THE REGULATION OF INSIDER TRADING IN HONG KONG

The Colony of Hong Kong has progressed considerably from the day when Lord Palmerston could correctly describe it as a 'barren island with hardly a house upon it.' Whilst of great importance as a financial and economic centre, Hong Kong has not, at least in the realm of corporation law made a significant contribution, and indeed has in recent years noticeably lagged behind countries such as Singapore and Malaysia, in developing and updating their laws. In one area, however, that of securities law the Colony has made a major step forward, and with the recent reforms in the field of company law generally it would appear that Hong Kong has been able to forge ahead into areas where British Governments, in particular, have behaved with undue caution. The purpose of this article is not to examine the new securities laws in Hong Kong generally but to fasten upon one particular aspect, that of insider trading, and associated abuses. No attempt has been made to compare the Hong Kong provisions with those to be found in other legal systems,[1] as it is considered that the somewhat unique position of the Crown Colony deserves a separate analysis.[2] On the other hand, it would be difficult to appreciate the regulatory mechanisms and the practical problems of enforcement, without at least some mention of the financial infrastructure and securities industry.

THE FINANCIAL INFRASTRUCTURE AND STOCK MARKET BOOM

The statistics of the Crown Colony's financial and banking institutions are impressive, and Hong Kong's growth in this area has been meteoric. There are some 74 licensed commercial banks, with some

[1] The question of the regulation of insider trading has become very topical in a number of countries, and it is indeed rare to find a country which is to any extent financially and economically developed that does not have some provisions in its laws relevant to the abuse of confidential nonpublic and material information by corporate officials and directors, no matter how rudimentary. Of course, in recent years attention has been concentrated more on the legislative regulation of insider abuse, for instance see the excellent article by Philip Pillai, on 'Insider Trading in Singapore and Malaysia' in (1974) 16 Mal. L.R. 333.

[2] Hong Kong has stronger legal and traditional ties with the United Kingdom today than countries such as Singapore and the Federation of Malaysia. There is considerable interchange between the Colony and Britain at both administrative and commercial levels.

The Report on Investor Protection of the Companies Law Revision Committee, 24th March 1971, paragraph 13, stated that Hong Kong company law has always been based firmly on the Companies Acts in Britain; and the Committee took it as a general principle, that unless there was a good reason to the contrary, arising out of local conditions, "it was desirable to follow the law in Britain, not only in relation to companies but also in relation to the prevention of fraud, protection of depositor, dealings in securities and unit trusts."

600 subsidiaries,[3] the number of merchant banks is ever growing[4] and there are some 2000 assorted finance and securities firms.[5] It should also be added that since 1962 the Colony's number of registered companies has similarly exploded, and now stands well above the 28,000 level. In 1961 the figure was around 5000. Hong Kong, despite its somewhat notorious reputation for corruption and commercial crime,[6] has managed to establish itself, in a very short time, as a leading regional financial fulcrum, even though Singapore remains as the centre of the Asian Dollar Market. The reasons for this, are naturally multifarious, and not susceptible to the rather perfunctory analysis the author would be capable of subjecting the discussion to. Nevertheless, in passing certain points are at least worth mentioning, insofar as they bear upon the question of securities regulation. The Hong Kong Colonial Government has traditionally been opposed to the enactment of stringent controls and restrictions in the field of finance, and indeed business generally.[7] This has resulted, perhaps rather by accident than design, in the Colony having a very low tax structure, a relatively strong currency and free foreign exchange. This last point is important from the point of view of viable securities regulation, as it means that vast sums of money are freely moveable and convertible. Thus securities can be rapidly liquidated and the proceeds withdrawn from the capital markets overnight. Indeed this factor no doubt assisted in the precipitous fall of the Hong Kong markets in 1973.[8]

Surprisingly, for its size Hong Kong has four reasonably large stock exchanges.[9] As Peter Mellor in the July *Banker 1974,* points

[3] *The Banker,* July 1974, page 775, 'The Continuing Appeal of Hong Kong.'

[4] There are about 30 British merchant banks operating in Hong Kong, and there are also a large number of American, Canadian, Japanese and local houses: *Financial Times* (London) 21st February 1974. The Hong Kong Banking Commission has only grudgingly allowed new commercial banks to open — see 'Surprise to all but the insiders', *Times* (London), 8th May 1973.

[5] Apart from the financial houses and institutions there are a number of syndicates which deal with money brokerage and engage in security and commodity speculation. This makes definitive regulation well nigh impossible, given the informal nature of many of these syndicates.

[6] Indeed, as the Full Court observed in *R.* v. *Hong Kong Dragon Co. Ltd.* (Crim. App. No. 889 of 1971) (April 12, 1972): 'Finally we would observe that commercial crime is just as endemic in Hong Kong as are crimes of violence and it has a longer history. Indeed commercial dishonesty may fairly be described as rampant.'

[7] This approach has invariably been the result of a legitimate desire on the part of the authorities to foster trade and commerce. Of course there has also been an often close association between the commercial sections of the community and the Colonial Government: see, for instance, 'Men and Matters, Clague's Hong Kong Troubles', *Financial Times* (London) August 8th 1975.

[8] See John Cousins, 'Hong Kong's Capital Markets' *The Banker,* July 1974, page 777. There was much resentment among the local population because of the large withdrawals from the capital markets and the Colony generally by the British banks and large investors, just before the market crashed. Whilst it is true most of the British investors did liquidate large sums of money, the selling was probably occasioned by greater market awareness, rather than any more sinister considerations.

[9] These are: The Hong Kong Stock Exchange Ltd., (which is an amalgam of the Hong Kong Stock Exchange Ltd., incorporated in 1891, by statute, and the Hong Kong Stock Broker's association incorporated in 1891, by statute, and the Hong Kong Stock Broker's association incorporated in 1921);
The Far East Exchange Ltd., established in December 1969, and whose daily turn-over now exceeds that of the other three;

out, their history is very similar to that of the provincial stock exchanges in the United Kingdom, insofar as, with the exception of the Hong Kong Stock Exchange, they were all set up by individual groups of businessmen in response to a need within the investing section of the community. It is worth mentioning that in addition to the factors briefly enumerated above making the Colony a very attractive financial centre, there are certain distinct advantages which have pushed these exchanges into a dimension where no worthwhile survey of securities regulation can afford to ignore.[10] Some of this factors are, the absence of capital gains tax,[11] the ready access to the free foreign exchange markets, and the convenience of a very prompt settlement system regarding share transactions, which are required to be finalised by 2.15pm on the first day of trading immediately pursuant to the execution of the order. These factors make securities dealing an exceedingly attractive pursuit; indeed for some of the local Chinese population, in recent years, their gambling instincts[12] have been allowed to run relatively free on the securities and commodities exchanges.

Although there is no real "over the counter" market in the Colony, transactions involving shares are often negotiated in solicitors' boardrooms.[13] But these transactions are insignificant in comparison to the exchange dealings and do not constitute really a regular market as such.

The meteoric rise of Hong Kong as a securities market centre has had a rather unusual aspect. 'It has been where an army of stock brokers has created a large and viable stock market, rather than the

The Kam Ngan Stock Exchange Ltd., known as the Gold and Silver Exchange, and opened in March 1971; and

The Kowloon Stock Exchange, established in January 1972.

Another stock exchange, the Asia Stock Exchange, was just about to be established when the Securities Ordinance came in. Part 2 of the 1974 Ordinance effectively prevents the establishment of new stock markets, unless such conform to the numerous restrictions and provisions included in that Part of the Ordinance. Under the provisions of the Ordinance all four exchanges are to become part of the Federation of Hong Kong Stock Exchanges (see, generally, a 'Guide to the Hong Kong Stock Market' by the Chartered Bank 1974). There is a possibility that the Kowloon Stock Exchange will merge with one of the others should the slump in business rise: see *Financial Times* (London), 11th December 1974.

[10] During a reasonably busy day on the exchanges the total turnover could well exceed £500 million: a turnover rivalling, and in a number of instances exceeding, that of London or Tokyo.

[11] This of course makes "short-swing" speculation for capital gains most attractive. The profits and dividends received from a company which is subject to the Hong Kong profits tax are paid tax free to the investor, resident or non-resident alike.

[12] See Frank Vogl, *Times,* 9th April 1974, who refers *inter alia* to the 'obsession of the business population entirely on the aim of making money fast.' Mr. J. Selwyn, the Commissioner for Securities, is reported as saying that 'I know the Executive Council will be very careful before they give the green light to the proposed commodities exchange, which could be used by the public as another gambling den': *South China Morning Post,* 17 January 1975.

[13] The definition in the Securities Ordinance 1974 of a stock market is 'a place where persons regularly meet together to negotiate sales and purchases of securities, or a place at which facilities are provided for bringing together sellers and purchasers of securities, but does not include the office of a stockbroker or of a member firm or corporate member of a stock exchange' (Section 2). Thus to be included within the regulatory framework of Part 2, there must be a 'regular' and not a merely 'frequent' making of bargains.

other way round'.[14] Until about six years ago, the only market for corporate securities was the old Hong Kong Stock Exchange. This relatively small exchange, having only some 80 or so active stocks, was dominated by the three major trading 'Hongs', Jardine Matheson, Hutchinson International and Wheelock Marden. There was an effective expatriate cartel, which operated to the virtual exclusion of Chinese stock dealers.[15] Nevertheless, soon it was realised that there was legally very little to prevent a syndicate establishing its very own stock market. The Far East Stock Exchange blossomed in late 1969; Kam Ngan a few months later, and the Kowloon in 1972. This resulted in a vast increase in the securities industry. There are now well over 1000 brokers,[16] and over 3000 securities are listed on the exchanges. This as one would expect led to a commission war of the worst type. By "wash sales" and other manipulative practices dealers encouraged customers to deal on margin and borrowed funds.[17] Then again the dealers openly competed to obtain the accounts of directors and various insiders, who might be expected to have valuable inside information or at least a greater degree of 'innate dealing skill'.[18]

Perhaps one of the most insidious practices bordening on the abuse of insider status was the exceedingly widespread practice of companies who wished to issue securities, in many cases not because they actually needed funds, but as John Cousins aptly puts it for 'face or fun'[19] placing a 25% issue in the hands of a number of individual dealers as agents at the offer price, invariably HK$1. Because of this wide dispersion, among many dealers an artificial supply and demand balance was constructed or easily manipulated. In such a rapacious market as was then operative, the lucky broker could sit

[14] Malcolm Surry, *Times* (London), May 8th 1973.

[15] This unfortunately, but of course almost inevitably, had the result that small illicit operations florished and 'bucket shops' prospered.

