance (Cap.420).

- *Priority to the clearing house in insolvency*

The statutory priority of proceedings of a recognized clearing house over the law of insolvency<sup>12</sup> and the provisions relating to default proceedings,<sup>13</sup> adjustment of prior transactions,<sup>14</sup> application of market collateral<sup>15</sup> and enforcement of judgments<sup>16</sup> are retained.

#### Exchange Controllers - Division 4

- *Recognition*

Regulation of these companies generally tracks the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555). A company cannot be an exchange controller unless recognized by the SFC.<sup>17</sup> Such recognition can be withdrawn in certain circumstances.<sup>18</sup>

- *Controlling and minority interests in controllers or exchange companies*

The SFC's approval is required before an interest of a recognized exchange controller in a recognized exchange company or clearing house is increased or decreased or a person becomes a minority controller of an exchange controller, recognized exchange company or recognized clearing house.<sup>19</sup> HKEx is the only exchange controller in existence and is deemed under section 10 of Schedule 10 to be recognized under Division 4 of Part III.

#### Investor Compensation Companies - Division 5

- *Background*

The SFO introduces a new investor compensation regime to replace the existing schemes set up under the SO (the Unified Exchange Compensation Fund) and the CTO (the Futures Exchange Compensation Fund). Under the existing arrangements, the relevant recognized exchange companies receive and determine claims for compensation.

- *Recognition of Investor Compensation Companies*

The new provisions in Division 5 of Part III enable the recognition of a company as an Investor Compensation Company ("ICC") by the SFC.<sup>20</sup> The ICC is to manage and administer the compensation fund to be established under Part XII. As with the other recognized market companies, the Commission has the power to withdraw recognition on certain grounds.<sup>21</sup>

[7] Section 36

[8] Section 37

[9] Section 43

[10] Sections 38 and 39

[11] Sections 40 and 41

[12] Section 45

[13] Sections 46 - 48

[14] Section 50

[15] Section 52

[16] Section 53

[17] Section 59

[18] Section 72

[19] Sections 60 and 61

[20] Section 79

[21] Section 85

- *Transfer of functions to ICC*

The Commission may request the CE in Council to make an order transferring any of the SFC's functions in Part XII or rules made under it relating to the compensation fund to a designated recognized ICC.<sup>22</sup> Such transferred functions may be resumed by the Commission following the same procedure.

#### Additional checks on the operators - Division 6

- *Restriction notices and suspension orders*

The existing powers of the SFC to issue restriction notices and suspension orders to recognized exchange companies, clearing houses and exchange controllers are preserved here and extended to ICCs.

#### Automated Trading Services - Division 7

- *Authorization of Automated Trading Services*

The SFO addresses the reality of electronic trading networks with provision for the authorization by the SFC of providers of ATS.

- *Targeting the Hong Kong market without authorization prohibited*

The provision or offer of provision of ATS by actively marketing (whether in Hong Kong or elsewhere) such services to persons in Hong Kong without authorization is prohibited.<sup>23</sup>

- *Withdrawal of authorization*

The SFC may in the interest of the investing public or the public interest withdraw any authorization granted and is empowered to make rules relating to the provision of ATS.

## Part IV - Offers of Investment

### The public and investment products

#### *Continuity*

This part of the Ordinance builds on the Protection of Investors Ordinance (Cap. 335) ("PIO") which prohibits the issue to the public of advertisements and documents relating to a wide range of investment products unless authorized by the SFC. It also carries forward section 15 of the SO which provides for the authorization by the SFC of unit trusts and mutual fund corporations.

#### *Change*

A new term "collective investment scheme" is introduced to embrace the concepts of unit trusts, mutual funds and investment arrangements in existing law which overlap to a certain degree. In addition, it is intended that this term will be flexible enough to capture new products and ensure they are regulated appropriately without the need to change the law.

#### *Key Provisions*

- *Authorization requirement for public advertisements, invitations and documents relating to investments.*

This is subject to a number of exemptions which are essentially taken from the PIO such as prospectuses complying with the Companies Ordinance (Cap.32) ("CO") and advertisements, invitations or documents issued by licensed persons. The existing defence for sellers or publishers of newspapers and other publication containing an advertisement subject to the authorization requirement is substantially expanded. It also exempts conduits and live broadcasters who issue any prohibited material in the ordinary course of their

[22] Section 80

[23] Section 95

business, without control over or modifying the contents of such material.

- *Authorization of investment products*

The existing power of the SFC under section 15 of the SO to approve unit trusts and mutual fund corporations is elaborated on here with an express power for the SFC to approve such products and also to impose requirements on the products as appropriate. The SFC is now also expressly empowered to withdraw any authorization granted in respect of an investment product.

- *Fraudulent or reckless misrepresentations to induce others to invest money*

The prohibition against such misrepresentations and the related offence provisions, together with the clear private right of action for investors who suffer loss as result of such misrepresentations are transported from the PIO.

## Part V - Licensing and Registration

### A single license, 9 regulated activities

#### *Continuity*

Persons who carry on business in a regulated activity will still need a licence and must be fit and proper. If licensed under existing law, a registrant will be deemed to be registered under the SFO and under the transitional arrangements set out in Schedule 10, will have two years to apply for a licence under the new arrangements.

#### *Change*

One of the major innovations of the SFO is the restructuring of the existing licensing system which is currently spread across 4 Ordinances including

[24] *There will continue to be a single business requirement for securities margin financiers - Section 118(1)(d)*

[25] *Dealing in securities, Dealing in futures contracts, Leveraged foreign exchange trading, Advising on securities, Advising on futures contracts, Advising on corporate finance, Providing automated trading services, Securities margin financing, Asset management*

[26] *Section 142*

the SO for the registration of securities dealers, investment advisers, securities margin financiers<sup>24</sup> and their representatives, the CTO for dealers in futures contracts, futures contracts advisers and their representatives and the LFETO for leveraged foreign exchange traders, as well as the Banking Ordinance (Cap. 155) ("BO"), for exempt dealers. Under the present law, intermediaries must apply separately to be registered for each type of activity in which they wish to engage. Now, there will be only one licence, which will be endorsed with the regulated activities in which the licensed person is permitted to engage.

#### *Key Provisions*

- *Regulated activities*

The nine regulated activities are set out and defined in Schedule 5<sup>25</sup> which may be amended by the Financial Secretary by notice in the Gazette<sup>26</sup> to cater for future developments in the industry. There are some new categories, namely, advising on corporate finance, asset management services and providing ATS. Only the last is a new activity (see below) as the others have been separated out from existing activities which may be carried on by a registered or exempt investment adviser under the SO. The remaining definitions of regulated activities are substantially the same as in the current law.

- *Automated trading services*

Developments in the market brought about by technological advancement have necessitated the creation of a new category of regulated activity to deal with the provision of ATS. Now, depending on the manner in which such providers conduct their business, they will be required either to obtain a licence under Part V or to seek authorization under Part III.



- *Licences for partnerships and sole-proprietorships will be phased out*

There will be two types of licences - corporate licences for corporations that carry on business in any of the regulated activities<sup>27</sup> and representative licences for individuals who perform or take part in any regulated activity for or on behalf of a licensed corporation.<sup>28</sup> Under the new licensing regime only corporations may be licensed to carry on business in a regulated activity.<sup>29</sup> Sole-proprietorships and partnerships will no longer be able to apply for licences. Transitional arrangements for the phasing out of these licences over a two-year period are made in Schedule 10.

