ANALYSIS

CORPORATE DIMENSIONS OF THE SECURITIES AND FUTURES ORDINANCE

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The enactment of the Securities and Futures Ordinance, which came into effect in April 2003, marked the end of a decade-long effort to consolidate 10 ordinances regulating the securities and futures markets in Hong Kong. While it is primarily a consolidating ordinance to regulate financial intermediaries and facilitate Internet trading, there are new provisions in the Ordinance that are likely to have significant implications for corporate governance in Hong Kong. This article analyses those provisions and concludes that while the Ordinance is a major positive development from the corporate governance perspective, there remain a number of unresolved issues, such as the status of the Listing Rules, and the independence of auditors, that still require urgent reforms.

Introduction

On 13 March 2002 the Securities and Futures Ordinance (SFO) was enacted and it was gazetted on 28 March, ending a decade long's effort to consolidate the securities legislation in Hong Kong, and to put together in one place securities law that has been developed rather haphazardly over the past 25 years. The SFO came into force on 1 April 2003 with all the subsidiary legislation.

The Hong Kong Special Administrative Region (SAR) Government is acutely aware of the importance of maintaining its place amongst the world's premier markets in the 21st century, and as the principal fund-raising centre for mainland China. It also recognizes the advancement of new technologies, and the arrival of many new financial products, new market participants, and new trading methods. The new innovations reduce costs and enable many more people to better manage their money. But, at the same time, it gives rise to new concerns about investor protection, volatility and market abuses.

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The enactment of the SFO was part of the government's effort to modernize Hong Kong's securities law in order to meet the challenges brought about by globalisation and technological innovations. The other two initiatives were the demutualisation and merger of the securities and futures exchanges, and the enhancement of technology infrastructure for on-line trading.[1] The Hong Kong Stock Exchange (SEHK) and the Hong Kong Futures Exchange were demutualised and the Hong Kong Exchanges and Clearing Ltd (HKEx) was created in March 2000 and successfully listed on its main board in June 2000. The technological enhancement of the infrastructure is ongoing and the SFO has been enacted to hold the new financial infrastructure together.

The purpose of the SFO is to consolidate the 10 Ordinances[2] relating to the securities and futures industry and to create a modern regulatory and legal framework that promotes market confidence, secures appropriate investor protection, reduces market malpractice and financial crime, and facilitates innovation and competition.[3] It is primarily concerned with the regulation of financial intermediaries and facilitating Internet trading. However, a number of provisions in the SFO will have profound impact on the corporate governance landscape in Hong Kong and it is the corporate dimension of the SFO which this article seeks to address.

1 Statutory Backing to Listing Rules and Takeovers Codes

As most public listed companies in Hong Kong are supervised by controlling families, the investing public are the minority shareholders. However, the law on minority shareholder protection in Hong Kong is ineffective to protect the public. The task of protecting the investing public falls primarily on the SEHK (by its listing rules)[4] and the Securities and Futures Commission (SFC) (in takeovers situation).

One of the long-standing and well-known issues concerning corporate governance in Hong Kong is the enforceability of the Listing Rules and the

1 *See* the Financial Secretary's speech in Mar 1999. *See* also the SFC, The Securities and Futures Bill, (Hong Kong: SFC, 2000), Foreword; Government of the Hong Kong Special Administrative Region, A Policy Paper on Securities and Futures Market Reform, Mar 1999, available at http://www.info.gov.hk/fstb/fsb/security/sec_1.doc.

2 Securities and Futures Commission Ordinance (Cap 24); Commodities Trading Ordinance (Cap 250); Securities Ordinance (Cap 333); Protection of Investors Ordinance (Cap 335); Stock Exchange Unification Ordinance (Cap 361); Securities (Insider Dealing) Ordinance (Cap 395); Securities (Disclosure of Interests) Ordinance (Cap 396); Securities (Clearing Houses) Ordinance (Cap 420); Leveraged Foreign Exchange Trading Ordinance (Cap 451); Exchanges and Clearing Houses (Merger) Ordinance (Cap 555).

3 *See* Legislative Council Brief – Regulatory Reform for the Securities and Futures Market – The Securities and Futures Bill (Nov 2000) available at http://www.hksfc.org.hk/eng/bills/html/bills/fsb-legco-be.doc.

4 Under a memorandum of understanding between the SFC and the SEHK dated 25 Nov 1991 and replaced by an amended memorandum of understanding dated 6 Mar 2000, the SEHK became the frontline regulator for the companies listed on it except the HKEx which is regulated by the SFC: *see* http://www.hkex.com.hk/.