[16] Securities transactions on the Exchanges are carried out between member brokers; there is no jobbing system as such, although some of the larger brokerage firms will make a price in larger lines of stock and thus to a limited extent perform as jobbers: Peter Mellor, 'Anatomy of a Stock Market', *Banker,* July 1974, page 785. A jobbing system has not been introduced as the Finance Department will not allow the necessary stamp duty concessions. Wedd Durlacher Mordaunt Ltd. investigated the feasibility of establishing a jobbing system, but even with the support of the Hong Kong Stock Exchange there was considerable opposition locally and in London. Thus at present nearly all brokers act in a dual capacity as brokers and dealers, with only a few performing anything approaching a jobbing or specialist function.

[17] A number of financial houses lent short and medium term funds on Hong Kong stock certificates as collateral. This was alright as long as the boom endured, but as soon as the share prices began to decline these holdings had to be liquidated, adding increased momentum to the collapse: see Vincent Mang, *Times* (London), 23rd August 1974, and the *Financial Times* (London), 3rd February 1975.

[18] It was more important, in many instances, that others knew that a particular broker held the account of an insider, as other investors and brokers would follow this broker into securities where it was reasonable to assume he had been tipped inside information. The broker with the insider's account could then pull out of that security, at great profit even though he actually had no inside information at all, and the transactions had been executed solely with the intention on his part of inducing a market following.

[19] *Times,* May 8th 1973. In 1971, 15 companies registered prospectuses and offered their shares to the public. In 1972 this figure shot up to 100, and companies were queuing up to invite the public to take their shares: Richard Field, The Law Relating to the Flotation of Securities in Hong Kong', *Hong Kong Law Journal,* Vol. 3, p. 147.

on his small parcel of shares, knowing he could not begin to satisfy the actual or generated demand of his customers whilst the prices rocketed within a matter of days, to in some cases ten-fold the issue price. He could then off-load, at a very handsome profit. In a large number of cases the price fell as sharply, if not more so than it rose, although of course because of the booming conditions on the markets in certain instances the prices did hold their positions for some time. The issuers were not unpleased with these practices; on the whole as they could issue their securities and obtain expansion capital with virtually no overheads, or they could issue at premium. Although the securities dealers invariably only held the issued shares as agents they often sold to nominees, and could thus retain them and thus effectively restrict supply in a rapacious sellers' market. Given the fact of commissions and the fact that placements are invariably underwritten the dealers made considerable profits on this type of market.[20]

The Hong Kong Government was criticised from a number of diverse sources about its seeming apathy to the wholesale creation of new securities exchanges and its failure to take cautionary steps to curb the excesses of the rampant new issues market. This criticism, whilst understandable, was largely misplaced as there was little or in most cases nothing that the Colonial Government could do under the then existing powers that it possessed.[21] The only real thing that the Government could do was to exercise indirect control through the power of the Governor in Council to impose a number of 'conditions' for recognition of securities exchanges under Section 2A of the Companies Ordinance. Although these conditions are binding only upon recognised Stock Exchanges, as most exchanges desire to be eligible for recognition, all tried to varying degrees to bring their rules, as much as was possible, into line with the Government's views.

The 'conditions' essentially lay down requirements for inclusion into the Exchanges' self-regulatory mechanisms and rules. Apart from a number of provisions relating to the running of the Exchange and its membership it was important that the rules of the Exchange were 'just and adequate to ensure fair dealing and protect investors,' if the Exchange was to be 'recognised'. To satisfy this criteria the rules must *inter alia* include provisions in the listing requirements for full prospectus disclosure on an application for listing, and that the con-

[20] See the Companies Law Revision Committee's First Report, paragraph 8.5, and 'The Law Relating to the Flotation of Securities in Hong Kong?' Hong Kong Law Journal, Vol. 3 page 150, by Richard Field. Mr. Surry (in the *Times,* May 8th 1973) goes on to say, 'Certain stockbrokers have made fortunes in this manner and now frequently crop up on the boards of companies about to make their market debut.' Surely this is a most vile aspect of insider trading as investors are and always will be at a great disadvantage at the promotional stage in a company's development. This is even more objectionable in developing countries, where pre-issue disclosure is poor, and the market largely unsophisticated: see Dr. Balakrishnan, Secretary to the Company Law Administration of the Central Government of India: Conference on Current Problems of Corporation Law: (Indian Law Institute, New Delhi; published by N.M. Tripathi Private Ltd., 1964), page 83.

[21] Mr. R. Garrett, then Chairman of the Securities Exchange Commission (U.S.A.), stated at a conference on insider trading held in London on the 3rd and 4th April 1975, that during the crisis of 1973 the Financial Secretary called in the Hong Kong Fire Brigade to clear some of the exchanges under the Colonies Fire and Safety regulations, as a means of putting some restraint on the situation.

tinuance of the listing be conditioned on full and fair disclosure by public announcements and annual reports and accounts. It was further necessary to provide that it was against the integrity of the exchange, and against its rules, for members to indulge in any dealings that would promote or assist in the promotion of a false market in the securities of a listed issuer. A 'false market' was defined as being a market in which the movement of the price of a security is brought about by contrived factors such as the operation of buyers and sellers acting in collaboration with each other, calculated to create a movement in the price which was not justified by the issuers' assets, earnings or prospects. In addition the conditions required that when exchange members were dealing on their own accounts they must inform their clients of this fact before the conclusion of the contract, and that the appropriate disclosure had to be confirmed by a notation in the 'contract note'. Members of the Exchange seeking Government 'recognition' also had to be bound, by their Exchanges rules, to maintain adequate records and books of account which were to be open to inspection by the Council and authorised auditors of the Exchange. Finally, and from our present point of view most significantly, there must be a prohibition in the rules on any member of an Exchange who is a director or auditor of a public company acting as a broker or dealer in the securities of that company or an issuer of the same group.[22]

The Companies Law Revision Committee in its First Report on Investor Protection, Part 11, found that these 'Conditions' had worked, and were working, reasonably well, within of course their obvious limitations.[23] Thus as well shall see later, the Hong Kong Securities Commission, under its powers in the Securities Ordinance of 1974 approved the Stock Exchange's rules broadly along the same lines as those that existed under the Governor's Conditions.

Another serious problem that the Colonial Government was faced with was that of the tremendous increase in the number of persons who held themselves out as willing and able to give 'professional' investment advice.[24] This industry blossomed overnight, and became a major factor in the rise of the markets in late 1971. Many of these so-called advisers had no professional training and had no allegiance to an established professional body. Furthermore, they were generally also dealers and brokers, and thus it was reasonable to assume that

[22] Furthermore under the terms of the Conditions for Recognition adequate arrangements must be made for the regular daily publication of full and accurate details of all transactions taking place between members, and official records of all transactions have to be maintained and be available for inspection by clients. Furthermore, there should be rules segregating clients' and members' funds. Of course, the presence of such rules, largely modelled on those of the London Stock Exchange, did not necessarily mean they were observed or indeed enforced.

[23] The Companies Law Revision Committee in its First Report on Investor Protection (at paragraph 6.49) states they are not necessarily persuaded that there should be legislation limiting the number of stock exchanges, such as the New South Wales Securities Industry Act 1970, in section 7A; by the requirement of a minimum deposit of one million Hong Kong dollars (paragraph 6.49, 6.60) sheer economics would provide the necessary limitation, in their view.

[24] Apart from 'pure investment advice; the intensity of the local investment climate is reflected in the fact that some forty local newspapers give share prices to an estimated 500,000 investors: *Times* (London), 8th May 1973.

the advice that they offered was not only suspect but far from 'uninterested'. To this problem was added that of mutual funds and investment companies operating on an offshore basis.[25] Whilst these operations have caused problems for most countries, the Hong Kong authorities were in the unenviable position of having neither the necessary laws nor the expertise to protect the large number of 'unsophisticated' investors in the Colony.

These various factors were to a greater or lesser extent all contributory causes and aspects of the stock market boom in the Colony. The combined effect on the financial situation in the Colony's capital markets was staggering; in June 1972 the Hang Seng Index stood at 400, by March 1973 it was past 1774, yet by July of that same year it had plummeted to 490. Although the reasons for such somersaults do not concern us, insofar as they are unrelated to the regulatory mechanisms designed to ensure fair and orderly markets, it is of some interest to note that Peter Mellor in the *Banker* writes that 'it was the very nature of Hong Kong and its people that bred this particular animal'.[26] In other words, despite the obvious regulatory deficiencies that existed and the numerous areas of abuse, a great responsibility for the behaviour of the market has to be laid at the door of the ordinary local Chinese investor. The vast bulk of local investors, who eagerly participated in the markets, were particularly unsophisticated and to a large extent motivated by an almost insatiable gambling urge.[27] No regulatory mechanism can operate effectively unless it reflects to a relatively high degree local conditions, and this is particularly so of both Hong Kong and securities laws in general. The average local investor has not been over-concerned in the past with long term growth, but rather short-term trading for capital profits. To this extent the local market is volatile and fickle. Unless there is an active market where there is always the possibility of a speculative profit the smaller investor and syndicates will move out into commodities. Furthermore, because of the relatively high proportion of private individual investors the market is easily upset by large institutional blocks of securities, and this factor of course adds to the volatile nature of the capital markets. Indeed many had hoped that the introduction of a jobbing system would alleviate this particular problem.

Because of the predominant desire among local investors to concentrate on capital accretions and profit taking, and the realisation

[25] See the Companies Law Revision Committee, First Report 1971, Chapters 10 and 11.

[26] Anatomy of a Stockmarket, *Banker* July 1974 at p. 788; see the *Financial Times* (London), 6th April 1974. For details of the market and the index see the *Hong Kong Stock Exchange Gazette,* January 1974.

[27] Many small businessmen, junior executives, and artisans gave up their work to speculate full time on the markets. It was of course these persons who were the hardest hit when the inevitable collapse came. The *Times* on August 23rd 1974 described the Hong Kong Exchanges as the biggest casinos in the world, and an editorial comment in the Hong Kong Law Journal (Vol. 2, page 258) stated that 'there is a growing feeling that transactions on the floor of the four stock exchanges have more in common with totalisator betting at Happy Valley than with the performance of local companies and the situation of the economy'. The *Times* also remarked that 'the Chinese seem to carry off successfully the curious paradox of being the shrewdest savers in the world as well as the most fearless gamblers' (London May 8th 1973).

among the large institutional investors and the more sophisticated sectors of the market that the index could not always remain at the magical figure of 1775, the market collapsed in a tremendous burst of profit taking and liquidating of investment positions. The fall was aggravated by the absence of long and medium term investors in any great number, and the failure of professional investors to step in.[28] With the crash came strong demands for increased supervision and regulation, both from the local and foreign interests, and it is to the Colonial Government's credit that a new order so rapidly has been brought into being. The pity is of course why so many legislatures have only been stunned into action once such a crash of confidence has occurred.[29] Before we look at the new regulatory mechanism in Hong Kong, however, we should first of all look briefly at the mechanics of the Exchanges, which are by far the most important markets for securities in the Crown Colony.