- *Registered institutions*

For the first time, authorized financial institutions (including banks) are required to be registered with the SFC if they wish to carry on one or more regulated activities (other than leveraged foreign exchange trading or providing securities margin finance). Under the SO, such institutions were exempted from the need to apply for a licence to deal in securities or to engage in investment advice and were outside the regulatory purview of the SFC. Instead, the HKMA was the front-line regulator. Now they will be regulated by the SFC and the HKMA jointly. Registered institutions and their representatives must also satisfy the "fitness and properness" requirements established by the SFC which will be considered and determined by the HKMA in their case.<sup>30</sup>

- *Exemptions and exclusions*

Under existing law, there are other groups of persons (as well as banks, who are no longer exempt) who are excluded from the registration requirement and

some of these (and others) continue to be excluded under the SFO in definitions of regulated activities in Part 2 of Schedule 5. Professional accountants and solicitors will continue to be excluded where they are providing advice wholly incidental to their profession as will trustee companies but to a lesser extent than under existing law. The exemption will only be available where they are providing advice or services wholly incidental to their overall trustee business.

- *Responsible officers*

A "responsible officer" concept is introduced with the requirement for any officer of the company who actively participates in, or supervises, the regulated activities of the company to be registered with the SFC as a "responsible officer", directly responsible for supervising the conduct of the regulated activities of the licensed corporation.<sup>31</sup> Every executive director<sup>32</sup> of the licensed corporation who actively participates in or is responsible for directly supervising the business for which the company is licensed, and at least two individuals, one of whom must be an executive director has to be approved by the SFC as a responsible officer.<sup>33</sup>

- *Temporary licences*

A further innovation is the power for the SFC to grant temporary licenses to corporations and to representatives who principally carry on business outside Hong Kong to conduct regulated activities in Hong Kong for a short period.<sup>34</sup>

- *Provisional licences*

In addition, there is provision for representatives to be given provisional licences pending the outcome of the approval of their application for a full licence.<sup>35</sup>

[27] Section 116

[28] Section 120

[29] Section 114

[30] Section 129

[31] Section 126

[32] Definition of "executive director" - section 113(1)

[33] Section 125

[34] Sections 117 and 121

[35] Section 120(2)

- *Fitness and propriety*

Those who apply under this Part to be licensed or registered must satisfy the SFC and the HKMA, if an authorized financial institution, of their fitness and propriety. Section 129 sets out the criteria that should be taken into account by the SFC and the HKMA in assessing fitness and propriety.

## Part VI - Capital Requirements, Client Assets, Records and Audit Relating to Intermediaries

### The ongoing operational requirements

#### *Continuity*

Provision for the financial resources of licensed corporations, the handling of client assets by intermediaries, the keeping of accounts and records and auditing requirements is currently spread across the SO, the CTO and the LFETO.

#### *Change*

The structure for these requirements is different to that in current law which prescribes the detailed requirements in primary legislation. Part VI only seeks to establish a framework, leaving the detailed requirements to be contained in subsidiary legislation to be made by the Commission.

#### *Key Provisions*

- *Capital requirements*

The financial resources of licensed corporations will be provided for in subsidiary legislation which will be based on the existing Financial Resources Rules ("FRRs") made under the SFCO and incorporating the LFETO FRRs.

[36] Section 157

[37] Section 158

- *Client assets*

The SFC is empowered to make rules regarding the dealing with and holding of client securities and collateral and client money. There will be two sets of rules, one dealing with client securities and the other dealing with client money.

- *Record keeping by intermediaries*

Division 4 of this Part provides the framework for rules for the keeping of accounts and records by intermediaries and associated entities (see below) and the preparation and provision to clients of contract notes, receipts and statements of account.

- *Audit*

Division 5 tracks sections 87 to 96 of the SO relating to the appointment of auditors. A licensed corporation is required to appoint an auditor and at the same time there is a power for the SFC to appoint its own auditor where it is concerned that there has been a certain failure on the part of the licensed corporation or on the request of a client. Auditors are encouraged to report any irregularities to the SFC in good faith<sup>36</sup> and this attracts immunity.<sup>37</sup>

- *Associated entities*

The concept of "associated entity" is introduced for the purpose of extending the requirements set out in this Part and in rules made under it to associated entities of intermediaries. An associated entity is defined in Schedule 1 to mean a company (or an overseas company complying with the provisions of Part XI of the CO) which -

- (a) is in a controlling entity relationship with an intermediary; and
- (b) receives or holds in Hong Kong client assets of the intermediary.

A "controlling entity relationship" is also defined in Schedule 1 as existing between two companies, if one has a certain degree of control over the vote, the board or an interest in shares carrying certain controlling rights in the other.

This will rectify the apparent regulatory gap in section 81 of the SO whereby a securities dealer can discharge his obligation to his client in respect of that client's securities held in the dealer's safe custody in Hong Kong by registering those securities in the name of his nominee. Under the new regime, with certain exceptions and limitations, an associated entity would be subject to the same set of rules as an intermediary. The regulatory intention is for the associated entities to match the standards to be expected from the intermediaries, thereby according a greater degree of protection to investors.

- *Registered institutions*

Most of the Part VI requirements will apply to registered institutions to the extent that they relate to the regulated activities conducted by them, but there are exceptions in relation to the FRRs and the submission of audited accounts, which are already covered by requirements under the BO.

## Part VII – Business Conduct of Intermediaries

### The ongoing requirements made of intermediaries and their representatives in conducting their business

#### *Continuity*

Under the existing regime, the only business conduct requirements that are found in subsidiary legislation are those applicable to leveraged foreign exchange

traders. All other business conduct requirements are set out in non-statutory codes of conduct.

#### *Change*

The Commission now has the power to make business conduct rules and issue codes of conduct, breach of which will go to fitness and properness, in relation to all intermediaries, including registered institutions, and their representatives.

#### *Key Provisions*

- *Conduct of intermediaries - rules and codes*

The requirements for the conduct of intermediaries and their representatives may be set out either in subsidiary legislation made under section 168 or in non-statutory codes of conduct published in the Gazette under section 169. Section 168 sets out in detail specific areas in which business conduct requirements may be made. However the SFC is not limited to these areas and is able to make other requirements where there is a need to regulate. These matters apply to both rules and codes.

- *Sanctions*

Breach of the rules is subject to criminal sanctions<sup>38</sup> and breach of any code of conduct may be taken into account in determining fitness and properness.<sup>39</sup>

- *Short selling*

The restrictions on short selling<sup>40</sup> essentially reiterate the requirements on short selling which appear in sections 80, 80A, 80B and 80C of the SO.