Hong Kong Codes on Takeovers and Mergers and Share Repurchases ("the Codes") against the offenders.[5] While the Listing Rules and the Codes are broadly in line with international standards,[6] there is room for improvement and there are continuing efforts to do so.[7] The Listing Committee of the SEHK also has contractual rights (but not statutory powers) to enforce the Listing Rules and to investigate breaches by conducting a hearing and calling such persons as appropriate to attend the hearing and to produce documents during such hearing.[8] Likewise, the SFC and the Panel on Takeovers and Mergers have relatively extensive powers to administer the Codes. However, the real problem is in the consequences of a breach. The Stock Exchange's remedies are restricted to civil remedies against the recalcitrant party for breach of the Listing Agreement and the directors' Declaration and Undertaking, the remedies of which are inadequate.[9] Although the Stock Exchange can suspend or withdraw a company's listing, this is unlikely to be used in most cases because any suspension or withdrawal is likely to also harm the minority shareholders whose interests the Listing Rules seek to protect. The more practical and effective actions the Stock Exchange can take against the party in breach are:[10] (1) to issue a private reprimand, a public statement of criticism or a public censure; (2) to report the misconduct to the SFC or other regulatory authorities (such as the Financial Secretary etc); (3) to ban professional advisers from representing the person in breach for a prescribed period of time; (4) to require rectification of the breach or remedial action; (5) to state publicly that the retention of a director who wilfully or persistently breaches the Listing Rules is prejudicial to the investors' interests; and (6) to

5 *See* The Government's Consultation Document on the Securities and Futures Bill, April 2000, (hereinafter the Consultation Document), paras 8.21–8.25.

6 For a more detailed discussion of the Rules and the Codes, *see* Say Goo, Improving Corporate Governance: Role of Shareholders and Regulators in Hong Kong, in Say Goo, Douglas Arner and Zhongfei Zhou (eds), *International Financial Sector Reform: Standard Setting and Infrastructure Development*, (London/The Hague/New York: Kluwer Law International, 2002), pp 493–496, 499–500.

7 *See*, for example, the HK Exchange & Clearing Ltd, Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues, Jan 2002 available at http://www.hkex.com.hk/. As for the Codes, as from 19 Oct 2001, the trigger threshold was reduced from 35% to 30% and the creeper from 5% to 2% in any 12-month period subject to transitional provisions: *see* http://www.hksfc.org.hk/eng/press_releases/html/press_release/01/01pr125_frame.html.

8 Rule 2A.15, LR. To assist the Stock Exchange in its investigation, a director is required to make a declaration and undertaking that he would cooperate in any investigation conducted by the Listing Committee (including answering questions, producing documents and attending a hearing or meeting). The directors also undertake to ensure the listed company complies with the Listing Rules, the SDI Ordinance, the Codes on Takeovers and Mergers and Share Repurchase, and all other relevant securities laws and regulations: *see* Appendix 5b, LR. As the undertaking is executed as a statutory declaration, any false information in it would constitute a criminal offence.

9 HKEx's chief executive Mr Paul Chow said: "At present, the exchange can only publicly reprimand those who have broken the listing rules. Because the rules have no statutory backing, they lack the teeth to discourage malpractice." *See* Enoch Yiu, HKEx willing to hand part of regulatory role to SFC, SCMP (Business), 14 June 2003, p 1; *see* also the Corporate Governance Review by the Standing Committee on Company Law Reform: A Consultation Paper on Proposals made in Phase II of the Review (June 2003) (hereinafter the SCCLR Consultation Paper Phase II), para 23.11.

10 Rule 2A.09, LR.

prohibit dealers and financial advisers from acting for a company that is wilfully or persistently in breach of the Listing Rules. While a breach of the Codes would also constitute a breach of the Listing Rules, the sanctions for breach of the Codes are similar. These remedies have been seen as inadequate by many commentators.[11]

Furthermore, shareholders do not have a right to enforce the Listing Rules or the Codes against the company or the regulators for failing to enforce those Rules or Codes. As far as shareholders are concerned, they do not have the force of law. The Listing Rules have the status of a contract between the SEHK and listed issuers.[12] The Codes only represent a consensus of opinion of those who participate in Hong Kong's financial markets and the SFC on the acceptable standards of commercial conduct and behaviour for takeover and merger transactions and share repurchases.[13]

In the version of the Securities and Future Bill which was made available to the public for consultation in July 1999, there was a proposal to empower the SFC to apply to the court for orders compelling compliance with the Listing Rules or the Codes in the event of non-compliance and disqualifying directors of listed corporations who had wilfully or persistently failed to discharge their duties under the Listing Rules or the Codes.[14] These proposals were similar to section 777 of the Corporations Law in Australia (which came into force on 4 September 1994). It was also proposed that any false or misleading disclosures made under either the Listing Rules or the Codes should be subject to possible civil claim for damages.[15]

These proposals were put forward in order to strengthen the enforceability of the Listing Rules and the Codes and should have been welcomed.[16] However, the market was not very enthusiastic about the proposals, and was concerned that any statutory backing to the Listing Rules and the Codes might make their application unduly legalistic.[17] In particular, the market stressed the need to maintain the non-statutory nature of the Listing Rules and Codes and the need to retain flexibility in both their content and interpretation so that they could evolve with market developments and innovations.[18]

As a result of the market sentiments, the government sought extensive legal advice in developing the proposal and was advised that, if the proposal as to conferring statutory backing to the Listing Rules and the Codes were

[11] *See*, for example, Mark Mobius and Dennis Chan, Corporate Governance in Hong Kong – Gaps That Need to be Filled, in Chee-Keong Low (ed), *Financial Markets in Hong Kong*, (Singapore: Springer, 2000), p 253.