STOCK EXCHANGE TRANSACTIONS: MARKET PROCEDURE AND TRANSFER OF TITLE

As there is no appreciable over-the-counter market in the Colony the four stock exchanges provide the only market for the sale or purchase of securities. Therefore it is of some relevance to briefly look at the way the markets operate so as to be able to appreciate how a transaction could be executed, perhaps initiated, on inside information.

On all the exchanges a system of priorities operates across the boards, with buyers and sellers taking terms on a first come, first served basis. The Hong Kong Stock Exchange Ltd. qualifies this by providing in its trading rules that a member broker may only buy or sell a total of two board lots[30] of any counter or dealing post if there

[28] It is perhaps interesting that no broker went bankrupt, at least publicly, during this period. Perhaps this indicates a reluctance on the part of the dealers to intervene in the market to preserve a degree of stability, which is regarded in many countries as the price that they should pay for their privileged position. Indeed, the Colony has had very few failures of securities houses over the last twenty-five years.

[29] On this point one has only to think of the United States of America and the 'New Deal' after the crash in the late 1920s, the state of the American securities industry in recent years, and the recent and current reform programmes in the United States. Australia is of course another fine example.

[30] Board lots — these are really parcels of shares in recognised predetermined trading units. In other words, it is the number of shares traded in as a unit on the main board, and the market prices quoted and trading rules are for board lots only. These board lots are not uniform, and are set at arbitrary amounts at the time the security was first listed, and subsequent revisions are infrequent because of the consequential complications for 'good delivery.' To qualify as a board lot share certificates and their accompanying transfer deeds must be delivered in amounts equal to the number of shares set as a board lot for that particular company (e.g. for Kwong Sang Hong the figure is 20 whilst Shanghai Kolanton it is 5,000). Incidentally, for example in the case of Kwong Sang Hong a single share certificate and transfers for 100 shares would not be marketable, and would have to be exchanged for five certificates in the board lot amount of 20 shares. As a general rule board lots are instantly marketable, and the market quotation for any company would be the current price for the board lots.

Odd lots, either in excess of or less than the board lots are traded, in some cases, but at two or three spreads below the market price. Of course, a broker can always split up board lots for several clients or have them held in nominee registration, and this is commonly done.

are other brokers behind him. If such a broker wishes to continue buying or selling at the same price he must drop to the rear of the queue and wait for this term to come round again. On the other three exchanges, the procedure is the same, except a maximum of six board lots is allowed if there are other members on the board waiting.

It is also a feature of the system that any buying rate for a board lot must not be four "spreads"[31] less than the last selling price; conversely, any selling rate should not be more than four spreads higher than the last purchase price. Although this does act as a limitation on wild fluctuations, there are a number of exceptions.[32]

Something of especial importance on the Hong Kong markets is that there are stringent requirements for good delivery. There are no account periods and the vast majority of transactions are for cash settlement the following business day. It is possible, however, to purchase or sell shares forward, the amount of forward being agreed upon between the parties. This is more usually done where large blocks of securities are involved or it is necessary to obtain the share certificates from abroad. Forward delivery is called 'delayed delivery' and payment will not fall due until the shares are actually delivered. Apart from the question of cost, the two types of transaction are exactly the same. Good delivery consists of share certificates in board lots, each certificate having attached to it a matching transfer deed signed by the registered shareholder as transferor. The position in the Colony regarding transfer is thus identical to that which existed in the United Kingdom before the Stock Transfer Act 1963.

Once the transfer deed is signed by the transferee, which transfers the title of the shares out of the registered shareholder's name and into his, the scrip is no longer negotiable and must go in to the issuer or its agent for registration of the transfer. However, once the deed has been signed by the transferor the securities take on a bearer aspect and are more or less negotiable. This causes significant problems in tracing intermediate purchasers and sellers, who do not sign the deed themselves, and never seek legal ownership of the securities. This has been a serious problem in the detection of frauds.[33]

It is regrettable that the Hong Kong exchanges are so scrip-orientated: and this provides a serious problem for overseas investors. As a result of this, many securities firms advise overseas clients, and

[31] The "spread" is the unit of rise or fall in a share. The *Guide to the Hong Kong Stock Exchange* (The Chartered Bank) page 5, gives the example that for instance where a share has a spread of H.K.$2, the rise and falls, bids and offers can only be recorded as H.K.$206, H.K.$208, H.K.$210, etc. The various stock exchanges fix their own particular spreads.

[32] Overseas securities with a local listing are exempted from this, and rubber shares are allowed to move up to eight spreads. Furthermore, at the opening of the market, where the market sentiment concurs, a seller or buyer may make his own initial rate, regardless of the prior days, where the market is falling or rising: *Guide to The Hong Kong Stock Market* (The Chartered Bank).

[33] The transfer deeds should not be dated and must carry a Hong Kong broker's 'chop' or stamp, confirming that the requisite stamp duty has been paid. Of course, provided that the 'chop' has been properly inserted, which is not always the case, it is possible to determine what securities' houses have been involved in the transaction. There is a general consensus of opinion, however, among brokers and administrators that I have spoken to that to trace intermediaries would be virtually impossible, in a high proportion of cases.

indeed for that matter Hong Kong clients, to hold shares in the Colony with one of the major banks or more usually in a nominee company.[34] Another very serious problem in Hong Kong is the very large number of share certificates which are either lost or just go missing.[35] Fraudulent transactions are undoubtedly facilitated by the fact that securities are bought and sold by mere delivery of the share scrips themselves, as though they were negotiable documents in the proper sense of the word. Generally no questions are asked on a transfer, even if the shares are registered in the name of someone other than the immediate seller. Furthermore, there is no ready means in any case of comparing the signature on the deed with that of the registered shareholder, to ensure that the transferor is that person. Given these considerations and the fact that the Companies Law Revision Committee observed in their Second Report on Company Law[36] that in many cases brokers do not know their clients personally (most being 'introduced by representatives or sub-representatives of no long or very solid standing') the implications for the regulation and detection of insider abuse are clear.[37] This is aggravated by the fact that owing to the time taken by companies to effect registration (which can be anything up to two months) during which time, of course there can be no dealing in the securities concerned as the certificates are not available, it is common practice to leave the shares in the negotiable form, that is, the transfer deeds are signed by the transferor but not the transferee, until it is required to transfer them; when the deed will be signed by the last purchaser, and sent off to the registrar concerned.[38] Thus in most cases investors usually prefer to retain their shares in negotiable form until it is necessary to obtain registration and legal ownership. Bearer securities, issued as such and, of course, not requiring deeds of transfer, are extremely rare, as the normal practice for registered securities operates in such a way as to afford many of the advantages and of course the problems of free negotiation, whilst the wide availability of nominees affords similar anonymity. The degree of automation on the Hong Kong Exchanges is not particularly great, and there is nothing approaching the sophisticated computer surveillance systems operating in the United States. An interesting recent development, and one favoured by the Com-

[34] For instance, for securities of the Hong Kong & Shanghai Banking Corporation, (London Register) to be dealt with in the Colony, and constitute good delivery they must not only be in board lots of 400 shares, but also be held in the name of bank nominees, Hong Kong, by convention of the Hong Kong Stock Exchange Ltd. Thus, any resident of Hong Kong, by depositing these shares in any account of the Hong Kong bank, can trade these securities more or less perpetually in bearer form. Of course the fact that so many securities are held in nominee and street names increases the chances that insiders trading on the basis of timely information will not be detected.

[35] See Henry Litton, 'Share Certificates: Lost and Gone Forever', Vol 3, Hong Kong Law Journal, p. 319. See also the *South China Morning Post,* 8th June 1973, and 3rd November 1974, for advertisements relating to lost certificates.

See also Section 14 of the Companies (Registration of Records) Ordinance and the Recommendations of the Companies Law Revision Committee, Second Report on Company Law (April 1973) pp. 104-108.

36 p. 108.

[37] There is no real parallel in the Colony to the traditional 'know your client rule' as required on the American Exchanges, and those of certain other countries.

[38] This will usually only be done when the company announces a date for the closure of its books for the purposes of distributing a dividend.

missioner for Securities, is the establishment of a central clearing house, set up by the Exchanges for the purposes of disseminating all proper information on corporate activities of listed issuers. This would be 'in a readily accessible form to the media'.[39]

THE COMPANIES LAW REVISION COMMITTEE — THE APPROACH OF REGULATION

Having examined the infrastructure, albeit somewhat perfunctorarily, we should now turn to the regulatory aspect of our present topic. In April 1962 the Governor appointed a Companies Law Revision Committee[40] under the chairmanship of Mr. W.K. Thomson, the Registrar of Companies. The terms of reference were modelled on those of the Jenkins Committee[41] and were "to consider and make recommendations as to the revision of Company Law in Hong Kong and in particular to recommend as soon as possible whether legislation for the prevention of frauds in relation to investments is required and if so the form which it should take." The work of the Committee did not really get under way however until 1968. Although this was in large measure due to the pressure of work upon Mr. Thomson in his position as Registrar of Companies, the Committee decided to wait and see the outcome of the recommendations of the Jenkins Committee in Britain. The Hong Kong Government were naturally disappointed when the United Kingdom Companies Act was passed in 1967, and reconvened their own Committee.[42]

The Committee decided to deal with the questions of company law reform and investor protection together, partly because there had been no real evidence of securities frauds that would have been prevented had the Hong Kong law been the same as in Britain. Indeed, it is somewhat surprising that very few instances of actual fraud have ever come to light in the Colony. Of course this is not to say that there are none. Nevertheless largely because of the rapid increase in mutual fund activity in the Colony, and the stock market boom, the Committee decided that the area of securities regulation required immediate priority and directed their attention to this area, leaving the question of company law reform to a second report.