- *Options trading*

The SFC is able to make rules prohibiting options trading except for exchange-traded options (i.e. stock options traded on the exchange) as in section 76(1) (a) of the SO.<sup>41</sup>

[38] Section 168(4)

[39] Section 169(4)

[40] Sections 170-172

[41] Section 173

- *Cold calling*

Cold calling is prohibited unless excluded.<sup>42</sup> This provision is based largely on section 39 of the LFETO concerning cold calling. In addition to exclusions for calls to solicitors, accountants or existing clients, there is provision for other exclusions to be made in rules.<sup>43</sup>

## Part VIII - Supervision and Investigations

### Gathering information - the SFC's inquiry, inspection, surveillance and investigatory powers

#### *Continuity*

Part VIII principally consolidates existing provisions on the SFC's supervision and investigation powers in the SFCO and the LFETO and standardizes some features of such powers. This has involved some reorganisation of existing provisions. While the new provisions do not always appear to be exactly like the existing ones, they retain the same substance in most major respects.

#### *Change*

Significant reforms are mainly confined to preliminary inquiries into listed corporations, supervisory inspections of intermediaries and their associated entities, and investigations into possible grounds for disciplinary action against intermediaries and those involved in their management.

#### *Key Provisions*

- *Power to require production of records and documents concerning listed corporations*

Section 179 is derived from section 29A of the SFCO which enables the SFC to conduct a relatively quick

and limited preliminary inquiry into suspected crime and misconduct in a listed company to protect the interests of the investing public. Section 29A of the SFCO empowers the SFC to obtain documents from the listed company under inquiry and its group companies, as well as explanation of such documents from past and present officers and employees of those companies. The new provision will extend the SFC's power to obtain documents and explanations to the parties most closely connected with the listed corporation concerned and its group corporations: their banks, auditors and transaction counter parties.<sup>44</sup> It is now clear that the SFC may also require an explanation of a document, its contents and the surrounding circumstances.<sup>45</sup>

- *Supervision of intermediaries and their associated entities*

Section 180 builds on section 30 of the SFCO and section 41 of the LFETO which currently enable the SFC to conduct supervisory inspections of licensed intermediaries to ensure that they comply with regulatory requirements. Now the SFC's supervisory powers cover associated entities of intermediaries. This aligns Part VIII with Parts VI-VII of the SFO. Banks are subject to supervision under this section but this is carried out by the HKMA as the relevant authority for conducting supervisory inspections of registered institutions and their associated entities.<sup>46</sup> The provision also clarifies and, in some minor respects, extends the SFC's existing power to obtain information from third parties where it is relevant to the inspection.<sup>47</sup>

- *Investigations and conduct of investigations*

Section 33 of the SFCO and section 44 of the LFETO which give the SFC its main investigation powers are largely reproduced in sections 182 and 183. Under

[42] Section 174

[43] Section 174(3)

[44] Section 179(1)(iii)-(v)

[45] Section 179(2)

[46] Section 180(17)

[47] Section 180(1)(c)(iii)

these powers, the SFC may require documents, explanations of documents, answers to questions during interviews and other reasonable assistance. Two new grounds in section 182<sup>48</sup> for the commencement of an investigation now enable the SFC to investigate any form of possible market misconduct and possible grounds for disciplinary proceedings under Part IX. The SFC is also now empowered to investigate non-compliance with conditions imposed in respect of collective investment schemes.

- *Use of incriminating evidence gathered in investigations*

The privilege against self-incrimination is preserved in section 187 which is based on section 33(6) of the SFCO. Incriminating evidence provided in the course of an investigation into the affairs of a listed company or under section 182 may not be used against the person providing the information in criminal proceedings other than those under certain provisions relating to the provision of false or misleading information or non-compliance with requirements to provide information and perjury.

- *Certification to Court of First Instance relating to non-compliance with requirements*

Division 4 contains a number of provisions most of which concern matters ancillary to the exercise of the SFC's inquiry, inspection, surveillance and investigation powers in Divisions 2 and 3. The key provisions are mostly taken from the SFCO and include a power of application by the SFC to the Court of First Instance for an order requiring compliance with the SFC's requirements under the Part VIII provisions.<sup>49</sup>

[48] Section 182(1)(c) and (e)

[49] Section 185

[50] Section 194(2)

[51] Section 194(1)(i)

[52] Section 194(1)(iv)

## Part IX - Discipline

### A broader range of proportionate disciplinary sanctions

#### *Continuity*

The current provisions governing the SFC's power to discipline securities and futures dealers and leveraged foreign exchange traders for misconduct or for conduct that reflects on their fitness and properness are dispersed over the SO, the CTO and the LFETO. Under these laws, the SFC is empowered, privately or publicly, to reprimand registered persons, as well as to suspend or revoke their licences. These sanctions are preserved (with some modifications) and substantially supplemented in the SFO.

#### *Change*

Under the Ordinance, new and intermediate sanctions will be available and the SFC will have greater flexibility in tailoring appropriate sanctions for improper conduct. The SFC will now be able to penalize improper conduct more effectively and fairly with the introduction of civil fines of up to HK\$10 million or 3 times the profit gained or loss avoided as a result of the misconduct,<sup>50</sup> and to suspend or revoke a licence in respect of part of a licensee's business.<sup>51</sup> The SFC will also be able to impose prohibition orders on those who have engaged in misconduct thus, for example, preventing them from applying to be licensed or registered, or to be approved as a responsible officer of a licensed corporation for a specified period.<sup>52</sup> One of the major changes to be brought about in this Part is the full application of the disciplinary regime to banks.

### *Key Provisions*

- *Misconduct*

"Misconduct" is defined as a contravention of the SFO, any of the subsidiary legislation made under it, any licence issued or registration made under the SFO, any condition imposed under the SFO or certain provisions of the BO or conduct prejudicial to the interest of the investing public or the public interest.<sup>53</sup>

- *Discipline of licensed persons*

Licensed persons, their responsible officers or those involved in their management who are guilty of misconduct or not fit and proper will be subject to the full range of disciplinary measures under section 194.

- *Discipline of registered institutions*

Any bank, executive officer or a person involved in the management of the bank's regulated business, or an individual named in the bank's register as conducting a regulated activity on its behalf who is guilty of misconduct or not fit and proper, will be subject to the full range of disciplinary measures under section 196.

- *Due Process*

Section 198 prescribes the requisite procedural requirements for the exercise of the disciplinary powers under this Part. In order to ensure that any disciplinary decision is informed, balanced and transparent, the SFC must provide the relevant party an opportunity of being heard before coming to the final decision and give written notice of and the reasons for any disciplinary decision.

- *Fining guidelines*

Section 199 provides for the publication of fining guidelines which must be adhered to by the SFC in imposing pecuniary penalties under this Part.

- *Appeal*

Finally, any party aggrieved by any of the disciplinary decisions of the SFC can appeal to the Securities and Futures Appeals Tribunal (see Part XI below).

## **Part X - Powers of Intervention and Proceedings**

### **Taking action to protect investors' interests**

#### *Continuity*

Part X builds on the existing powers of the SFC in sections 38 to 43 of the SFCO to intervene in the business or affairs of licensed corporations. Also retained are the powers of the SFC to apply to the courts for certain orders including injunctive orders against those guilty of contraventions of the securities laws, against listed corporations in cases of unfair prejudice against minority shareholders and winding up or bankruptcy orders in the public interest. These powers are currently set out in sections 37A, 45, 46 and 55 of the SFCO and section 144 of the SO.