[12] *See* the Consultation Document, para 8.21.

[13] *Ibid.*

[14] *Ibid.*, para 8.22.

[15] *Ibid.*

[16] *Ibid.*, para 8.23.

[17] *Ibid.*

[18] *Ibid.*

implemented and the SFC were to be empowered to enforce compliance with the Listing Rules and the Codes, such Rules and Codes would have the status of law and effectively became statutory provisions.[19] They would then be subject to normal rules of statutory interpretation and procedures for amendment, and would lose the flexibility and expeditious interpretation that are considered to be so vital for the market.[20] The government, however, did not provide in the consultation document any analysis of the authority for the rather, with respect, dubious legal advice obtained.

As mentioned above, since 1994 the Australian Securities and Investments Commission (or any person aggrieved) has the right to apply to the court for orders for the enforcement of stock exchange business rules or listing rules under section 777 of the Corporations Law, and there is no indication that the Australian Stock Exchange business rules or listing rules have become inflexible as a result. For example, in *Australian Stock Exchange Ltd v Hudson Securities Pty Ltd*,[21] in the Supreme Court of New South Wales (Equity Division), on the question whether the statutory basis which underpins the business rules (like the Listing Rules) and addresses the public functions of the Stock Exchange has any implications for whether the business rules are to be construed purposively, Santow J took the view that:

> "... clearly the rules are not themselves statutory, so as to be subject to the purposive interpretation application to provisions of the Corporations Law ..."

In interpreting the business rules, the court took into account their contractual, constitutional and statutory context to give effect to the purpose of the rules which is to provide "adequate arrangements for monitoring and enforcing compliance" directed to ensuring that "each stock market is an orderly and fair market". This approach was not challenged on appeal to the Court of Appeal of the Supreme Court of New South Wales.[22] With the appropriate system in place, there is no reason why such a purposive approach to interpretation of the Listing Rules cannot be adopted in Hong Kong.

As the Standing Committee on Company Law Reform (SCCLR) points out, statutory backing does not necessarily mean that all the provisions in the Listing Rules will become primary legislation; statutory backing can set out empowering provisions and fundamental principles in primary law, supplemented by rules (subsidiary legislation), codes and guidelines (non-statutory).[23] In the SCCLR's view breaches of the statutory provisions would attract penalties which can range

19 *Ibid.*, para 8.24.
20 *Ibid.*
21 (1999) 33 ACSP 416.
22 *See Hudson Securities Pty Ltd v Australian Stock Exchange Ltd* (2000) 35 ACSR 55.
23 SCCLR Consultation Paper Phase II, para 23.13.

from disqualification of directors, to fines down to reprimands, and the Listing Rules would be interpreted in accordance with codes and guidelines.[24]

Nevertheless, as a result of the market response and the legal advice obtained, the government decided to drop the proposal to provide statutory backing to the Listing Rules and the Codes.[25] Instead, the government decided to strengthen the law on disclosure of information by introducing the Securities and Futures Legislation (Provision of False Information) Bill, which was introduced into the Legislative Council in March 2000.[26] This later became section 384 of the new SFO. The government hoped that this would go some way in enhancing the accuracy of disclosures by making the provision of false or misleading reports to the SFC (under the new dual filing system) or other relevant regulators a criminal offence.[27]

However, as a result of the recent unfortunate Penny Stocks Incident,[28] many have once again called for the statutory backing to the Listing Rules.[29] In particular, the Expert Group appointed by the Financial Secretary on 26 September 2002 to review the operation of the securities and futures market regulatory structure has offered two options to ease the concern that any statutory backing to the Listing Rules would render the Rules subject to vetting by the legislature and can be overturned, and that the application and administration of the Rules would become a legalistic process requiring strict rules of legal interpretation.[30] The first option is to link the Listing Rules to some provision without making the Listing Rules subsidiary legislation.[31] For example, a subsidiary legislation could require full, accurate and timely disclosure to the satisfaction of the SEHK (though the Expert Group suggests that this should be replaced by a new Hong Kong Listing Authority to be established within the SFC), and what would satisfy the SEHK (or the HKLA) would be set out in the Listing Rules.[32] This way, a

24 *Ibid.*

25 Consultation Document, para 8.25.

26 *Ibid.*

27 *Ibid.*

28 That is the incident which took place on 26 July 2002, following the release of a "Consultation Paper on Proposed Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Criteria and Cancellation of Listing Procedures" by the HKEx for public consultation on 25 July 2002, whereby 577 of the 761 stocks listed on the Main Board of the HKEx (many of which had a quoted closing price of $0.5 or below as of 25 July 2002 (commonly called penny stocks)) recorded a loss totaling $10.91 billion: for the detail of the incident *see* the Report of the Panel of Inquiry on the Penny Stocks Incident (9 Sept 2002) available at http://www.info.gov.hk/info/pennystock-e.htm.

29 *See* the Report by the Expert Group to review the Operation of the Securities and Futures Market Regulatory Structure (March 2003) (hereinafter Expert Group Report), paras 2.58, 3.44 available at http://www.info.gov.hk/info/expert/expertreport-e.htm; the SCCLR Consultation Paper Phase II, para 23.16; and Justice Anthony Rogers, Chairman of the SCCLR reportedly saying that Listing Rules should be given statutory backing: *see* Enoch Yiu, Shareholder culpability in spotlight, SCMP, June 12 2003, Business, p 3.

