

Guide to

Legislative Proposals on

Powers of Intervention and Proceedings

(to be included in the Securities and Futures Bill)

5th July 1999

Introduction

1. At present, the Securities Ordinance, the Securities and Futures Commission Ordinance (the “SFCO”) and the Leveraged Foreign Exchange Trading Ordinance (the “LFETO”) provide the Securities and Futures Commission (the “Commission”) with certain powers of intervention applicable to licensed persons, as well as the powers to initiate proceedings for injunctive orders or other relief in other appropriate cases.
2. The proposed Securities and Futures Bill (the “Composite Bill”) will reenact without material changes the provisions (Sections 45 and 46 of the SFCO) that empower the Commission to petition a court for winding up a corporation. It will also reenact, with one clarifying amendment, those provisions (Sections 38 to 43 of the SFCO and Sections 49 to 54 of the LFETO) relating to the Commission’s powers of intervention in restricting the business or asset transfers of a licensed person in appropriate cases.
3. However, the Composite Bill will modify the provision (Section 55 of the SFCO) providing that the Commission may apply to a court for injunction against contravention of securities regulation. More specifically, the Bill will broaden the court’s power to cover persons who aid, abet, or induce a contravention of securities regulation, create a private cause of action for persons materially affected by the contravention, and allow the court to fashion other remedies including payment of damages.
4. The Composite Bill will also amend the provision (Section 37A of the SFCO) that authorizes the Commission to petition a court for appropriate remedies in cases where the affairs of a listed corporation have been conducted in a manner unfairly prejudicial to the interest of all or any part or its members. In

response to the comments of Rogers, J. in In the Matter of Chesterfield Limited (M.P. 3504/94) and the ensuing recommendations of the Law Reform Commission, the Composite Bill will expand the court's power to disqualify a person who has engaged in misconduct from being a director or otherwise taking part in the management of a corporation. In addition, the Bill will include some clarifying amendments.

Powers of Intervention

5. Section 38 of the SFCO and Section 49 of the LFETO authorize the Commission to exercise certain powers of intervention when it appears that:
 - a licensed person is not a fit and proper person;
 - the licensed person has contravened or failed to comply with provisions of securities regulation;
 - there are other grounds for revoking or suspending the licensed person's license; or
 - the exercise of such powers is desirable in the interest of the investing public.
6. Sections 39 to 41 of the SFCO and Sections 50 to 52 of the LFETO specify the Commission's powers of intervention as the powers to:
 - restrict the licensed person's business;
 - prohibit the licensed person from dealing with property or assets in a specified manner, or require the licensed person to deal with property or assets in a specified manner; and
 - require the licensed person to maintain property or assets in a specified manner.

7. Section 42 of the SFCO and Section 53 of the LFETO set out the procedures for exercising such powers, while Section 43 and Section 54 provide for subsequent withdrawal, substitution, or variation of a notice of intervention.
8. A licensed person who has engaged in conduct causing the Commission to exercise its powers of intervention could not always be relied upon to comply with a restriction, prohibition, or requirement. Furthermore, a failing intermediary may be tempted to violate any applicable prohibition or requirement on dealing with or maintenance of client property or assets in order to hide its financial troubles and to stay afloat. The Commission, therefore, has on occasions required licensed persons to transfer property and assets to it for safe keeping. In the interest of transparency and clarity, the Composite Bill will include a new provision to state expressly that the Commission has the power to require assets be transferred and held in trust.

Application for Injunction and Other Orders

9. Section 144 of the Securities Ordinance, Section 55 of the SFCO, and Section 13 of the LFETO provide that if, on application by the Commission, the Court of First Instance is satisfied that a person is reasonably likely to contravene a provision of the relevant Ordinances, a regulation, rule or direction made thereunder, or any notice given pursuant to the Commission's powers in regulating the business of a licensed person, the court may grant an injunction against such contravention as well as an order directing the relevant persons to take the appropriate steps.

Including Persons Who Have Aided, Abetted, or Induced a Contravention

10. Consistent with the general approach in many other areas of law, the Composite Bill will make persons who have aided, abetted, induced, been knowingly concerned in, or attempted or conspired to commit a contravention liable to the same degree as a person who has actually committed the misconduct.

Creating a Private Cause of Action

11. At present, a person who suffers loss as a consequence of another's misconduct in the securities and futures market may be able to seek redress in court under contract, common law, or in equity. However, he or she will have to fashion the claim in traditional contract, tort, or breach of fiduciary duty terms. Although contravention of a regulatory requirement or prohibition resulting in injury to others may be prima facie evidence of a breach of duty, the breach will not, of itself, give rise to a cause of action.
12. Moreover, having to fashion a claim in contract, tort, or equity may lead to protracted preliminary arguments about the availability of the cause of action and the particularization of the alleged breach. Such arguments increase the cost of litigation unnecessarily, and make it more difficult for an injured party to seek recompense from the offending person.
13. The Composite Bill will simplify the legal process for redress by expressly allowing a person who is or might be materially affected by another person's market misconduct or criminal offences to apply to the Court of First Instance for an injunction or other remedies. For definitions of "market misconduct"

and criminal offences under the Composite Bill, please see *Guide to Legislative Proposals on Establishing a Market Misconduct Tribunal*.