#### *Change*

A new power is conferred on the SFC to seek the court's assistance in compelling compliance with a prohibition or requirement set out in a restriction notice served under sections 204-206 and 208 where this has not occurred. The Court of First Instance ("CFI") may, if it is satisfied that the failure is without reasonable excuse, punish a person for such non-compliance. This provision is similar to section 33 (13) of the SFCO. The SFC's power to seek injunctions and other orders under sections 55 of the SFCO and 144 of the SO is expanded so that such orders may also be sought against persons who have aided, abetted or induced contraventions. The range of orders that may be sought is also expanded.

[53] Section 193(1)

### *Key Provisions*

- *Restriction notices*

The SFC can issue restriction notices to restrict the business activities of a licensed corporation<sup>54</sup> or to prevent a licensed corporation from disposing of or dealing with property held on behalf of clients<sup>55</sup> or to require a licensed corporation to maintain specified property in Hong Kong or elsewhere.<sup>56</sup> These powers are designed to freeze assets of the licensed corporation and prevent any further dissipation through further trading in circumstances where client property is at risk or the licensed corporation has contravened the legal requirements or any other circumstances specified in section 207.

- *Certification proceedings*

The power to apply to the CFI in case of non-compliance with restriction notices is also set out in Division 1 of this Part.<sup>57</sup>

- *Application for injunctive orders*

A variety of orders may be sought by the SFC where contraventions have occurred or are likely to occur, including injunctive orders to prevent the contraventions or further occurrences and orders appointing an administrator.<sup>58</sup>

- *Application for remedies against listed corporations*

The SFC may apply to the CFI for various orders where the business or affairs of a listed corporation have been conducted oppressively, fraudulently or in a manner which is unfairly prejudicial to its members.<sup>59</sup> This is based on Section 37A of the SFCO.

[54] Section 204

[55] Section 205

[56] Section 206

[57] Section 211

## **Part XI - The Securities and Futures Appeals Tribunal**

### **A powerful safeguard to ensure balance and fairness**

#### *Continuity*

At present, persons (other than exempt dealers) may appeal certain SFC decisions concerning licensing, discipline and restrictions on licensed persons' business to the Securities and Futures Appeals Panel. This Part is derived from these existing appeal provisions under Part III of the SFCO.

#### *Change*

The Ordinance replaces the existing part-time Panel with an independent full-time appeals body, chaired by a judge. A wider range of the SFC's decisions will be subject to review by the Securities and Futures Appeals Tribunal. The Tribunal's jurisdiction will also cover appeals from decisions of the SFC and HKMA concerning registered institutions under the SFC.

#### *Key Provisions*

- *The Securities and Futures Appeals Tribunal*

The Securities and Futures Appeals Tribunal (the "SFAT") is made up of three members, including a judge as Chairman and two lay members.<sup>60</sup> The SFAT's constitution and basic procedural matters are provided for in Part 1 of Schedule 8. The Chief Executive may establish additional tribunals under this jurisdiction if necessary.<sup>61</sup>

[58] Section 213

[59] Section 214

[60] Section 216(2)-(3)

[61] Section 216(5)

- *Specified decisions*

The matters over which the SFAT has jurisdiction are specified in Part 2 of Schedule 8 and are defined as "specified decisions".<sup>62</sup> These include certain decisions made by the HKMA and will also include appeals from SFC or Investor Compensation Company decisions on the quantum of investor compensation awards.

- *Decisions of the SFAT*

Upon review of the decision under appeal, the Tribunal may confirm, vary or set aside the decision or substitute any other decision which the Tribunal considers more appropriate or it may remit the matter to the SFC with directions to revisit the decision.<sup>63</sup> Before making a decision, the SFAT must give the parties a reasonable opportunity of being heard and the civil standard of proof will apply in the determination of any questions or issues by the Tribunal.<sup>64</sup>

- *Applications for review*

An application for review of a specified decision must be made by the person against whom the decision is made within 21 days of notice of the decision. The SFAT has a power to extend the time for appeal if it is satisfied that there is good reason for granting an extension.<sup>65</sup>

- *The SFAT's powers*

The SFAT has extensive powers to consider any material, require witnesses to attend and testify or produce evidence, administer oaths and affirmations, prohibit the disclosure of information about SFAT proceedings, to stay proceedings and make other ancillary orders.<sup>66</sup> It is a criminal offence to disobey an SFAT order or to interfere with or disrupt SFAT proceedings.<sup>67</sup> The SFAT has the same powers as the CFI to punish contempt of the Tribunal.<sup>68</sup>

[62] Section 215

[63] Section 218(2)-(4)

[64] Section 218(5)&(7)

[65] Section 217

[66] Section 219(1)

[67] Section 219(2)

[68] Section 221

[69] Section 229

[70] Section 230

- *Appeal from SFAT decisions*

A party to a review has a right of appeal to the Court of Appeal ("CA") against a decision of the SFAT on a point of law. The CA may allow or dismiss the appeal or remit the matter to the SFAT with such directions as it considers appropriate.<sup>69</sup> An appeal to the CA from an SFAT decision does not operate as a stay of execution of that decision unless the CA otherwise orders.<sup>70</sup>

## Part XII - Investor Compensation

### A new single compensation fund

#### *Continuity*

Arrangements are already in place under existing law for the compensation of investors who suffer loss as a result of defaults by securities and futures dealers who are exchange participants. The existing funds, the Unified Exchange Compensation Fund ("UECF") and the Futures Exchange Compensation Fund ("FECF") will be replaced by a new investor compensation fund but the basis for making claims will largely follow existing arrangements. The existing funds will continue in operation until the new fund is in place and all claims against them have been settled.

#### *Change*

The Ordinance puts in place a framework for a single Investor Compensation Fund ("ICF") with extended coverage to defaults by a wider range of intermediaries including non-exchange participants. The new compensation scheme will have a limit of compensation per investor instead of the statutory per broker limit which currently applies regardless of the size of the losses or the number of investors claiming compensation in respect of the default.



### *Key Provisions*

- *Funding*

Initial funding will come from a transfer of assets in the UECF and the FECF leaving sufficient funds behind to cover outstanding claims.<sup>71</sup> Provision for these and other transitional arrangements is made in sections 73 to 76 of Schedule 10.

- *Accounts and investment of monies*

The SFC must deposit all amounts in the ICF with an authorised financial institution.<sup>72</sup> It is required to keep proper accounts<sup>73</sup> and is empowered to invest the monies in a specified manner.<sup>74</sup>

- *Payments out of the ICF*

Payments that can be made out of the ICF include administration expenses, relevant legal expenses, insurance and the amounts of claims.<sup>75</sup>

- *Subrogation*

Provision is made for the SFC to be subrogated to the rights of claimants to the extent of compensation payments made to the claimants.<sup>76</sup> There is a matching subrogation provision in section 87 (in Part III) in favour of an ICC.