It was a paramount concern of the Committee to try and keep the Hong Kong Law as uniform as was possible with that of the United Kingdom. The Hong Kong Companies Ordinance was almost identical with the British Companies Act of 1929; including Sections 82-84 of the 1861 Larceny Act dealing with the keeping and falsification of accounts; and Sections 32 and 33 of that Act dealing with false pretences and knowingly receiving property obtained in circumstances which amounted to a crime in the Larceny Ordinance. However, since 1932 the British law had largely left that of the Colony behind; most noticeably in Hong Kong's absence of an equivalent provision to the Prevention of Fraud (Investment) Acts of 1939 and 1958. In chapter 4 of their First Report the Committee acknowledge

39 *South China Morning Post,* 17th January 1975.
40 Hong Kong Government Gazette, 19th April 1962.
41 Report of the Company Law Committee (Cmnd 1749).
42 Companies Law Revision Committee, First Report 1971, paragraphs 1-6.

'as the laws stands, opportunities for fraud and for reckless misrepresentation as to the worth of securities undoubtedly exist'.[43]

The Committee was concerned to strike a balance between the reasonable protection of the investing public and the imposition of a scheme that would be unduly restrictive and quite possibly have a detrimental effect. The Committee rightly considered that whilst it was possible to seek to reduce to a minimum the opportunities for fraud, it was impossible and undesirable to seek to protect all persons, no matter how careless or reckless they might be. The Committee saw the solution to this particular problem, at least in part in encouraging investors to seek and obtain adequate professional and independent advice. The problem was. and still today is, that there just is not sufficient expertise in the Colony to adequately supply the tremendous demand for investment advice. For instance, Richard Mang writing in the *Times,* states that in recent months and years, 'gossip and wishful thinking have been passed on as expert advice, and many investment decisions are made on the basis of vague promises from butchers, bakers and candlestick makers turned stockbroker'.[44] Whilst there are signs that the securities industry is becoming much more professional in both its membership and approach in Hong Kong, there is still considerable evidence that the process has only recently began.[45]

POSSIBLE ANTI-INSIDER TRADING PROVISION?

Ironically the Companies Law Revision Committee may have hit upon a provision which, although not generally considered in the context of insider abuse, could in certain instances provide a mechanism to regulate this particular type of abuse. The irony is, of course that the Hong Kong authorities have not thought of the provision that we are about to discuss in this light.

The Companies Law Revision Committee were particularly interested in Section 13 of the United Kingdom Prevention of Fraud (Investments) Act 1958, as amended by the Protection of Depositors Act 1963.[46] It is of some interest to note that the Committee specifically pointed out that Section 13 was very comprehensive, covering not only statements, promises and forecasts known to be false or

[43] First Report, paragraph 4.1.

[44] *Times* (London) 23rd August 1974. Seats on the Exchanges were bought and sold like personal franchises, and there was in the period of the Stock Market boom a wild scramble to obtain seats on the Exchanges, which could fetch far in excess of £35,000. This is not to say that there are not some highly respectable and professional securities houses in the Colony, and not only among the expatriate sections of the community.

[45] Malcolm Surry, *Times* (London) 8th May 1973. The First Report of the Companies Law Revision Committee (at paragraph 2.25) stated that apart from the 'free' advice offered by the American, Canadian and British securities firms there was virtually no other source of reliable investment advice in the Colony. Rumour still plays an incredibly important role in the Colony's capital markets: see *Financial Times* (London) 13th June 1974, regarding Hutchinson International and Burmah Oil.

[46] The Committee stated that 'we are of the opinion that this is a most useful section which should be adopted in Hong Kong: 'First Report (paragraph 4.12). This was also the view the Commercial Crimes Office of the Hong Kong Police, in their evidence to the Committee.

deceptive but also the 'dishonest concealment of material facts'.[47] The proposal that this provision should be enacted in the Colony's legislation was strengthened by a recommendation that the suggestion of the Jenkins Committee, that there should be a civil remedy as well as the criminal one for a violation of Section 13, should likewise be accepted by the Colonial legislature, although the British Government had ignored it.[48] It was thus strongly recommended to the Governor that legislation along the lines of Sections 13 and 14[49] of the United Kingdom Prevention of Fraud (Investments) Act 1958 be introduced before the Legislative Council as soon as was possible. After a delay, occasioned by the need to formalise the proposals for a Ordinance on securities regulation of some two years, a Protection of Investors Bill was presented to the Legislative Council towards the end of 1973.[50] This Ordinance deals almost exclusively with fraudulently and recklessly inducing people to invest, and the regulation of advertisements and documents relating to investments, leaving the other matters of concern to the Securities Ordinance. Because of this, the Protection of Investors Bill escaped most of the criticisms and controversy which swamped the main securities legislation. Whilst not surprising, it is anomalous: as the provision of this much smaller Ordinance, being some fifteen times as long could prove, at least in the short term, much more extreme and serious for current investment practices, than was ever imagined.

The Protection of Investors Ordinance was enacted virtually unchanged on the 20th February 1974.[51] Section 3 of the Ordinance makes it an offence, punishable on indictment with a very serious penalty of a fine of one million Hong Kong dollars and seven years imprisonment, to fraudulently or recklessly induce persons to invest their money in, among other things, securities. Although Section 3(1) is very similar to Section 13(1) of the British Act it is probably worthwhile to set it out, here:

> Section 3(1) Any person who, by any fraudulent or reckless misrepresentation, induces another person —
>
> (a) to enter into or offer to enter into any agreement —
>
> i) for or with a view to acquiring, disposing of, subscribing for or underwriting securities; or

[47] First Report, paragraph 4.12.

[48] First Report, paragraph 4.15; and see the Jenkins Committee Report at paragraph 264(a). Unfortunately the British authorities have not sought to utilise Section 13 in a number of instances where such a provision, on a liberal construction of the words, would have covered the facts. Indeed there are surprisingly few cases on Section 13 in England. See *R.* v. *Bates* (1952) 2 All. E.R. 824; *R.* v. *Russell* (1953) 1 W.L.R. 77; *R.* v. *Grunwald* (1963) 1 Q.B. 150; and *R.* v. *Markus* (1974) 3 All. E.R. 705.

[49] Section 14 of the 1958 Act regulates investment circulars: see paragraphs 4.16 to 4.24 and 6.1 to 6.34 of the First Report. The Committee were also in favour of the enactment of the dealer registration sections in the United Kingdom Act; and the Licensed Dealers (Conduct of Business) Rules 1960, with minor alterations were also considered as appropriate for adoption in the Colony: see Chapters 4 to 6, of the First Report, and Chapter 9 with regard to Takeovers.

[50] Protection of Investors Ordinance 1973 (Legal Supplement No. 3 to the Hong Kong Government Gazette: Sup. to Gazette No. 39, Friday 28th September 1973 Vol. CXV).

[51] Legal Supplement No. 1 to the Hong Kong *Government Gazette,* Friday 22nd February 1974.

ii) the purpose or effect, or pretended purpose or effect, of which is to secure to any of the parties to the agreement a profit from the yield of securities or by reference to fluctuations in the value of the securities or property other than securities, or

(b) to take part in or offer to take part in any investment arrangements in respect of property other than securities,

shall be guilty of an offence.

(2) For the purposes of subsection (1) 'fraudulent or reckless misrepresentation' means

(a) any statement —

(i) which to the knowledge of its maker was false, misleading or deceptive; or

(ii) which is false, misleading, or deceptive and was made recklessly;

(iii) which was made recklessly.

(b) any promise —

(i) which the maker of the promise had no intention of fulfilling;

(ii) which to the knowledge of the maker of the promise, was not capable of being fulfilled; or

(iii) which was made recklessly;

(c) any forecast —

(i) which to the knowledge of the maker of the forecast was not justified on the facts known to him at the time when he made it; or

(ii) which was not justified on the facts known to the maker of the forecast at the time when he made it and was made recklessly; or

(d) any statement or forecast from which the maker of the statement intentionally or recklessly omitted a material fact, with the result that the statement was thereby rendered untrue, misleading or deceptive, or as the case may, the forecast was thereby not capable of being justified or was thereby rendered misleading or deceptive.

This provision has however probably been substantially narrowed from the original draft in the Bill, unrealised by the legislators. Clause 3(2)(c) provided that the dishonest concealment of "material facts" for the purposes of Clause 3 would itself be a "fraudulent or reckless misrepresentation." Thus from this wording it would appear that merely the nondisclosure of material price-sensitive inside information would constitute a fraudulent or reckless misrepresentation inducing the other party to deal with the insider. It would seem that the insider abusing his privileged position to take advantage of the unsuspecting party to the transaction would of itself be sufficient for a showing of dishonesty. Defining the fraudulent misrepresentation as the dishonest nondisclosure *sola,* meant in effect that there was no need for a showing of a duty to disclose such as under the law relating to *suppressio veri suggestio falsi.* In effect a duty to disclose all material facts was placed upon anyone engaged in investment dealings, provided there was the element of dishonesty present coming under the terms of clause 3. It was doubtful whether the exact implications and far-reaching repercussions of this wording were realised, especially as the provision was discussed and referred to as a remedy for fraudulent mistatements and representations[52] although in effect

[52] Explanatory Memorandum to the Protection of Investors Bill. Clause 3, Sup. to Gazette No. 39, Volume CXV.

the definition of such was so wide as to render a mere nondisclosure of a relevant fact *ipso jure* a misrepresentation. This broader interpretation is all the more startling when one compares the severity of these criminal penalties with those provided for actual insiders under the Securities Ordinance,[53] which are much less severe. The Bill was however amended by the Legislative Council with the intention of improving its clarity, and instead of providing simply that dishonest nondisclosure constituted a fraudulent or reckless misrepresentation, Section 3(2)(d) expands upon this. Now, the omission must be intentional or reckless, 'with the result that the statement was thereby rendered untrue, misleading or deceptive.' The effect of this is to require a positive statement, and thus the position is virtually put back to that of *suppressio veri, suggestis falsi.* The mere dishonest omission of a material fact is now arguably not sufficient without some kind of statement which renders the omission untrue, misleading or deceptive. This is unfortunate and retrograde from the standpoint of the Bill. Of course, even under Section 3 it is possible, provided there is some kind of statement (even, probably, an implied assertion)[54] which by a material omission is rendered false or deceptive, that an insider might be held liable.

It is interesting that whilst an official has conceded that Section 3 had not been considered in this light he thought that it might well provide a useful weapon to utilise against insider trading.[55] This is a commendable approach and it is to be hoped that the Hong Kong authorities will adopt a more enlightened and less cautious approach than have the British on this point. When the present author approached the British Department of Trade, which is charged with the administration of company law in the United Kingdom, about the

53 Section 140 (10); H.K.$50,000 and imprisonment for 2 years.
The Companies Law Revision Committee in its discussion of the topic in the First Report (paragraph 4.12) spoke of Section 13 covering dishonest concealments of material facts, among other things, and this was not necessarily placed in the context of misrepresentation as such but was treated as a separate ground of liability, along with 'statements, promises or forecasts known to be misleading, false or deceptive . and the reckless making of statements, promises or forecasts which are in fact misleading false or deceptive'. The Committee, as has already been pointed out, recommended the complete adoption of this provision.