14. The creation of this statutory private cause of action is intended only to eliminate the unreasonable necessity of fitting an act that contravenes securities regulation into traditional common law precepts. An applicant for relief will still have to prove the defendant's violation of the relevant prohibitions, causation of harm, and materiality of injury. Persons other than the injured party will not be entitled to bring a claim under this cause of action, whether for themselves or on behalf of others as a class.
15. The proposed private cause of action follows international trend in facilitating investors in their taking responsibility for themselves, and is accepted practice in other leading jurisdictions. In the United States, Sections 11 and 12 of the Securities Act expressly provide for private causes of action for violations of the securities registration requirements. Section 16(b) of the Securities Exchange Act (the "SEA") allow public companies to sue their directors, officers, and major shareholders for "short swing" trading. Section 18 gives a right of action to any person who purchases or sells a security in reliance on misleading statements in a reported filed under that act. Courts have recognized an implied private cause of action for violation of Section 14 of the SEA in connection with proxy solicitations and tender offers. But most importantly, there is a right for action for violation of Rule 10b-5 (made under Section 10(b) of the SEA). Volumes of case law have interpreted this anti-fraud rule to cover an extremely wide variety of situations, thus effectively providing a catchall cause of action for private litigants.

16. In the United Kingdom, Section 80 of the proposed Financial Services and Markets Bill uses simpler language. Under the section, “a contravention of an authorised person is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents apply to actions for breach of statutory duty”.
17. Australia takes a substantially similar approach. Section 1324(1) of the Corporations Law extends the right of action to “[any] person whose interests have been, are or would be affected by the conduct [that contravenes a legal provision]”.

Allowing the Court to Fashion Other Remedies

18. A corollary of giving aggrieved persons a right of action is making available a remedy in damages in addition to injunctive relief. Accordingly, the Composite Bill empowers the Court of First Instance to make an order, whether in addition to or in substitution for an injunction, requiring payment of damages.

Remedy in Cases of Unfair Prejudice

19. Section 37A of the SFCO authorizes the Commission, after consultation with the Financial Secretary, to apply to the Court of First Instance for certain remedies if it appears to the Commission from any information (including information obtained in a Section 29A investigation) that “the affairs of a listed company are being or have been conducted in a manner unfairly prejudicial to the interest of its members generally or of some part of the members”.

20. Perhaps the most general of the remedies available is for the court to “make any order it think[s] fit, whether for regulating the conduct of the company’s affairs in future, or for the purchase of the shares of any members of the company”. However, in In the Matter of Chesterfield, Rogers, J. stated his concern that Section 37A imposes limits upon the scope of the orders which a court can make – for example, not allowing a court to prohibit a person from being involved in the management of companies generally even if the person has engaged in serious misconduct. The judge suggested that the law be revised in this regard. The Standing Committee on Company Law Reform subsequently discussed this issue and recommended the addition of an express provision. Accordingly, the Composite Bill will include a new provision empowering the court to disqualify a person from being a director or otherwise taking part in the management of any corporation (other than authorized financial institutions) for up to five years.
21. In addition, the Composite Bill will also clarify that the court may exercise its powers in relation to events surrounding the formation of a corporation, and whether or not at the time of application for remedy the relevant corporation is still listed.

Power to Intervene in Third-Party Proceedings

22. Litigation where the Commission is not a party may nevertheless involve points of law that are relevant to the Commission’s functions and responsibilities as regulator. The recent CA Pacific case provides an illustrative example. An issue arose in the liquidation of CA Pacific Securities Ltd. over the clients’ interest in securities held in CCASS. This issue is one of

great public interest, and the Commission's expert views may have assisted the court. However, the Commission was not able to voice its opinion in the relevant proceedings because it was not a party to the suit.

23. Several other leading jurisdictions have mechanisms whereby the specialist regulator may submit its expert views for the benefit of the court in third-party proceedings. Such is particularly helpful when issues are not fully litigated by opposing parties (for example, where a party is absent or not represented by counsel). It may also be valuable where there is a real uncertainty about the application of a provision. The Composite Bill will add a new section, modeled upon a provision in the Corporations Law of Australia, to provide the Commission with a right, exercisable upon consultation with the Secretary for Justice, to intervene and be heard in relevant third-party proceedings (other than criminal proceedings) where it has an interest in the matter by virtue of its statutory powers and functions.

Public Consultation

24. A person who is or might be materially affected by a licensed person's violation of securities law should have a statutory right of action. Such a private cause of action simplifies the pleading process, and follows the international trend in facilitating investors in their taking responsibility for themselves.
25. There will also be occasions where private lawsuits give rise to issues of important public interest, or issues that bear on the Commission's functions and responsibilities. The Commission should be able to intervene and become a party to such proceedings so that it may provide its expert views for the

benefit of the court, and in order that the public's interest is represented in the legal process.

26. The Government and the Commission believe the proposals detailed in this Guide will improve the regulatory framework and put it on par with the best of international standards, thereby enhancing Hong Kong's competitiveness as an international financial centre. Comments and views are sought from the financial community and the general public. Please write to the Securities and Futures Commission, 12th floor, Edinburgh Tower, The Landmark, 15 Queen's Road, Central, Hong Kong or e-mail to <newbill@hksfc.org.hk>. In view of the tight legislative timetable, we would be grateful if your comments and suggestions could reach the Commission before 6 August 1999.