- *Rules for funding the scheme and providing for the maximum amount of compensation*

The CE in Council may make rules to provide for the means of funding the compensation fund and the maximum amount of compensation.<sup>77</sup>

- *Rules by the SFC*

The SFC may make rules to provide for the making of claims, excluding certain persons from the right to compensation, determination and payment of compensation and the requisite procedures and systems and other related matters.<sup>78</sup>

[71] Section 237  
[72] Section 239  
[73] Section 240  
[74] Section 241

[75] Section 242  
[76] Section 243  
[77] Section 244(1)

[78] Section 244(2)  
[79] Section 251(2)-(5)  
[80] Section 252(1) and (2)

## **Part XIII - The Market Misconduct Tribunal**

### **A civil system to address market misconduct**

#### *Continuity*

The work of the civil Insider Dealing Tribunal (the "IDT") established under the Securities and Futures (Insider Dealing) Ordinance (Cap. 395) ("S(ID)O") will be built upon with the establishment of the Market Misconduct Tribunal ("MMT"). Its composition, procedures and powers which will largely emulate those of the IDT.

#### *Change*

An expanded civil market misconduct regime is established to deal with all types of market misconduct, not just insider dealing, armed with a wider range of sanctions.

#### *Key Provisions*

- *The Market Misconduct Tribunal*

Divisions 2 and 3 of Part XIII and Schedule 9 describe the composition, procedures and powers of the proposed MMT. The MMT will be chaired by a judge assisted by two members and a presenting officer appointed by the Secretary for Justice will conduct proceedings.<sup>79</sup> Schedule 9 sets out provisions governing the composition of the Tribunal and the procedures to be followed by the MMT. These cover the appointment of members, the procedures for hearings and powers to direct attendance at preliminary conferences and to make consent orders.

- *Initiating proceedings before the MMT*

The Financial Secretary will institute proceedings before the MMT following a report of suspected market misconduct by the SFC or following a referral from the Secretary for Justice.<sup>80</sup>

- *Proceedings of the MMT*

The principal function of the MMT will be to decide whether or not market misconduct has taken place, and if so, to identify the person or persons who engaged in it. The MMT will also determine whether a profit was gained or loss avoided as a result of the market misconduct and calculate the amount.<sup>81</sup> The MMT will only be able to identify someone as having engaged in market misconduct if they have been granted a reasonable opportunity to be heard.<sup>82</sup> The MMT will sit in public unless it decides that, in the interests of justice, all or part of a sitting will be held in private.

- *Evidence before the MMT*

Like the IDT, the MMT will have powers to receive any evidence, whether or not admissible in civil or criminal proceedings, to compel the giving of evidence including testimony on oath or affirmation, to prohibit the publication of information about evidence the MMT receives or any part of any MMT proceedings conducted in private.<sup>83</sup> The MMT will make its findings on the civil standard of proof.<sup>84</sup>

- *Orders of the MMT*

At the end of proceedings, the MMT will be able to impose the following sanctions on those persons it identifies as having engaged in market misconduct under section 257-

- (a) an order prohibiting involvement in the management of a listed corporation or any other specified corporation for a period of up to 5 years ("disqualification order");
- (b) an order that the person must not trade in financial products which the SFC regulates, for a period of up to five years ("cold shoulder order");
- (c) an order that the person must not again engage in any specified form of market misconduct ("cease and desist order");
- (d) an order for the payment of any profit gained or loss avoided by that person as a result of the market misconduct ("disgorgement order");
- (e) an order that the person pay to the Government its expenses in relation to the proceedings and any investigation ("Government costs order");
- (f) an order that the person pay the SFC's expenses ("SFC costs order"); and
- (g) an order recommending disciplinary action by any relevant professional body of which the person is a member ("disciplinary referral order").

Disgorgement orders, disqualification orders and Government costs orders are all modelled on orders which the IDT may presently impose in relation to insider dealing (sections 23(1)(a) and (b) and 27 of the S(ID)O). Failure to comply with a disqualification, cold shoulder or cease and desist order will be a criminal offence punishable by a maximum \$1 million fine and/or 2 years' imprisonment.<sup>85</sup>

- *Market misconduct defined*<sup>86</sup>

"Market misconduct" is -

- (i) insider dealing,
- (ii) false trading within the meaning of section 274,
- (iii) price rigging within the meaning of section 275,
- (iv) disclosure of information about prohibited transactions within the meaning of section 276,

[81] Section 252(3) and (4)

[82] Section 252(6)

[83] Section 253

[84] Section 252(7)

[85] Section 257(10)

[86] Section 245(1)

- (v) disclosure of false and misleading information inducing transactions within the meaning of section 277, and
- (vi) stock market manipulation within the meaning of section 278.

- *Insider dealing (section 270)*

The insider dealing provisions are based on the existing provisions in sections 9-12 of the S(ID)O and their supporting definitions in sections 2 and 4-8 of that Ordinance. Division 4 repeats the substance of the existing insider dealing provisions with some rewording and clarification of the defence provisions. The other major changes to the insider dealing provisions have occurred through changes to the supporting definitions. Those changes are:

- (a) the insider dealing provisions will in future apply to dealing not only in securities that are issued and listed, but also to unissued and/or unlisted securities of a company that is already listed;<sup>87</sup>
- (b) the insider dealing provisions will in future apply to inside information not only about the relevant corporation but also information about a shareholder or officer of the corporation or about the listed securities of the corporation or their derivatives, matters which may also impact upon the price of the listed securities;<sup>88</sup>
- (c) a person who holds or has an interest in 5% or more of the share capital of a corporation will be regarded as a substantial shareholder for the purposes of determining who is an insider (connected with a corporation),

consistent with the changes to the regime for disclosure of interests in the capital of a listed corporation in Part XV.<sup>89</sup>

Insider dealing is defined in section 270 and certain defences are set out in sections 271- 273.

- *Insider dealing defences (sections 271-273)*

The defences to the insider dealing provisions are derived from existing law in sections 10-12 of the S(ID)O. However, the provisions are somewhat differently worded and their layout altered slightly to make them clearer. Two new defences are added. The first<sup>90</sup> is to cover a person who introduces for the purposes of trading a third party to a person whom the third party knows or should know is an insider . The second is based on paragraphs 3 and 4 of Schedule 1 to the UK Criminal Justice Act and provides a defence to a person who trades with knowledge of his own trading intentions or activities and also to those who simply execute or facilitate the trade on his behalf.<sup>91</sup> The new defence caters for the situation in which a person, whose trading intentions or activities might be price sensitive information (e.g. a substantial shareholder and therefore a connected person), increases his stake in a listed company. Without such a defence, such a person might otherwise be prohibited from trading.

- *False trading (section 274)*

False trading occurs when a person -

- (i) intentionally or recklessly engages in conduct which creates a false or misleading appearance of active trading or with respect to the price of, or market for, securities traded on a recognised market or through an authorized ATS;<sup>92</sup>

[87] Section 245(2) - definition of "listed securities"

[88] Section 245(2) - definition of "relevant information"

[89] Section 247(3)

[90] Section 271(7)

[91] Section 271(8) and (10)

[92] Section 274(1)

- (ii) engages in similar conduct in Hong Kong affecting securities or futures contracts traded on a relevant overseas market;<sup>93</sup>
- (iii) intentionally or recklessly is involved in transactions to create an artificial price for securities traded on a recognized market or through an authorized ATS;<sup>94</sup>
- (iv) engages in conduct similar to (iii) in Hong Kong which affects securities or futures contracts traded on a relevant overseas market;<sup>95</sup>
- (v) intentionally or recklessly enters into transactions known as "wash sales"<sup>96</sup> and "matched orders".<sup>97 98</sup>

- *Price rigging (section 275)*

Price rigging occurs when a person -

- (i) engages in a wash sale of securities which has the effect of maintaining, increasing, reducing, stabilizing or causing fluctuations in the price of securities traded on a relevant recognized market or through an authorized ATS;<sup>99</sup> or
- (ii) in Hong Kong or elsewhere, engages in any fictitious or artificial transaction or device with the intention that, or being reckless as to whether, it has the effect of maintaining, increasing, reducing, stabilizing or causing fluctuations in, the price of securities or futures contracts traded on a relevant recognised market or through an authorized ATS.<sup>100</sup>

The same conduct by a person in Hong Kong, which affects securities or futures contracts traded on a relevant overseas market, is also covered.