54 How far an implied assertion would be regarded as a statement within Section 3 is a moot point. Certainly it should at least be arguable that as insider trading is outlawed under the provisions of the Securities Ordinance there is an implied assertion that the insider has no privileged information. It is difficult to say however that there is a representation that a person is obeying the law, merely by his doing an act such as selling a security. For this could introduce a wide area of undefined tort, or in some cases contractual liability far in excess of that presently contemplated. It should be pointed out that the insider trading provisions themselves do not as such place a duty of disclosure on the insider, but only a duty not to trade.

55 The possibility of using Section 3 in the context of insider trading in Hong Kong is not solely of academic interest, as the statutory provisions on insider trading in the Securities Ordinance (as we shall see in due course) have not as yet been implemented. Thus at present the Commissioner and his staff have, apart from the possible use of administrative sanctions against brokers and dealers, no viable means of restricting the use of insider information which has been identified as immoral and deserving of legal sanction by the fact of legislation having been passed. Whether the courts would allow the circumvention of the stipulated provisions on insider trading is an open question, but it is respectfully submitted that as Section 3 is a totally independent provision in an entirely different Ordinances there should be no problem. But on this point see Section 139 of the Securities Ordinance, which is very similar to Section 3, at least in the context of inducing sales.

possibility of using Section 13 in certain cases of insider trading, the answer was less than encouraging. One of the Department's lawyers wrote that in view of the decision in *Percival* v. *Wright*[56] (which held that directors who were approached by shareholders asking to be bought out are under no obligation to disclose material price-sensitive information, as their duties as fiduciaries were owed to the Corporation and not to the shareholders individually) it was not dishonest to fail to disclose inside information. In essence the Department considers that as it would not appear that there is civil liability in the event of an insider's non-disclosure of inside information, it follows that such cannot constitute dishonesty from the standpoint of the criminal law. This proposition by itself is at best doubtful, and in any case there probably is civil liability to the corporation. Moreover, the wrong is not necessarily the failure to disclose, but the failure to disclose whilst trading upon the basis of the inside information. There is a duty clearly recognised in the United States of America under Section 10B and Rule 10b5 of the Securities Exchange Act 1934, that where a person is in possession of inside information he must choose whether to disclose or abstain from trading. Surely it could well be argued that, at least on the wording of Section 13, a similar duty is applicable under the Prevention of Frauds (Investment) Act 1958.[57] Certainly in Hong Kong, where the legislature has clearly held insider trading to be dishonest under both the civil and criminal law in enacting the Securities Ordinance, objections such as those voiced by the British Department of Trade should be disregarded.

Following the recommendations of the Companies Law Revision Committee at paragraph 4.15 of the Second Report, liability in tort for inducing persons to invest in certain cases is provided for in Section 8 of the Protection of Investors Ordinance.[58] Section 8 is more or less identical to Section 3, except that the liability extends beyond fraudulent and reckless misrepresentations to negligent ones. Thus the remarks made on the criminal liability provisions relating to insiders apply equally here. Incidentally, the civil action is stated

[56] [1902] 2 Ch. 421.

[57] There would appear to be a number of cases in recent months that would have lent themselves to this treatment, see for instance, Department of Trade Investigation into the First Re-Investment Trust Ltd., Nelsen Financial Trust Ltd. and English and Scottish Unit Trust Holdings Ltd. (1974 H.M.S.O.), and Department of Trade Investigation into John Willment Automobiles Ltd. (1975 H.M.S.O.).

[58] The provisions of Section 8 are virtually identical to those of Section 3, except there is also liability for 'false, misleading or deceptive' statements (Section 8(2)(a)(iii)); promises (Section 8(2)(b)(iii)); forecasts (Section 8(2)(c)(ii)) 'which were made without reasonable care having been taken to ensure its accuracy ... or that it could be fulfilled'. In addition Section 8(2) (d) provides 'fraudulent, reckless, misrepresentations' include 'any statement or forecast from which the maker of the statement intentionally, recklessly or negligently omitted a material fact of which he bad knowledge or ought to have had knowledge, with the result that the statement was thereby rendered untrue, misleading or deceptive or, as the case may be, the forecast was thereby not capable of being justified, or was thereby rendered misleading or deceptive.' Thus in effect the provisions of Section 3 are expanded so as to include liability for negligence.

In addition Subsection (3) provides that where the statement was made by a corporation it is to be rebuttably presumed that every director caused or authorised the statement (see Section 7). Furthermore, a person is deemed to be a director of a company if he occupies the position of director by whatever name he may be called, or is a person in accordance with whose directions or instructions the directors of the company or any of them act.

in subsection (6) to be independent of any criminal proceedings, and in addition to any right of action that may already exist at law.

The wording of Clause 8 of the Bill was again altered by the Legislative Council, for the purpose of giving greater clarity. Unlike the case of Section 3 the amended version differed little if anything in substance from the earlier form. In effect the clause provided where any person alleges that he has, as a result of any false, misleading or deceptive statement, forecast or promise, whether oral or written and whether made to him personally or as a member of the public, entered into a securities transaction, and that he has because of his reliance on the statement, forecast or promise suffered pecuniary loss, he may institute civil proceedings against any person who made the statement, to recover such sum by way of damages as the court considers just and equitable. The defendant in subclause (2) (provided he could prove that he had reasonable cause to believe and did believe that the statement was true or that it was justified) would escape liability. It is important to note that in both versions, however, no mention is made of a material nondisclosure by itself constituting a false, reckless or negligent misrepresentation.

The Bill, so far as civil liability is concerned, completely leaves open the question of liability for omissions, and therefore it would only appear to envisage an action for a material omission insofar as such could be brought within the terms of 'false, misleading and deceptive' statements under the ordinary law. It is respectfully submitted that it is extremely doubtful whether one could try and apply the definitions in Clause 3(2)c in the context of Clause 8. Indeed Clause 3(2) specifically provides that the definitions therein contained are for the purposes of that provision. The lack of concern about liability for omissions is most strange when one considers the apparent strictness of the criminal provisions on this topic. Nevertheless, as has been pointed out, Section 8 2(d) does provide for recovery in cases of omission, provided it is in the context of a statement which is rendered by that omission false or misleading. It is unfortunate that the Government did not address itself properly to this question, and their initial approach to the admittedly difficult problem of liability for omissions seems extremely confused. Surely it would have been more logical to have afforded a civil remedy for nondisclosure, with damages at the court's discretion, as was indeed proposed in clause 8 for fraudulent, reckless and negligent misrepresentations, than to leave the question of omission to the ordinary law in civil cases, yet in criminal to visit a fine of one million dollars and seven years' imprisonment on such. Thus although in certain cases these provisions might avail in an insider trading situation, their impact has been reduced, unwritingly, by the Hong Kong legislature in an attempt to achieve greater clarity. In passing, it should also be noted that a provision substantially the same as these sections, was included in Section 138 of the Securities Ordinance 1974, in the context of a remedy against manipulation.[59]

[59] It should be pointed out in passing that under the Protection of Investors Ordinance there are also provisions for the seizure of documents (Section 6) and liability for directors etc. where the offence is committed by the corporation under Section 7, identical to the provisions in the Securities Ordinance, which we will be looking at in due course.

An Overview of the Regulatory Pattern

Turning away from substantive law, back to the question of general securities regulation, it is vitally important to realise that there was nothing remotely resembling a developed self-regulatory framework within the securities industry in Hong Kong. This absence of a viable self-regulatory structure was the result of numerous considerations, not least among them being the very way in which the securities industry has tremendously expanded over the last few years. Furthermore, there was no focal point, such as a central or leading Stock Exchange through which viable self-regulation could be channelled. Indeed the Exchanges in many respects had been at each other's throats and had been in no mood to make a sincere and determined effort to cooperate with each other and, of course, the Government, in the erection of a self-regulatory regime. In this respect the position in the Colony bore a resemblance to the position in the United States of America prior to the legislative programmes of the early 1930s. Moreover, the various 'professional' elements in the securities industry had not developed to an extent sufficient to enable self-regulatory functions to be designed or entrusted to them. If the recent amount of controversy surrounding the establishment of a Commodities Exchange in the Colony is an accurate indication, it would seem there are still wide divisions of opinion and outlook among the various sections of the industry.[60]

The Companies Law Revision Committee expressed some concern about the suitability of persons employed in the securities industry, in their First Report, on the Protection of Investors. In particular the Committee was concerned that the only regulatory framework in the Colony was that provided by the criminal law, which necessarily was too limited in its application and illsuited to a complex environment such as the securities industry had become. The Committee pointed out that they understood a reasonable amount of persons engaged in the industry were regulated by the National Association of Securities Dealers (N.A.S.D.) insofar as they were employed by American broker dealer firms who were members. However, this by any estimation was a very small proportion of the people employed overall in the industry. An attempt was made in 1970 to set up a Hong Kong Securities Dealers Association, with a code of ethics and regulatory mechanisms, but it failed, mainly through apathy and trenchant opposition from a small section of the industry. In theory, most of the expatriate British securities houses and banks with their many tentacled interests should have been able to instill a degree of self-regulation among the various institutions, which in most instances they helped to create in the first place. However this neglects the fact, already pointed out, that among the expatriate businessmen working in the Colony, the very absence of regulation, whether legal or not, was one of the main attractions of Hong Kong. It would be wrong to examine the regulatory patterns in the Colony without accounting for this very important factor, no matter how unpopular it might be to raise it. It is true that the British firms operating in

[60] Whilst speculation and dealing in commodities and commodities futures is an area of not inconsiderable interest from the point of view of securities regulation, no attempt will be made here to discuss the present position in Hong Kong on this matter, other than to point out that a Commodities Ordinance is currently being drafted.

the Colony were to a greater or lesser extent subject to the relatively strict selfregulatory mechanisms in the City of London. For instance, Rule 61 of the Stock Exchanges Rules and Regulations allows a member firm to establish an overseas branch only with the prior consent of the Council of the Exchange, which must be renewed annually. Moreover, under this Rule the overseas branch must operate wholly under the control and in the name of the Member Firm, and be managed by an approved person. In addition Rule 61(4)c provides that 'the business of the Office shall be conducted in accordance with the Rules and Regulations of the Stock Exchange'. Then, there is of course the London Code on Take-overs and Mergers, which so far as local conditions would allow, applies in such cases. However, as recent events have only too well shown, the effect of these codes and regulations must not be overemphasised. It is interesting to note that the Committee in their First Report pointed out, that 'the leading banks, accountants and solicitors' in the Colony 'would not allow their names to be used in take-over documents that did not conform in general to the British pattern.'[61]

Nevertheless, as a general proposition dealers and their representatives in the Colony were found to be unregulated in any meaningful sense of the word. 'There is therefore in most cases no effective sanction for any breach (not amounting to a criminal offence) of what would generally be accepted as fair and reasonable standards of conducting securities business.'[62] Because of the absence of such an amorphous but extremely powerful concentration of financial and business interest such as in the City and the absence of any counterpart of the Governor of the Bank of England 'who is the acknowledged, if not titular, head of the City', and who can wield tremendous influence and weight in any given direction, the Committee concluded that regulation of broker dealers and investment advisers[63] and also takeover bids would have to be based on legislation. There was no substratum within the financial community upon which the self-regulation mechanism so successful in other countries could be based, at least in the short term.