30 Expert Group report, para 2.58.

31 Expert Group report, para 3.46.

32 *Ibid.*

failure to comply with the Listing Rules would mean a failure to comply with the relevant subsidiary legislation, and so the regulator will have investigative power under the subsidiary legislation to investigate suspected breaches and impose tougher sanctions for proven breaches.[33] At the same time, the Listing Rules can be amended flexibly as and when required. The other option which will lead to essentially the same outcome is to issue the Listing Rules as codes or guidelines under section 399 of the SFO.[34] The Listing Rules will remain non-statutory but the SEHK (or the HKLA) will have statutory investigative powers and the range of existing sanctions available for breach of Codes will be available immediately.[35] But as the Expert Group points out, the only limitation is that this range of sanctions is more restricted than those available for breach of subsidiary legislation under option one and the problems presented by the dual filing system will remain.[36]

2 Statutory Private Right of Action Against Market Misconduct

As we have seen from the above discussion, a shareholder who suffers loss as a result of the breach of Listing Rules and Takeovers Codes must rely on the HKSE and the SFC to enforce those rules respectively, and cannot obtain a personal remedy. At common law, the shareholder or any other person who suffers loss as a result of market misconduct may be able to seek redress through civil action (in contract, tort or restitution) against a person responsible for the misconduct.[37] However, this can be costly and it is by no means straightforward.[38] The SFO now provides a partial solution to this problem. It contains a provision for a right of civil action in respect of market misconduct for which the shareholder or person affected can claim compensation for loss and other remedies.[39] Market misconduct may overlap with certain aspects of the Listing Rules or the Codes, but breach of the Listing Rules or the Codes *per se* is not market misconduct. One significant gap in the SFO is that it does not contain a general provision similar to section 777 of the Australia Corporations Law which allows a person aggrieved by the failure to comply with the business rules or listing rules to apply to the court for an order for the compliance and enforcement of those rules.[40]

33 *Ibid.*
34 Expert Group Report, para 3.47.
35 *Ibid.*
36 *Ibid.* For the problems of dual filing system *see* Expert Group Report, para 2.53: failure to file a document or omissions from a filed document might not give rise to liability.
37 Consultation Document, executive summary, para 19.
38 *Ibid.*
39 SFO, ss 281 and 305.
40 For cases of application by aggrieved person *see Campbell Investment (Aust) Pty Ltd v Arnotts Ltd* (1992) 9 ACSR 660; *Quancorp Pty Ltd v MacDonald* (1997) 24 ACSR 745; Re R G Capital Radio Pty Ltd (formerly SEA FM Ltd) (1998) 26 ACSR 622; *Quancorp Pty Ltd v MacDonald* (1998) 28 ACSR 520; and *Quancorp Pty Ltd v MacDonald* (1999) 32 ACSR 50.

To prevent vexatious claims, under the SFO, no person against whom the action is brought will be liable to pay compensation unless the Court is satisfied that it is fair, just and reasonable in the circumstances.[41] It will be interesting to see how this provision is interpreted by the court. To assist the plaintiff, the SFO allows a finding by the Market Misconduct Tribunal (MMT) that a person has engaged in market misconduct to be admitted into evidence in a private civil action, provided it is probative and relevant to his suit.[42] Similarly a finding of market misconduct by a court under the criminal route can be used as evidence in private civil action.[43] This is likely to be of considerable assistance.

Nevertheless, a shareholder remains unable to enforce the Listing Rules and the Codes, although the threat of potential civil liability may bolster the effectiveness of the civil market misconduct regime in conferring adequate protection to the market against market misconduct.

3 *Market Misconduct*

(a) Civil remedies: Market Misconduct Tribunal

As the SFO is primarily about the regulation of the market intermediaries and participants in order to ensure market integrity and investor protection, the government believed that effective action had to be taken against market misconduct.[44] Prior to the SFO, market manipulation was a criminal offence. However, sophisticated market practices and techniques had made it difficult to obtain sufficient evidence to prove market manipulation to the criminal standard, ie, beyond a reasonable doubt.[45] This meant that many offenders had been able to escape punishment or liability. Thus, the SFO provides an alternative civil route under the jurisdiction of the MMT[46] to the existing criminal route in dealing with market manipulation.[47] In other words, market manipulation is now subject to a civil action before MMT in addition to being a criminal offence.