- *Stock market manipulation (section 278)*

Stock market manipulation occurs when a person, in Hong Kong or elsewhere, engages directly or indirectly in two or more transactions in securities of a corporation that by themselves or in conjunction with other transactions:

- (a) increase or are likely to increase the price of securities traded on a relevant recognised market or through an authorized ATS with the intention of inducing another person to buy or subscribe for, or to refrain from selling, securities issued by that corporation or a related corporation;
- (b) reduce or are likely to reduce the price of securities traded on a relevant recognized market or through an authorized ATS with the intention of inducing another person to sell, or refrain from buying, securities issued by that corporation or a related corporation; or
- (c) maintain or stabilize or are likely to maintain or stabilize the price of securities traded on a relevant recognized market or through an authorized ATS with the intention of inducing another person to sell, buy or subscribe for, or to refrain from selling, buying or subscribing for, securities issued by that corporation or a related corporation.

[93] Section 274(2) [94] Section 274(3) [95] Section 274(4)

[96] "wash sales" are transactions in which a person buys or sells securities without a change of beneficial ownership in the transaction.

[97] "matched orders" are transactions in which a person offers to sell securities at a price that is substantially the same as the price at which he has made or proposes to make, or he knows an associate of his has made or proposes to make, an offer to buy substantially the same number of securities and vice versa

[98] Section 274(5) [99] Section 275(1)(a) [100] Section 275(1)(b)

As with the other market misconduct provisions, the same conduct by a person in Hong Kong which affects securities or futures contracts traded on a relevant overseas market will be prohibited.

- *Disclosure of information about prohibited transactions (section 276)*

This form of market misconduct occurs when a person -

- (a) discloses information concerning the effect on the price of the securities of a corporation or futures contracts;
  - (b) by a transaction in breach of the market manipulation provisions in Part XIII or Part XIV relating to the securities of that corporation or a related corporation or futures contracts (respectively);
  - (c) if the person disclosing the information or an associate of his has directly or indirectly entered into the prohibited transaction or has received or expects to receive a benefit as a result of the disclosure.
- *Disclosure of false or misleading information about securities or futures contracts (section 277)*

This form of market misconduct concerns the disclosure of false or misleading information about securities or futures contracts that is likely to induce investment decisions or have a material price effect. A person will have engaged in market misconduct if he discloses or is involved in the disclosure of -

- (a) information likely to induce others to enter into transactions or to affect the price of securities, that is false or misleading in a material fact or through the omission of a material fact; and

- (b) he knows, or is reckless or negligent as to whether, the information is false or misleading in a material fact or through the omission of a material fact.<sup>101</sup>

Defences will be available for those who passively disseminate false or misleading information owing to the nature, or an aspect, of their business, which involves disseminating information received from others and who are not in a position to check the accuracy of that information. These defences will be for persons who operate a "conduit" style business such as printers and publishers,<sup>102</sup> those who simply issue or reproduce information provided by others where the information is wholly devised by another person such as internet website operators<sup>103</sup> and broadcasters.<sup>104</sup> They are only available if the person did not know the information was materially false or misleading.

- *Private right of action*

Section 281 creates a private right of civil action for any person who suffers pecuniary loss as a result of market misconduct. A person who has committed market misconduct will be liable to pay damages to any other person for pecuniary loss the other person has suffered as a result of the market misconduct, whether the loss arises from having entered into a transaction or dealing at a price affected by the market misconduct or otherwise. A limiting factor exists in that damages will only be payable if it is fair, just and reasonable in the circumstances.<sup>105</sup> Findings of the MMT in relation to the Part XIII market misconduct provisions will be admissible in evidence in a private civil action.<sup>106</sup> The courts will be able to impose injunctions in addition to or in substitution for damages.<sup>107</sup>

[101] Section 277(1)  
[102] Section 277(2)  
[103] Section 277(3)

[104] Section 277(4)  
[105] Section 281(2)

[106] Section 281(7)  
[107] Section 281(6)

- *Safe harbour rules*

The SFC will, after consultation with the Financial Secretary, be able to make rules which will create exceptions to the market misconduct civil and criminal provisions.<sup>108</sup> It is proposed to make rules permitting certain price stabilization activities during an initial public offering.

## Part XIV - Offences Relating To Dealings In Securities And Futures Contracts

### The criminal regime for market misconduct

#### *Continuity*

Presently, all forms of market misconduct other than insider dealing are criminal offences under sections 135-139 of the SO and sections 62-65 of the CTO. The offences cover false markets and trading, restrictions on fixing prices for securities and false or misleading statements. In addition, the SO and CTO criminalize fraud and the employment of fraudulent or deceptive devices (section 136 SO and section 63 CTO). The existing criminal regime will be retained and expanded.

#### *Change*

Under the expanded criminal regime, the maximum criminal sanctions will be increased to a maximum of 10 years' imprisonment and/or fines of up to \$10 million. All forms of market misconduct, including insider dealing, will now be subject to prosecution as a criminal offence.

#### *Key Provisions*

- *The market misconduct offences*

The provisions creating offences for the six forms of market misconduct mirror those in Part XIII. The offence of disclosure of false and misleading

information inducing transactions, unlike its counterpart in Part XIII, does not cover negligent disclosure. Only disclosure of such information made knowingly or recklessly will be subject to criminal sanctions.<sup>109</sup>

- *Additional offences*

Division 4 creates a number of offences relating to:

- acts of fraud or deception involving securities, futures contracts or leveraged foreign exchange trading;<sup>110</sup>
- false or misleading information relating to leveraged foreign exchange contracts,<sup>111</sup> in the same manner as section 298 applies to securities or futures contracts; and
- "bucketing" or falsely representing that a futures contract has been executed or arranged on another person's behalf on a recognized futures market or an authorized ATS.<sup>112</sup>

These offences have not been dealt with in the same manner as conduct designated as market misconduct and are only subject to the criminal regime.