So far as the Stock Exchanges were concerned, the Companies Law Revision Committee, as we have already seen, was of the opinion that it would be wrong to seek to regulate their numbers legally. However, they did consider that it was unsatisfactory to continue the regulation of exchanges solely on the indirect basis of the 'Conditions for Recognition' although such had worked reasonably well. The main reason for this was that apart from Section 2A of the Companies Ordinance (which laid down the recognition procedure) the only other main provision relevant to 'recognised stock exchanges' was Section 344(2) of the Companies Ordinance, which allowed recognised exchanges to give certificates of exemption with regard to the prospectus provisions of the companies laws, on the basis that the issuer concerned would comply with the requirements of the Exchange instead. This was at best a rather dubious privilege, and the Committee were concerned that persons seeking to establish an exchange in the future might not be too concerned about becoming 'recognised' and thus

[61] First Report, paragraph 9.11.
[62] First Report, paragraph 6.10.
[63] First Report, paragraph 6.10; see also Part VI of the Securities Ordinance 1974.

remain outside the regulatory mechanism.[64] It was thus recommended that the Governor in Council should be given statutory powers to make uniform rules for all stock exchanges operating in Hong Kong, whether such were recognised or not. It was emphasised, however, that the then existing 'conditions' should provide the basis for these rules, and this has been accepted by the Government, who, however, delegated the rule-making power to the new Securities Commission.

On the delicate although from our present point of view highly relevant, question of whether there should be legal regulation of the Securities industry by some new kind of governmental regulatory body, the Committee were fully convinced that the Government should not get too deeply involved in the regulation and supervision of the securities markets, and dealings thereon. The main consideration should be, it was recommended, to ensure that the stock exchanges 'take action throught self-regulation to remedy abuses whenever they appear to show signs of developing.[65] The Committee did recommend however the setting up of a Securities Advisory Board, with a Commissioner of Securities as an ex-officio member, and six other nongovernmental or dealer members, as well as a chairman on a part-time basis. This Board would 'take up with the Stock Exchanges' anything that gave the Board concern, the assumption being that it would be speedly corrected; failing which a report could be made to the Government, whereupon necessary legislative action might be considered. This last point is open to much criticism, with the greatest respect to the Hong Kong legislative process: it would seem strange that a matter of sufficient urgency and concern to warrant a report to the Government should have to wait unremedied whilst the report is duly considered, legislation proposed and drafted, and then put into the legislative machinery. The absurdity of this is all the more patent when one considers the nature of securities regulation and the invariable technicality of subject-matter.

The Committee did recommend legislation in accordance with the recommendations of the Jenkins Committee, on the establishment of a stock exchange compensation fund, and on the question of listing of securities. Although the topic of Stock Exchange listing is only of peripheral concern in our present discussion, one significant point should be mentioned. In the Colony it has been the practice of the new exchanges to automatically list all securities already listed on existing exchanges. This resulted in multiple listings on several different markets. This had profound repercussions on the operation of the disclosure mechanism. A corporation which, by virtue of its

[64] First Report, paragraph 6.50.

[65] Paragraph 6.58. The Committee perfunctorily looked at the American Securities Exchange Commission, but were persuaded by the Jenkins Committee (see Cmnd. 1749, at paragraph 176, and a Report of a Study of the Securities Markets in Singapore and Malaysia, by Mr. George Ferris, Jr.) that self-regulation was as a general proposition preferable to rigid governmental interference. The Committee strengthened its conclusions by referring to the Corporate Affairs Commissions in Australia, which the Committee emphasised was not an S.E.C. as such. Ironically since the Committee published its First Report both Australia and to a lesser extent Singapore have come much closer to the S.E.C. mode of regulation; and even in the United Kingdom it would appear that it will not be too long before some form of Companies Commission is established. In fact, the Hong Kong Securities Commission that was set up despite the Report has continually been moving towards a regulatory posture.

listing agreement with one exchange was under an obligation to comply with that particular exchange's disclosure and timely reporting rules, could well find itself in the unenviable position of being listed on exchanges with which it had signed no listing agreement, and was thus under no obligations with regard to disclosure. This inevitably created temporary although serious imbalances of information, with of course great possibilities for abuse. Whilst imbalances of information occur in a number of circumstances, and are one of the reasons for arbitrage transactions, the potentialities for abuse were all the more in Hong Kong because of the close geographic proximity between the markets and the complete ease of moving in and out of different markets.[66] Apart from the possibilities for abuse there was also the fact that a viable disclosure mechanism could hardly operate to any effect, at least with regard to timely disclosure, in such an environment. The Committee recommended that a security should only be multiple-listed if the issuer was under an obligation to at least the first exchange to make proper disclosure.[67] This did not go very far in solving the imbalance problem, although it did ensure that the issuer would be obligated to disclose to at least one exchange. We have already mentioned the current attempts to solve this problem at least in part by the creation of an information clearing house.[68]

Fraud and Manipulation

The Committee was quite naturally concerned about the prevention of fraud and manipulation of the securities markets in the Colony, and devoted a considerable amount of attention to this area. Surprisingly the Committee did not deal with the question of insider trading here, but for reasons we will elaborate on in due course left it to its Second Report on the Reform of Company Law, although it would have obviously been more in context in the First Report on the Protection of Investors.

In their discussion of manipulation and fraud the Committee referred to the New South Wales Securities Industry Act 1970[69] and were strongly influenced by such in their recommendations. The

66 Informational imbalances are of course highly disruptive to investors' confidence, and a number of countries have in recent years attempted to iron out such irregularities. For instance this is one of the main reasons behind the proposed Directive and Draft Recommendation of the European Economic Community on the publication of prospectuses when securities are admitted to stock exchange quotation.

67 The Committee also considered that the first Stock Exchange to list a particular security should not be allowed to cancel the listing agreement without the approval of the Securities Advisory Council because of the impact that cancellation might have on multiple listings: see First Report, paragraphs 6.64 and 6.65.

68 See footnote 39.

The Committee considered that the Exchanges should retain their complete discretion over listing, and although the exchanges should be persuaded to ensure the maximum amount of disclosure the exchanges should be under no duty to judge individual investment merits of securities. Likewise the exchanges should retain their control over their own membership and trading rules, subject to considerations of uniformity and the exception of certain important matters, such as the continuance of the basic rule that all contracts were to be for cash on a spot basis.

69 See Sections 70-75 and also Section 75A which is specifically directed towards insider trading, but which was added after the Committee wrote their report in 1971. See also the similar enactments in the Singapore Securities Industry Act 1970.

Committee recommended legislation to outlaw manipulative conduct, as they considered, that the possibility of a conspiracy charge under the common law, or the requirement that 'recognised stock exchanges' provide in their rules a prohibition on the creation of a false market, under the 'conditions' already referred to, were inadequate. In the result the Committee endorsed the provisions on manipulation and the creation of false markets in the Australian and Singapore statutes.[70]

As we have already seen, the provisions relating to fraudulent and reckless misrepresentations were included in the Protection of Investors Ordinance 1974. However, the bulk of the provisions recommended by the Committee on manipulation and fraud founded themselves in Part XII of the Securities Ordinance, which deals with the prevention of improper trading practices. The main provision is Section 135, which renders it an offence to intentionally create a false or misleading appearance of active trading or a false market in respect of any securities.[71] This provision includes a number of specific

[70] First Report, paragraph 6.72, *et seq.*
Since the Securities Ordinance the Commission have been charged with certain responsibilities with regard to the Stock Exchange rules, under Section 14. The H.K. Exchange in consultation with the Commissioner issued an amended set of rules and regulations in January 1974. Concerning false markets Rule 63 provides 'No member shall knowingly or without due care deal in such manner as shall promote or assist in the promotion of a false market. A false market is defined as a market in which the movement of the price of shares is brought about or sought to be brought about by contrived factors, such as the operation of buyers and sellers acting in collaboration with each other, calculated to create a movement of price which is not justified by assets or earnings or prospects.' See Section 135(2) (a) of the Ordinance which defines a false market in sustantially similar terms.

[71] Section 135 was adapted from the New South Wales provisions, and reads as follows,

(1) A person shall not intentionally create or cause to be created, or do anything with the intention of creating —

(a) a false or misleading appearance of active trading in any securities on any stock market in Hong Kong;

(b) a false market in respect of any securities on any such stock market.

(2) For the purposes of subsection 1(b) a false market is created in relation to securities when the market price of those securities is raised or depressed or pegged or stabilized by means of —

(a) sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for those securities that is not justified either by the assets of the corporation which issued the securities or by the profits (including anticipated profits) of the corporation;

(b) any act which has the effect of preventing or inhibiting the free negotiation of market prices for the purchases or sale of the securities; or

(c) the employment of any fictitous transaction or device or any other form of acception or contrivance.

(3) A person shall not with the intention of depressing, raising, or causing fluctuations in the market price of any securities effect any purchase or sale of any such securities which involves no change in the beneficial ownership of those securities.

(4) A purchase or sale of securities involves no change in beneficial ownership within the meaning of subsection (1) if a person who held an interest in the securities before the purchase or sale, or a person associated with him in relation to those securities, holds an interest in the securities after the purchase or sale.

(5) A person shall not circulate or disseminate or authorize or be concerned in the circulation or dissemination of, any statement or information to the effect that the price of any securities will or is likely to rise or fall because of the market operations of one or more persons which, to his knowledge, are conducted in contravention of subsection (1).