In addition, the MMT, chaired by Mr Justice Lugar-Mawson, now assumes the jurisdiction of the previous Insider Dealing Tribunal to handle insider dealing (which was only subject to civil sanction prior to the SFO). A number of other specified market misconduct activities are also subject to civil action before the MMT, such as stock market manipulation, false trading in

41 SFO, ss 281(2), 305(2).
42 SFO, ss 281(7), 305(6).
43 Evidence Ordinance s 62.
44 The Consultation Document, Executive Summary, para 20.
45 *Ibid.* For a rare example of a successful prosecution see *Securities and Futures Commission v Choi Wai Zak* [2003] 1 HKC 30.
46 The MMT will be chaired by a judge of the Court of First Instance, assisted by two market practitioners appointed by the Chief Executive.
47 The Consultation Document, Executive Summary, para 20.

securities or futures contracts, price rigging in securities or futures markets, disclosure of information about prohibited transactions in securities or futures contracts, and disclosure of false or misleading information inducing transactions in securities or futures contracts.[48] All these types of misconduct and market manipulation and insider dealing are now referred to as market misconduct to be subject to civil claim before the MMT. The advantage of this is that the civil standard of proof is used, ie, a balance of probabilities in determining whether market misconduct has been established.[49] This can overcome the current problem of proving these activities to the criminal standard.[50]

The other advantage is the range of sanctions the MMT can impose:[51]

(i) issue a "disqualification" order to disqualify a director from being a director of any listed company for a period of up to five years;
(ii) issue a "cold shoulder" order (ie, a person is denied access to market facilities) for a period of up to five years;
(iii) issue a "cease and desist" order (ie, an order not to breach the provisions of market misconduct again);
(iv) order disgorgement of profits plus compound interest thereon;
(v) order payment of legal costs and investigation expenses; and
(vi) refer to any body of which the person who has engaged in market misconduct is a member for possible disciplinary action.

(b) Criminal offences: the court

While the SFO provides civil remedies before the MMT, it was thought that it would still be necessary to retain criminal liability for such market misconduct to send the right message to the market that these activities would not be tolerated.[52] Thus, as an alternative to civil proceedings before the MMT, the SFO also provides a criminal route for dealing with market misconduct activities where there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution before the courts.[53] The US, the UK and Australia all have dual criminal and civil routes for dealing with market misconduct, and this factor has influenced the government in choosing this option.[54] The penalties under the SFO are also substantially increased to a maximum penalty of 10 years' imprisonment or a fine of up to

48 SFO, s 245.
49 SFO, ss 252(7), 387.
50 The Consultation Document, para 11.4.
51 SFO, s 257(1).
52 The Consultation Document, paras 11.13–11.14.
53 *Ibid.*, para 23.
54 *Ibid.*, para 11.15.

$10 million for conviction on indictment, and $1 million and three years' imprisonment for summary conviction.[55] However, the rule against double jeopardy applies so that a person cannot be tried in both the MMT and the courts for the same market misconduct.[56]

The offences of market misconduct mirror the civil actions in the MMT. In other words, all the market misconduct under the civil route are also criminalised, if not already so. Thus, insider dealing becomes a criminal offence. This brings the law in line with other comparable jurisdictions, including the US, the UK and Australia.[57] Indeed, as the government pointed out, it would be inconsistent to subject other instances of market misconduct to both civil and criminal regimes and leave insider dealing to be dealt with under a civil regime only.[58] The provisions defining insider dealing in the Securities (Insider Dealing) Ordinance were adopted for criminalising insider dealing as they had become well accepted and familiar to participants over the past nine years.[59]

(c) Choosing between civil and criminal route

The initial decision will be made by the SFC whether to refer a matter to the Financial Secretary for possible referral to the MMT or to refer the matter to the Secretary for Justice for criminal prosecution in the court.[60] However, the Financial Secretary and the Secretary for Justice both have the power to re-direct the case to the other regime if he or she disagrees with the SFC's referral.[61]

(d) Mental element, defences and "safe harbour" rules

In order to protect legitimate securities or futures trading, the SFO provides, first, that most offences require a mental element,[62] while other instances of blatantly manipulative trading are deemed to be wrongful,[63] unless the defendant can establish that none of his or her purposes was a prohibited purpose.[64] Second, there are a number of defences available such as due

55 SFO, s 303.
56 SFO, ss 283, 307.
57 The Consultation Document, para 11.14.
58 *Ibid*.
59 *Ibid*.
60 *Ibid*., para 11.17. The SFC is able to prosecute less serious offences in summary actions in a Magistrate Court for any other offence under the SFO.
61 SFO, s 252(9), (10).
62 Including insider dealing, false trading in securities and futures, stock market manipulation, fraud and deception: SFO, ss 291, 295, 299, 300; Consultation Document, para 12.7(a).
63 For example, trading with no change in beneficial ownership, matching buy and sell orders by related parties, trading involving any artificial or fictitious transaction or device: SFO, s 295(5); Consultation Document, para 12.7(b).
64 SFO, ss 295(7), 296(5); Consultation Document, para 12.7(b).

diligence defences, or the defence of good faith without knowledge.[65] Third, the SFC is empowered under the SFO to make "safe harbour" (ie exemptions) rules for exempting conduct from the provisions relating to civil and criminal market misconduct, subject to consultation with the public and the Financial Secretary, and approval by the Legislative Council.[66]