- *Right of civil action*

Section 305 creates a private right of civil action for those who suffer pecuniary loss as a result of conduct in breach of the criminal offences under this Part. It is analogous to section 281 in Part XIII

- *No double jeopardy*

A person will not face the "double jeopardy" of being subject to civil proceedings before the MMT under Part XIII and prosecution under Part XIV in relation to the same conduct. A person who has been subject to proceedings before the MMT may not be

[108] Sections 282 and 306

[109] Section 298

[110] Section 300

[111] Section 301

[112] Section 302

prosecuted for an offence under Part XIV in relation to the same conduct.<sup>113</sup> Similarly, a person who has been charged in criminal proceedings under Part XIV may not have MMT proceedings in relation to the same conduct brought against him if those criminal proceedings are still pending or no further criminal proceedings could be brought against that person under Part XIV in relation to the same conduct.<sup>114</sup>

## Part XV - Disclosure of Interests

### Fuller, better, timely information for investors

#### *Continuity*

Part XV modernises the regime for the disclosure of interests in securities which is presently in the Securities (Disclosure of Interests) Ordinance (Cap. 396) ("S(DI)O"). Since the enactment of the S(DI)O in 1988, market participants have become familiar with its concepts and the SFO retains them as far as possible. Part XV also follows the drafting conventions in the S(DI)O as far as possible to make the new disclosure regime easier to understand.

#### *Change*

Bringing Hong Kong in line with international disclosure and regulatory standards, the SFO reduces the substantial shareholding disclosure from 10% to 5% and the notification period for disclosure is reduced from 5 days to 3 business days. There will be greater transparency for investors with requirements for the disclosure of the consideration payable or receivable in respect of acquisitions or disposals of interests in shares by substantial shareholders and the identity of persons who control corporate substantial shareholders. New requirements for the disclosure of interests in shares arising under all types of derivatives and changes in

the nature of an interest in shares will also help to ensure that investors have a more complete picture of dealings by substantial shareholders and directors in the future.

#### *Layout*

Part XV is separated into 13 Divisions -

- (a) Divisions 2, 3 and 4 deal with the reporting obligations of substantial shareholders;
- (b) Divisions 7, 8 and 9 deal with the reporting obligations of directors and chief executives; and
- (c) Other Divisions deal with matters such as maintenance of registers, investigations and imposition of restrictions on shareholdings in listed corporations.

#### *Key Provisions*

##### Substantial Shareholders

- *Duty of disclosure - cases in which it arises*

The duty of disclosure arises when, in the circumstances set out in section 313, a person acquires or disposes of an interest in the relevant share capital of a listed corporation or there is a change in the nature of his existing interest.<sup>115</sup> At present, a substantial shareholder must give a notification if he acquires an interest in shares or ceases to have an interest in shares and there is a change in the percentage level of his interest (section 4(5)(b) of S(DI)O). However, there are situations where a person may enter into a transaction which dramatically changes the nature of his interest without changing the percentage level, for example where a substantial shareholder exercises an option to buy or sell shares or in the case of stock lending. Such transactions are not, at present, notifiable but will be under the SFO.

[113] Section 307

[114] Section 283

[115] Section 310(1). Subsections (2) and (3) provide for disclosure in respect of specific interests held at specified times.

- *Disclosure duty in respect of derivatives*

At present, under the S(DI)O, the disclosure requirement only applies to physically settled derivatives. Under the SFO persons will have to disclose all interests in shares which are the "underlying shares" of equity derivatives whether issued or unissued. "Underlying shares" are the shares in the relevant share capital of a listed corporation which may be required to be delivered under the equity derivatives, or by reference to the price of which the value of the equity derivatives is determined (in the case of cash settled derivatives). Substantial shareholders must disclose long positions<sup>116</sup> and short positions separately.<sup>117</sup>

Section 322(8) sets out circumstances in which a person is taken to have an interest in shares that are the underlying shares of equity derivatives and section 322(9) explains the number of shares in which the person is taken to be interested. Section 322(10) sets out circumstances in which a person shall be regarded as ceasing to be interested in shares and sections 322(11) to (14) explain the number of shares in which he is regarded as ceasing to be interested.

- *Disclosure of short positions*

Disclosure of short positions in shares in listed corporations will be required. The term "short position" is defined in section 308(1). Separate provisions require disclosure of short positions. These follow the same methodology as the S(DI)O uses for long positions, with the events set out in section 310 and the circumstances giving rise to the duty of disclosure set out in section 313. A person (other than a director) with a short position will only be under a duty to give a notification if he is interested in 5% or more of the shares in a listed corporation i.e. he must be a substantial shareholder

before he is under a duty to disclose a short position.<sup>118</sup>

The threshold for a change in a short position giving rise to a duty of disclosure is 1%. Thereafter, as with long positions, a disclosure is only prompted by a change in the short position that results in the short position crossing a percentage level, or ceasing to have a short position of at least 1%. The disclosure regime will not permit netting-off of long and short positions for the purpose of calculating the percentage level of a person's interests.<sup>119</sup>

- *Notifiable interests*

The threshold at which the notification requirement kicks in for substantial shareholders is now 5%.<sup>120</sup> Section 314 prescribes the manner in which the percentage level is to be calculated for the purpose of determining whether there is a notifiable interest.

- *Notification*

A person under a duty of disclosure must give notification to the listed corporation concerned and the relevant exchange company in the form specified by the SFC by notice in the Gazette.<sup>121</sup> In order to streamline the submission, and processing by SEHK of disclosures required under Part XV, standard disclosure forms will be used in future. The use of standard forms will become even more important as electronic filing becomes the norm.

- *Notification period*

With certain exceptions the notification period is within 3 business days after the day on which the person becomes aware of the occurrence of the discloseable matter.<sup>122</sup> Longer periods have been allowed for notification where the requirement to notify is prompted by an external event. A substantial shareholder is given 10 business days to give notice -

[116] Sections 311(2) and 322(8)

[117] Sections 312 and 322(12)

[118] Sections 313(4) to (6)

[119] Section 314(3)

[120] Section 315

[121] Section 324

[122] Section 325(1)



- (a) when a corporation becomes listed;
- (b) when shares of a class in which he is interested become relevant share capital;
- (c) on commencement of Part XV; and
- (d) on a reduction in the disclosure thresholds.

- *Discretionary trusts*

The existing provisions are amended to improve transparency with respect to certain discretionary trusts. A founder of the trust who retains a power to influence the discretion of the trustees is deemed by sections 322(4)(b) and 345(4) to be interested in shares held by the trust. The term "founder of the trust" is defined in clause 308(1).

- *Pledged security interests*

The SFO clarifies that an interest in shares held as security for a loan ceases to be an exempt security interest if -

- (a) the lender is entitled to exercise voting rights following a default by the borrower and has shown an intention, or taken any step, to exercise the voting rights; or
- (b) the power of sale is exercisable and the lender offers the shares for sale and notice is required of that interest.<sup>123</sup>

- *Investment managers and trust companies*

The exemption currently made available to local SFC registered investment managers and trust companies under the Securities (Disclosure of Interests) (Exclusions) Regulations is removed.