See also Rule 63 of the Hong Kong Stock Exchanges Rules and Regulations (1974).

activities separately dealt with in the New South Wales Act, and also interestingly in the Securities Ordinance Bill. Clause 132(1) of the Bill (which was enacted as Section 135(1) of the Ordinance) deals with the creation of a false market in securities, as such. For instance, a false appearance of active trading would probably exist where a dealer crosses a transaction for related persons and *a fortiori* for the same person, for the purpose of creating a price for dormant or relatively inactive stock.[72] As under the Stock Exchange rules a false market is defined *inter alia* as a market in which the prices do not reflect the underlying assets of the issuer or the potential for profits in the enterprise, this could well prove to be a too narrow definition, imposing in some instances perhaps unjustified liability, as the market price of securities can be influenced quite legitimately by a number of factors other than mere assets value and earnings, actual or estimated. Indeed, it is hard to see how the market price of a particular security in such a volatile market as that in the Colony, and with such a dubious disclosure mechanism, could be rationalised in this way.

Clause 134(2) of the Bill and Section 135(3) and Sections 135(4) deal with the creation of fluctuations in market prices which, however, involve no changes in beneficial ownership, or are transactions between associated persons. The implications of Section 135(4) are particularly significant, as the term 'associated persons' is defined quite widely in Section 4, as we shall see later. Thus a purchase or sale will come within the prohibition on the creation of a manipulated market under Section 135(3) where the person who held the interest prior to the transaction or an associated person is found to hold the same interest subsequent to the transaction. Another provision that deserves our attention is that of Section 135(5), which was Clause 133(2) under the Bill, which creates a separate offence to circulate or indeed be involved in the circulation of any statement or information that the price of a security will rise or fall because of a current manipulative operation in violation of Section 135(1). It is not easy to grasp what the Colonial legislature thought that this particular subsection or indeed separate provision in the Bill, should mean. It would seem to prevent 'insiders' to the manipulation, increasing the impact of their illicit activities by circulating rumours as to the results they are seeking to achieve, by virtue of those very manipulative transactions. This would also seem to catch persons who, although not engaging in the manipulative transactions, facilitate the manipulative purpose by inducing supporting transactions. The problem is, however, that these possibilities hardly provide a good reason for having this separate offence, as in the vast majority of cases the persons concerned would be implicated directly in the violation of subsection (1), or could be brought into such a violation as aiders and abettors, as well as conspirators. Indeed it would seem that Section 135(5) has positive dangers; for instance, suppose that a financial journalist discovers a market rigging operation and advises his readers of this, and to hold on to their securities because the price after the artificial fluctuations will revert to its correct level, would he be liable under Section 135(5)? In fact the provision could operate so as to prevent persons discovering market abuses disclosing such, and thus sub-

[72] See A.H. Smith 'The Hong Kong Securities Ordinance, (Law Lectures for Practitioners, (Hong Kong Law Journal, 1974), p. 47.

stantially impede enforcement efforts.[73] Thus whilst the idea behind the subsection of preventing the circulation of manipulative rumours which can, and have in the past, greatly disrupted the capital markets, is no doubt commendable the uncertainty of application surrounding Section 135(5) is most regrettable. It should be noted in this respect, that both the Bill, Clause 133(2) and the New South Wales provisions, Section 71(3) of the Securities Industry Act, provided that a person would only be liable if he circulated such information 'in consideration or anticipation of a reward or benefit.' This has the beneficial effect of limiting the offence to persons who are either privy or involved in the manipulation or at least have a financial interest in the operation. It is submitted that it would be stretching the words 'reward or benefit' too widely to include the case of the journalist who is merely performing his job, or the investor or issuer who on discovering manipulative activity urges the market to remain firm.

Of course it is true that the provision is directed to the 'intentional creation of a false market', and this will inevitably restrict the scope of the provision. The Companies Law Revision Committee actually rejected the wording of the New South Wales Securities Industry Act, Section 70, on this point. The Australian Act merely provides that 'a person shall not create or cause to be created or do anything which is calculated to create a false market'. The Committee expressed the view that someone might well do something calculated to create a false market or a misleading appearance of trading without actually intending to do so.[74] To remove this danger the First Report recommended, and the Ordinance enacted, that the acts must be perpetrated 'with the intention of creating' a false market. It is doubtful whether this distinction is particularly meaningful, as in the vast majority of cases intention or at least recklessness, which is usually regarded as a sufficient mental element, would be evident from the very acts carried out. Whilst this does introduce a subjective analysis, it would have to be a highly unsophisticated investor who was engaging in manipulative conduct, if intention or recklessness was not to be constructively attributed to him.

The regulatory pattern is continued by Section 137 which prohibits persons effecting transactions for the purpose of pegging or stabilising the price of securities in contravention of any regulations made under this section. It should be noted that it is no offence to attempt to peg a price, provided this is not done with the intention of creating a false market, insofar as it does not upset the free negotiation of the market or strive to create a price unsupported by underlying assets or profits. Section 138 outlaws the making of false statements, including statements rendered false by omission, which the maker knows or has reasonable grounds for believing to be such, relating to the securities or the performance of a company, for the purposes of inducing a sale, but seemingly not a purchase. Rather anomalously, the restriction of this provision to the inducing of sales, as opposed to purchases, is left entirely unexplained. One can only surmise that this may have resulted from the legislators' perfunctory

[73] Of course, much would depend upon the interpretation of Section 135(1). It is however undesirable that the threat or uncertainty of possible liability exists, no matter how theoretical or remote.

[74] First Report, paragraph 6.73.

examination of United States materials and the relationship of the civil liability provisions under the Securities Act 1933 and those of the Securities Exchange Act 1934, in particular Rule 10b5.[75]

Perhaps for our present purposes the most interesting anti-manipulation provision is Section 136, which is modelled on rule 10b5, paragraphs (1) and (2), of the American Securities Exchange Commissions Rules and Regulations, issued under Section 10b of the 1934 Securities Exchange Act.[76] The Companies Law Revision Committee, in their first Report (paragraph 6.73, sub-paragraph (2)) recommended the adoption of this very controversial rule in preference to Section 71 of the New South Wales Securities Industry Act 1970. The Committee considered that Section 71 was unsatisfactory as it threw the onus of proof on to the defendant, to establish 'that he acted without malice and solely to protect or further his own lawful interests'. Furthermore, it is interesting that the Committee considered that the Australian provision was too wide in that it prohibits a person from effecting, taking part in or being concerned in the carrying out, either directly or indirectly, of any transaction, in any class of securities which has the effect of raising or lowering the price of securities of that class, for the purpose of inducing purchases and sales in that particular class of security, unless the defendant establishes that his conduct was proper, by the criteria that we have just mentioned.

It is open to question to what extent a Colonial or indeed even a United Kingdom Court would hold that Section 136 applied to insider trading. Certainly it is true that many cases involving insiders trading on the basis of privileged information often also involve manipulative aspects, and at least in these instances the conduct should come within the Section. For instance, an insider considering that the market is out of touch with his more informed valuation, based upon inside information, might engage in manipulative wash sales, so that he can offload an existing inventory of stock that he possesses. In doing this the insider has engaged in both manipulation and insider trading. On the other hand, the insider might be aware of the likelihood of a future outside takeover bid: in such a case he might engage in wash transactions with the intention of forcing the market price down so that he could acquire a substantial holding, which will enable him to sell or negotiate at an enhanced price. Indeed, it has not been unknown for corporations prior to their announcement of a takeover offer to engage in manipulative transactions with the intention of lowering the market price of the target corporation's stock,

[75] Section 138 adds nothing to the provisions in the Investor Protection Ordinance 1974 (Sections 3 and 8) and as the Committee in its First Report observed provides an alternative thereto in certain cases. What was said when discussing those provisions applies with equal force here.
Clause 135 of the Bill, whilst in substance much the same as Section 138, did not require a sale or purchase to be induced or attempted in consequence of the falsity. It merely prohibits the making or dissemination of such information or statements relating to securities, and in this respect corresponds with Section 73 of the New South Wales Securities Industry Act.

[76] Section 136 (Clause 133(1) of the Bill) provides:
A person shall not, directly or indirectly, in connection with any transaction with any other person involving the purchase, sale or exchange of securities —
a) employ any device, scheme or artifice, to defraud that other person; or
b) engage in any act, practice or course of business which operates as a fraud or deception, or is likely to operate as a fraud or deception, of that other person.

so that the offer need only reflect this lower price. In these, and in other instances it would seem that Section 136 should be applicable.

Of course it is unlikely Section 136 would ever be construed as providing a remedy as wide or as comprehensive as Rule 10b5; this is particularly so as sub-paragraph (2) of the Rule has been excluded from the section.[77] Furthermore, it is a moot point, in any case, as to how far it is possible to say that insider trading does involve the creation of a false market. In actual fact because of the existence of inside information, it is probable the market is falsified to the extent that the undisclosed information would materially effect the price of the stock concerned. The falsity is created by the mere existence of the information, and is an entirely independent consideration other than that of a person taking advantage of the informational imbalance. In many ways the last thing that an insider trading on inside information is doing or for that matter intends to do is to create or assist in the creation of a false market: he is merely taking advantage of an existing deficiency in the disclosure mechanism. He is one of the few persons trading on 'true' facts, and it is because the rest of the market is labouring under a misconception that he can make his illicit profit. This analysis is confirmed by the fact that in the United States it has been recognised for some time that issuers, and indeed possibly third parties, are under a duty to release material information, unless an overwhelming corporate purpose is served by nondisclosure, so as to prevent falsification of the market, regardless of whether that corporation or third party is actually trading.[78] Thus whilst, as has already been pointed out, insider trading and manipulation can be related in a given course of conduct, the two abuses are essentially separate, and confusion can result in attempting to apply manipulation provisions to insider trading cases and *vice versa.* The difficulty is where the relevant provision seems to straddle both types of conduct, as Rule 10b3 certainly does, and Section 136 appears to.

The Companies Law Revision Committee at paragraph 6.73(5) recommended that the penalties for violation of the anti-manipulative provisions should be relatively severe and should equate with those they recommended for Section 3 of the Protection of Investors Ordinance, namely seven years' imprisonment or a unspecified fine, or both. In both instances the Committee's recommendations were at least in part ignored; Section 3 limits a fine to one million Hong Kong dollars, and Section 139 of the Securities Ordinance cuts the penalties down to those of two years and Hong Kong $50,000 for violations of the anti-manipulation sections.[79] This is unfortunate, as the crime

[77] Paragraph (2) of Rule 10b(5) renders it unlawful... 'to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made in the light of the circumstances under which they were made not misleading.' The vast majority of insider trading cases in the United States involve this paragraph, usually with one of the other two paragraphs.