(e) Extraterritoriality

The SFO follows international practice by adopting the principle of extraterritoriality for its provisions on certain market misconduct offences, namely false trading, price rigging, disclosure of false or misleading information inducing transactions or leveraged foreign exchange contracts, and stock market manipulation.[67] Thus, conduct outside Hong Kong with respect to Hong Kong traded securities and futures, and conduct in Hong Kong with respect to foreign traded securities and futures are all covered.[68] However, it is important that Hong Kong does not legislate for or enforce the laws of other jurisdictions. Therefore, false trading, price rigging and stock market manipulation in Hong Kong that affects a foreign market will only be criminalised if it is also an offence in the foreign market alleged to be affected were it to be committed there.[69]

4 The Investigative Powers of the SFC

Previously, the SFC could review the books and records of a listed company or members of its group on a limited basis when it appeared to the SFC that there was misconduct in the management of the company. Under section 29A of the repealed SFC Ordinance, the SFC had limited power to require production of and make limited inquiries about the records and documents of a listed company and its group companies where there were reasons to suspect fraud, misfeasance or other misconduct in relation to the formation, management or business of that listed company or to suspect that there had not been proper disclosure to shareholders.[70] This was intended to enable the SFC to conduct a limited, fast and discreet inquiry into the possibility of such misconduct but did not enable a full company inspection.[71]

On the basis of the findings under the preliminary inspections carried out under section 29A, the SFC might then apply for a variety of orders to

65 SFO, s 298(3); Consultation Document, paras 12.6, 12.7(c).
66 SFO, s 306(1), (2); Consultation Document, paras 11.22, 12.18.
67 SFO, ss 295, 296, 298, 299, 301.
68 Consultation Document, para 12.14.
69 SFO, s 306(3), Consultation Document, para 12.16.
70 Consultation Document, para 6.4(a).
71 *Ibid.*

prevent contraventions or wrongdoings and to seek appropriate remedial action, including appointing a receiver or manager over the whole or a part of the listed company's business.[72] In practice, however, this power of inspection was not very useful because the SFC had only limited ability to place the entries in those documents in any meaningful context or to check their veracity for the following reasons:

(i) The power might be interpreted as only requiring the company under investigation to make an explanation of what an entry in a record or document related to and not an explanation of the circumstances in which the entry was made.[73] The SFO now cures this ambiguity by putting beyond doubt the SFC's power to ask for an explanation of not only an entry in a record or document but also the reasons for which it was made, the circumstances under which it was prepared or created and the details of any instructions given in connection with the making of that entry.[74]

(ii) Under section 29A of the SFC Ordinance, the SFC did not have the power to require a third party (eg the company's auditors,[75] bankers,[76] and transaction counterparties[77]) to supplement or verify the records or documents produced by a listed company or its group companies, or explanations of them.[78] This often prevented the SFC from ascertaining the real nature of a company's transactions or purported transactions as recorded in its own books and documents.[79] The SFO now enhances the SFC's powers in this regard by enabling it to seek records and documents relating to the affairs of a listed company or its group companies from those third parties.[80]

There are safeguards built into the SFO to prevent abuses of the SFC's new investigative power. To obtain records or documents from a bank or an auditor, the SFC must first have reasonable cause to believe, and certify

[72] *Ibid.*, para 6.7.
[73] *Ibid.*, para 6.7(a).
[74] *Ibid.*, and SFO, s 179.
[75] A company's auditors perform an important role in corporate regulation and are required to form an opinion on a company's financial affairs and in doing so will have performed certain verification checks. Thus, access to an auditor's records and documents not only assists the SFC in conducting a preliminary listed company inquiry, but may also forestall the need to pursue certain avenues of inquiry, supplement the information obtained from a listed company and its group companies, and confirm the veracity of such information: Consultation Document, para 6.8(a).
[76] It was intended that s 29A of the SFC Ordinance would give the SFC the power to obtain records and documents from the banks of listed companies and their group companies. The SFO had been able to do that in practice. However, doubts had been expressed whether the existing wording of the relevant provisions achieved this intention: *ibid.*, para 6.8(b).
[77] Prior to the SFO, inquiries conducted by the SFC under s 29A of the SFC Ordinance had been hampered by the SFC's inability to verify the propriety or genuineness of transactions reflected in the books and records of a listed company or one of its group companies by examining records or documents of the person with whom those companies had allegedly transacted: *ibid.*, para 6.8(c).
[78] *Ibid.*, para 6.7(b). The SFC already had power under s 29A of the SFC Ordinance to obtain records or documents relating to the affairs of a listed company or its group companies from persons in possession of such records or documents, and this power is preserved in the SFO: *ibid.*, para 6.8(d).
[79] *Ibid.*
[80] *Ibid.*, and SFO, s 179.

in writing that it has reasonable cause to believe, that (a) the bank or the auditor is in possession of any record or document[81] relating to the affairs of the corporation under investigation; and (b) the record or document required to be produced relates to the affairs of such corporation, and is relevant to the investigation.[82] In the case of a transaction counterparty, the SFC must also show that it has reasonable cause to believe that the transaction counterparty has had dealings with the listed company under inquiry or one of its group companies.[83] In addition, in relation to transaction counterparties and persons in possession of company records or documents, the SFC must have reasonable cause to believe that the record or document sought cannot be obtained from the listed company under inquiry or any of its group companies, or any bank or auditor of such a company.[84] There is also a duty of secrecy and confidentiality on SFC staff and third party providing assistance.[85] With the improvement on the SFC's power of investigation, the SFC should be in a better position to inquire more effectively into allegations of fraud or other misconduct in respect of listed companies, and as a result, provide better protection to the investing public.