- *Reduction of disclosure burden*

One of the major objectives of the new disclosure regime is to reduce the unnecessary compliance burden of the existing disclosure regime. The SFO includes a number of changes to minimise the disclosure burden. It -

- (a) exempts substantial shareholders from disclosing small changes in their interests in shares - the *de minimis* exemption<sup>124</sup> - no notice will be required if a change in an interest in shares involves crossing over a percentage level and the last notification was given because of crossing over of the same percentage level, provided that the difference between the new percentage figure and the percentage figure disclosed in the last notification is less than 0.5% of the issued share capital of the listed corporation concerned;
- (b) exempts transactions by members of a wholly owned group of companies (and changes in the nature of their interests)<sup>125</sup> provided the ultimate holding company of the group gives notice;
- (c) removes the obligation on a person to aggregate interests of corporations that are investment managers, custodians or trustees if their power to vote or deal is exercised independently;<sup>126</sup>
- (d) exempts holders, trustees and custodians of collective investment schemes if such persons have no discretion in exercising rights and providing for exemption of approved overseas schemes;<sup>127</sup>

[123] Section 323(7)  
 [124] Section 313(7)  
 [125] Section 313(10)

[126] Section 316(5) and (7)  
 [127] Section 323(1)(c)

- (e) widens the exemption for security interests to include margin financing, and security interests held by qualified lenders that are regulated overseas in approved jurisdictions;<sup>128</sup>
  - (f) introduces more structured notification forms to facilitate disclosure and dissemination of information; and
  - (g) removes requirements to disclose particulars of registered shareholders and changes in those particulars (formerly sections 7(6) and (7) of the S(DI)O)).
- *Power to investigate listed corporation's ownership*

The Financial Secretary may appoint inspectors to conduct an investigation into the ownership or control of a listed corporation.<sup>129</sup> Division 11 contains provision for this power and related powers. Division 12 makes provision for the CFI (on the application of the listed corporation) or the Financial Secretary to impose restrictions on shares of a listed corporation.

#### Disclosure by directors and chief executives

The disclosure regime for directors and chief executives has always been wider than that for substantial shareholders, requiring disclosure of interests in any shares or debentures of the listed corporation of which they are a director or chief executive and any associated corporation. There is also no threshold percentage before disclosure is required and all dealings must be notified. Division 7 requires disclosure of interests in shares held through derivatives by directors and chief executives and changes in the nature of interests in shares and debentures.<sup>130</sup> These provisions have been extended in a similar manner to those for substantial shareholders.

[128] Section 323(1)(f) & (6)

[129] Section 356

[130] Sections 342-344

## Part XVI - Miscellaneous

### *Continuity*

This Part will rationalize and consolidate many of the provisions which have common application to the exercise of a number of regulatory powers and certain statutory requirements that are replicated in current law across the patchwork of Ordinances administered by the SFC.

### *Change*

Also included in this Part are a number of miscellaneous provisions which do not fit neatly into the other parts of the SFO. A number of these represent innovations which reflect the increasing role that private law may have in the regulation of the securities and futures industry. The SFC is given standing to intervene as a party in litigation between private persons in cases which concern a regulated matter and a new right of private action creates civil liability for false or misleading public communications concerning securities and futures contracts.

### *Key Provisions*

- *Secrecy*

The stringent secrecy obligations imposed on the SFC and other designated parties under section 59 of the SFCO are preserved and somewhat clarified.<sup>131</sup>

- *Immunity*

As under the SFCO, statutory immunity is granted to public officers in relation to their performance in good faith of the statutory functions of the SFC.<sup>132</sup>

[131] Section 378

[132] Section 380

- *Immunity for auditors of listed corporations*

Auditors of listed corporations are granted immunity from liability under the common law if they choose to report to the SFC suspected fraud and other improper practices of which they become aware in the course of their auditing work.<sup>133</sup>

- *Provision of false and misleading information to the SFC*

The Securities and Futures Legislation (Provision of False Information) Ordinance 2000 created offences with respect to providing false and misleading information to the SFC and the front-line market operators, the exchanges. Section 384 unifies the offences in a single provision. A person will be liable to criminal prosecution if he or she submits false or misleading information, with the knowledge that, or reckless as to whether, the information is false or misleading. This mental element is echoed in section 383 concerning false or misleading representations in applications to the SFC.

- *Power of SFC to intervene in proceedings*

The SFC will be able to intervene in civil proceedings between third parties in cases which concern a matter provided for in the SFO or in Parts II or XII of the CO, or in which the SFC has an interest by virtue of its statutory functions.<sup>134</sup>

- *Liability of officers of corporations for offences by corporations*

Where an offence under the SFO committed by a corporation is aided or abetted, counseled or procured by, or committed with the consent of, or is attributable to the recklessness of, an officer of the corporation, that officer will be guilty of the offence and liable to punishment accordingly.<sup>135</sup>

- *Private right of action for false and misleading public communications*

Liability is created for false and misleading communications to the public concerning securities or futures contracts or having an effect on the price of securities or dealings in futures contracts made knowingly, recklessly or negligently.<sup>136</sup> As with the market misconduct offence of disclosure of false and misleading information inducing transactions,<sup>137</sup> defences are available for conduits such as printers, publishers and the like, website operators and broadcasters.

- *Financial Secretary to prescribe securities, futures contracts and investment arrangements*

The Financial Secretary is able to prescribe by notice in the Gazette, new financial products as constituting investment arrangements<sup>138</sup> and securities and futures contracts,<sup>139</sup> thereby including these products in the regulatory regime. A similar mechanism is adopted under the PIO.

- *Rules by the SFC*

The SFC is given a general rule-making power resembling section 146A of the SO and also a reserve power to make rules that are necessary for the furtherance of its regulatory objectives and the performance of its functions. This latter rule-making power may only be exercised after consultation with the Financial Secretary.<sup>140</sup>

- *Consultation requirement*

The Commission is now obliged by law to release drafts of all rules it proposes to make under the SFO for public consultation and to publish an account of comments received on the drafts and the SFC's response.<sup>141</sup>

[133] Section 381

[134] Section 385

[135] Section 390

[136] Section 391(1)

[137] Sections 277 and 298

[138] Section 393

[139] Section 392

[140] Section 397

[141] Section 398

- *Codes and guidelines*

The SFC may publish codes and guidelines to provide guidance for the furtherance of its regulatory objectives, in relation to its functions and in relation to the operation of any provision of the SFO.<sup>142</sup>

## Part XVII - Repeals and Related Provisions

### A bridge

#### *Continuity*

The transitional provisions are crucial for ensuring continuity and a smooth transition from the old to the new.

#### *Change*

The ten Ordinances are repealed.

#### *Key Provisions*

- *Repeals*

The existing law will be repealed on a day appointed by the Financial Secretary by notice in the Gazette.<sup>143</sup> This will be after the necessary subsidiary legislation has been passed by the Legislative Council.

- *Transitional arrangements*

The detailed provisions are contained in Schedule 10. Part 1 covers the transitional arrangements for each Part of the SFO providing for matters such as

the continuing application of certain provisions of existing laws for specified periods or for specified purposes, the continued operation or existence of the SFC, the continuation of acts started under the old law and not yet completed (such as investigations) and the move from the old licensing regime to the new. Part 2 of Schedule 10 sets out the consequential amendments to other Ordinances.

## Conclusion

### The end and the beginning

Section 406 repeals the old laws but as we have shown many will be staying with us in one form or another if they have stood the test of time or are able to be adapted for the 21<sup>st</sup> century. There are also innovations in the new law to address the changes brought about by globalisation, technological advances and market development. As we have said, both these updated familiar provisions and the new ones are crafted in such a way so as to provide the necessary flexibility to develop along with the markets in the future. What we have tried to do in this article is to sketch out a roadmap to enable those who need to use the SFO to find the familiar provisions derived from existing law and the new provisions with equal ease. We hope that this will provide a helpful structure to facilitate the familiarization process. ■■

[142] Section 399

[143] Section 406