5 *Disclosure of Interests*

Previously, anyone who acquired or disposed of 10 per cent of issued voting share capital in a listed company was required to disclose that interest within five days of acquiring or disposing of the interest. Any person who having held 10 per cent or more acquired another whole figure percentage (any percentage level that was not whole figure to be rounded down) also had to make disclosure. Shares held by a person's spouse or children were deemed to be held by that person. In addition, any two or more persons who agreed to acquire shares with obligations and restrictions on the use, retention or disposal of shares (ie concert parties) were covered by the same rules. Directors and chief executive officers were required to disclose their shareholding and any acquisition or disposal of shares in the company regardless of the percentage they held. They were also deemed to be interested in their spouse's and children's shares and debentures.

In order to allow investors to have equal and timely access to full and accurate data on the shareholdings in listed companies which is price-sensitive

81 The records or documents to be obtained from an auditor must be in the nature of "audit working papers" which means: (a) any record or document prepared by or on behalf of an auditor; and (b) any record or document obtained and retained by or on behalf of an auditor, for or in connection with the performance of any of his functions relating to the conduct of any audit of the accounts of a corporation: SFO s 178.

82 *Ibid.*, s 179(6), (7).

83 *Ibid.*, s 179(8)(a).

84 *Ibid.*, s 179(8)(b)(iii).

85 *Ibid.*, s 378.

so that they can make informed investment decisions, the SFO tightens the disclosure threshold (from 10 per cent to 5 per cent) and the time limit for disclosure (from five days to three days). This brings Hong Kong in line with international disclosure and regulatory standards.[86] The new disclosure threshold of 5 per cent is comparable to that in Japan, the US, Australia, New Zealand, Singapore, Malaysia, Indonesia, Thailand, and mainland China.[87] In the UK, the threshold is as low as 3 per cent.[88] As for the notification period, it is one day in Thailand; two business days in the UK, Australia, and Singapore; three business days in mainland China; 10 in the US and Indonesia; and 14 in Malaysia.[89] In New Zealand it is as soon as one has knowledge. The initial proposal was to reduce it from five days to two business days, but this did not receive majority support in the market and so it was in the end settled for three days. The government believes that this will still provide an expedient and efficient level of disclosure without placing too much burden on the market.[90]

In deciding whether a person's holding is above the threshold, all the underlying shares of equity derivatives, that a person has, or ceases to have, will be taken into account.[91] The same goes for disclosure by directors and chief executive officers.[92] Where a substantial shareholder (ie a person with 5 per cent or more shareholding) comes to have or ceases to have a short position, or when there is a change in the short position by 1 per cent, he is obliged to disclose the short position.[93] Where a director or chief executive officer comes to have or ceases to have a short position,[94] or has a short position when the company becomes listed[95] or when the SFO comes into force,[96] or when he becomes a director or chief executive officer of the company,[97] he is under a duty of disclosure. Similarly, he is under the same duty of disclosure if he has a short position in a company which has become an associated company of the listed company.[98] The SFO also requires the disclosure of any change in the nature of an interest in shares held by director or chief executive officer

86 Consultation Document, paras 13.1–13.3.
87 *Ibid.*, para 13.8 and Annex E.
88 *Ibid.*
89 *Ibid.*
90 *Ibid.*
91 *Ibid.*, para 13.15, SFO, s 311.
92 SFO, s 342.
93 *Ibid.*, s 313(4) to (6). A short position arises when one sells shares which one does not actually have in anticipation of falling prices. For the legal definition *see ibid.* s 308.
94 *Ibid.*, s 341(1)(f).
95 *Ibid.*, s 341(2)(a)(ii).
96 *Ibid.*, s 341(2)(b)(ii).
97 *Ibid.*, s 341(2)(c)(ii).
98 *Ibid.*, s 341(2)(d)(ii).

or a substantial shareholder.[99] This is to give the public a full picture of the ownership structure, as for example when a substantial shareholder converts his derivative interest in shares into a direct interest in shares.[100]

As was previously the case, failure to make disclosure is an offence and is liable on conviction on indictment to a fine at level 6 (currently HK$100,000)[101] and to imprisonment for 2 years; or (ii) on summary conviction to a fine at level 3 (currently HK$10,000)[102] and to imprisonment for six months.[103] These penalties have been criticized as being too lenient.[104]

6 *Immunity for Auditors of Listed Companies*

The rapid development of the financial markets and the increasing complexities of financial transactions has meant that there is greater scope for persons responsible for fraud or other questionable practices to disguise the true nature of their activities.[105] Auditors are in a very good position to detect fraud or irregularity. However, those who wish to serve the public interest by reporting their concerns to the regulatory authority may face a civil claim at common law, for example, for negligence or breach of confidentiality or suffer professional embarrassment and financial penalty.[106] Potential liability in defamation is also a major concern.

To remove the risk of such adverse consequences, the SFO now provides auditors of listed corporations with a statutory immunity from liability under the common law, if they choose to report to the SFC suspected fraud and other fraudulent or improper practices of which they become aware in the course of their auditing work.[107] It does not impose upon them any duty to report.

In determining whether there are circumstances suggesting that fraud, misfeasance or other misconduct has been committed, the auditor is entitled to take a subjective opinion. This is because, as the accountancy profession pointed out, unless an auditor is personally involved in or possesses first hand knowledge of fraud, misfeasance or other misconduct, he must necessarily

99 *Ibid.*, s 341(1)(e), (5).
100 Consultation Document, para 13.23.
101 *See* Criminal Procedure Ordinance (Cap 221), s 113B(1), Sch 8.
102 *Ibid.*
103 SFO, ss 328, 351. Under the repealed S(DI)O, the penalty is $10,000 plus 6 months' imprisonment or $100,000 plus 2 years' imprisonment: S(DI)O ss 15(3), 28(8).
104 *See* Mark Mobius and Dennis Chan, Note 11 above, p 255 citing the Wah Lee Case (penalty imposed: HK$24,000 plus cost to SFC $12,200), the Hwa Kay Thai Case (penalty: $18,000), and the South East Asia Wood Case (penalty: $80,000 plus cost to SFC $50,000) as examples.
105 Consultation Document, para 14.6.
106 *Ibid.*
107 *Ibid.*, para 14.7, SFO s 381.

rely on his own judgment or interpretation of circumstantial evidence such as books and records of the listed corporation in determining whether to make a report to the regulator.[108]

This is a small step towards encouraging auditors to play an active role in corporate governance. There is currently a review taken by the Hong Kong Society of Accountants (HKSA) of its Practice Review Programme and the SCCLR has also urged the government to consider a number of issues relating to the regulation and independence of auditors which are beyond the scope of this article. For example whether auditors should be regulated by an independent body, whether auditors should be allowed to provide non-auditing services to the same company for which auditing services are provided, and whether there should be mandatory rotation of auditors every few years.[109] There is also a private members' bill by the HKSA to propose, *inter alia*, the establishment of an Independent Investigation Board to deal with alleged accounting, auditing and ethical irregularities related to listed companies to improve the corporate governance standard in Hong Kong.[110]

Conclusion

The SFO is a positive development in many respects from the perspectives of corporate governance in Hong Kong. First, shareholders of listed companies will now be able to bring actions for loss suffered as a result of market misconduct by directors and other shareholders. This will help shareholders to overcome some of the problems with derivative actions, as it is unlikely that market misconduct could be the subject of a derivative action, and the inability to enforce the Listing Rules or Takeovers Code, to the extent that the conduct complained of is a market misconduct. Second, it will enhance the protection to investors / shareholders by more timely and better disclosure of substantial shareholding interests. Not only will it help investors to have a clearer idea of the company share ownership structure before investing, but it will also help prevent insider dealing and ensure compliance with the Takeovers Code. Third, it makes certain conduct of directors or controlling shareholders a market misconduct offence with more severe penalty, or subjects such conduct to civil remedies before the MMT, also with fairly heavy penalties. While the criminal route may not have a major utility given its

[108] Consultation Document, para 14.8.

[109] *See* the SCCLR Consultation Paper Phase II, Chapter 5. The SCCLR recommends that there should not be mandatory rotation of audit firms but there should be mandatory rotation of both the lead and concurring audit partners every five years.

[110] *See* http://www.hksa.org.hk/whatsnew/legco_eng_130603.pdf.

evidential difficulty in proving a case in practice, the civil liability before the MMT is likely to deter corporate abuses in relation to market misconduct. Fourth, it significantly increases the SFC's investigatory power and prevents fraudulent transactions. Finally, it provides immunity to an auditor who blows the whistle. This will hopefully encourage more auditors to play a more active role in corporate governance.

On the down side, gaps in the Listing Rules and Takeovers Code remain to be filled and the enforcement of Listing Rules remains weak. Thus, conduct short of market misconduct (eg expropriation or disguised privatisation as allegedly occurred in Boto International Holdings Ltd)[111] is likely to continue. The government has missed the opportunity to strengthen the Listing Rules and Takeovers Code: tougher sanctions for breach of Listing Rules and Takeovers Code, such as those available before the MMT, could have been prescribed. Also, shareholders' statutory rights of action for loss suffered as a result of market misconduct could have been extended to loss suffered as a result of any breach of Listing Rules or Takeovers Code. However, with the advice from reform bodies of such high standing as the SCCLR and the government appointed Expert Group calling for the statutory backing to the Listing Rules, it is hoped that the government will not miss the opportunity this time. Finally, auditors' immunity is unlikely to make much difference unless other initiatives currently being considered are implemented as soon as possible. For example the requirement that auditors do not provide consultancy work to the same company for which they are auditors and companies are required to change their auditors periodically, say every five years.[112] It is hoped that the SCCLR's recommendations in this regard will be implemented soon.

[111] For a discussion of this case *see* Goo, Say H. and Weber, Rolf H., The Expropriation Game: Minority Shareholders' Protection, (2003) *HKLJ* 71.

[112] Cf Sarbanes-Oxley Act 2002 (US).