[78] For example, see *S.E.C.* v. *Texas Gulf Sulphur Co.* 401 M.2d.833 (2d Cir. 1968) and *Financial Industrial Fund Inc.* v. *McDonnell Douglas Corporation* 474 F.2d 514 (10th Cir. 1973).

[79] As we shall see later, this is in line with the penalties for insider trading. Thus to bring the more hefty punishments into operation one would have to try and use Section 3 of the Protection of Investors Ordinance 1974.

of manipulation is a serious matter, and one that has a far greater potential for harm, than say insider trading. There has however been much controversy in the Colony about the severity of criminal penalties in the cases of so-called white collar crimes. Pressure has been applied from many quarters to reduce fines against businessmen and factory owners, for violation of non-violent statutory crimes, such as those under the social regulatory Ordinances, and in cases of commercial fraud.[80] We shall be discussing the question of enforcement later on, when we look at insider trading under new legislation. Nevertheless perhaps it should be mentioned here that until very recently, when the Haw Par affair arose,[81] the Commission had received 'no specific complaints about market manipulation' with regard the anti-manipulation provisions in Part XII of the Securities Ordinance, which unlike the insider trading provisions have been fully implemented.

Following the recommendations of the Committee, the Government has adopted the approach of the New South Wales Legislature, and has in Section 141 provided for an action in tort, for recovery of damages, by any person who has sustained pecuniary loss,[82] as a result of having sold or bought securities at a price affected by the manipulative activity outlawed by the provisions in Part XII, with the exception of Section 140 (the insider trading provision) which has its own remedies. This tortious action is specifically in addition to any other right of action a plaintiff might have, and is independent of any criminal conviction.

Short selling and Option Transactions

Perhaps at this juncture we should also mention the questions of option dealings and short selling: for both, regarded at least in the more sophisticated financial communities as legitimate market practices, are nevertheless well suited to abuse by insiders and manipulators. The Committee's recommendations were, in short, that there should be no option or forward dealings at all. The legislation however only prohibits dealers, either registered or exempt, engaging in forward or

80 The *Hong Kong Law Journal* (Volume 2; number 3) in an editorial (page 257) came out strongly against the leniency that was in consequence of this pressure being afforded to persons convicted of so-called "white collar" crimes. It is interesting to note a statement by the Full Court in *Hong Kong Dragon Co. Ltd. Crim. App. No. 889 of 1971* (April 12th, 1972): 'we find it ironic that representatives of those who complain of allegedly lenient sentences in the case of theft accompanied by violence are the first to complain of perfectly reasonable sentences inflicted for more subtle and widespread methods of parting the victim from his money. Commercial honesty, if demonstrably not the lifeblood of this community, should at any rate be so regarded.'

81 In view of the current investigations in both the Colony and in London into a number of associated companies and individuals apparently involved in the Haw Par affair, it would seem prudent not to enter into discussion about this matter. It should be pointed out that the repercussions that the exposure and investigation of this affair in the Colony, and also in Singapore and London, can be expected to have on the problem of effective securities regulation are particularly significant from the point of view of anti-insider trading and anti-manipulation provisions.

82 Although the measure of damages is not indicated, and would have to be determined by the Courts, it would seem probable that the damages would be the difference between the price the plaintiff dealt and the market price that would have existed if the defendent had not engaged in the manipulative transactions falsifying the market. This would be essentially a "tort" measure of damages

option transactions in the Crown Colony,[83] or even holding themselves out as willing to do so. This provision does not apply to private individuals who are not dealers. Thus as Mr. Smith points out,[84] it is illegal for the sophisticated investor to forward deal, but not the unsophisticated layman. This seems quite illogical, especially as it was the wild dealings in this type of securities which did great harm during the market boom and crash. It would seem the Government regards the professional investor as in more need of its protection than the small local investor.

It should also be pointed out, that by virtue of the wording in Section 76(1) (a), it would appear that a non-dealer is at perfect liberty to confer an option on a dealer, but not *vice versa.* The logic of this escapes Mr. Smith, and also with respect the present author. The provisions are exclusively confined to 'any securities listed on a stock exchange in Hong Kong,[85] and thus anyone, even a dealer, would be at liberty to deal forward or in options in unlisted securities or those just about to be listed. It was this very practice which was such a serious abuse, and we have already seen how dealers could make incredible profits by this device. The restrictions in the section, however, when applicable do include dealings in listed securities on or off the exchanges.[86] It is also important to note that under the Rules and Regulations of the Hong Kong Stock Exchange (in particular Rules 56 and 57) 'options are not permitted in any quoted security' and 'no forward bargains are permitted except that in the case of new issues trading may, at the Council's discretion, commence in advance of the issue of scrip'.[87] Whilst it is probably quite true that the effect of the Stock Exchange's rules and practices, at least with regard to listed securities, renders a number of the criticisms made of section 76 academic, the simple fact is that the law, particu-

[83] See First Report; paragraph 6.68, Clause 74 of the Bill and Section 76 of the Securities Ordinance 1974. This preserves the traditional rule on the exchanges, that all dealings must be following.
Subsection (2) provides a penalty of a Hong Kong $5,000 fine. There is a defence under subsection (3) if the accused proves he did everything reasonable and practical to secure completion of the transaction within the permitted period i.e., the next day of trading. Furthermore, a contract in violation of this section is unenforceable by either party, under Section 76(4).

[84] 'The Hong Kong Securities Ordinance', Law Lectures for Practitioners, Hong Kong Law Journal, 1974, p. 44), Mr. Smith's article is a most useful summary of the whole Ordinance, and throughly commended to the reader.

[85] Section 76(1). The provisions of the Ordinance do not generally distinguish between listed and unlisted securities, and apply equally to both. Thus the provisions on improper trading cover listed and unlisted securities alike; for the definition of securities and stock see Section 2 of the Ordinance.

[86] It would seem that the Colonial Government has not adequately thought out the implications of these provisions. Mr. Smith in his article (see note 84, *supra),* points out that the requirement that any contract or dealing in listed securities must be completed by the next day of trading will create numerous difficulties, both of interpretation and substantive law. A particular problem will arise in the determination of when a securities transaction or contract is completed, especially as the parties can specifically provide as to when completion will take effect. Furthermore, underwriting contracts and subscription contracts are not usually completed within twenty four hours. It would seem these transactions, and possibly a number of other unobjectionable transactions such as equitable mortgages and preemption rights, would be struck down by this section.

[87] See also Board Trading Rules and By-laws of the Hong Kong Stock Exchange Ltd. The other stock exchanges operate similar rules.

larly a new law in a field such as this, should not have to be propped up and reinforced in this manner.

Section 80 of the Ordinance, which extends to all persons, whether dealers or not, but is restricted to dealings in listed securities on a stock exchange, provides that it is unlawful to engage in short sales.[88] There are certain qualifications to liability, the most significant being that a person acting in good faith in the reasonable and honest belief that he has a right, title or interest to the securities he purports to sell is excluded from the prohibition; likewise a dealer acting in good faith for or on behalf of some other persons is excused, if he reasonably and honestly believes that other person can make good delivery. This of course imposes a relatively heavy burden on the broker, and he will have to be sure that his client can make good delivery. The broker's problem is aggravated by the fact that, as we have already seen, in many cases there is nothing like the close client and broker relationship that exists, and is indeed fostered, in for instance the United States or Britain. In addition the complexities of the Hong Kong stock transfer system compound the broker's dilemma. It is an open question how far the broker should go; obviously much will depend upon his relationship with the particular client, and whether there are any circumstances that should have put him upon enquiry.

Short selling was a serious problem in the Colony, and as in other countries, when the stock markets have declined, no doubt helped to accentuate if not precipitate the collapse. Whilst empirical evidence is naturally unavailable, it would seem a reasonable assumption that short selling operations were used to a considerable extent by insiders, manipulators and their privies, to maximise their illicit profits. For this reason it is respectfully submitted that the prohibition should have been universal and not restricted solely to stock exchange transactions, even though at present the over-the-counter market in the Colony is very small. The offence under Section 80, carries a penalty of a fine of 10,000 Hong Kong dollars and six months' imprisonment, significantly more than the penalties for violation of the forward trading provisions.

Conflicts of Interest in the Securities Industry

It is generally recognised that persons employed in the securities industry are often in a privileged position so far as their own personal transactions are concerned. In many cases brokers and dealers will receive the benefit of reduction on transactional expenses, that persons not in their position are required to pay in full. More importantly however brokers, dealers and investment advisers are invariably in a position to acquire and use inside information. Apart from the normal corporate inside information that is available to directors and officers, and in some cases principal shareholders of issuers, these professionals in the securities business are in receipt of 'market information.' This type of information is not generated within the

[88] Section 80 prohibits a person selling securities, which includes a purported sale, an offer or a holding out that he is entitled to sell, of any security on a stock exchange unless he has, or has reasonable grounds to believe that his principal has, a presently exercisable and unconditional right to vest the security in the purchaser thereof.

relevant corporation but from outside it. For instance, the advance knowledge that a large institutional investor intends to place an order for a large proportion of the outstanding securities of a particular issuer could be highly material and lucrative information.

It is not possible to enter into an extended discussion of this aspect of insider trading here, and in any case the distinction between internally generated 'inside' information and market information is in many cases a matter of degree. Furthermore, the distinction has tended to become important only in those countries operating a rather more sophisticated and developed form of regulation than the sort we are presently examining. Nevertheless, the Hong Kong Securities Commission is conscious of the privileged position of dealers in particular, and it is perhaps worth while to briefly consider the relevant provisions discouraging the grosser kinds of insider abuse in this context.

Under the terms of Section 25 of the Securities Ordinance a company may apply to the Securities Commission for approval as a Stock Exchange, provided that a number of requirements are observed in its memorandum and articles of association. These requirements, as we have already mentioned, to a great extent reflect the former 'Conditions for Recognition,' and are similarly directed to ensuring the soundness and viability of the Exchange and its membership. By Section 25(3) (e) the Exchange's rules must ensure that all dealings by its members are in such a manner as to protect and promote the interests of investors. As was formerly required in the 'conditions' when a dealer who is a member of the Exchange seeks to deal on his own account he must notify this fact to the person he is dealing with,[89] in the contract note. Under Section 75 every dealer with regard to every securities contract must, not later than the end of the next trading day, draw up a contract note, which must also be delivered to his principal if he was acting as an agent. Although this note must contain certain details, it is significant that it need not disclose the name of the other party to the transaction, unless of course it was the dealer himself.[90]

Furthermore, as under the previous 'conditions for recognition', there must be a provision in the exchange's rules preventing a member

[89] This is reflected in the Rules and Regulations of the Hong Kong Stock Exchange, Rule 58, members when buying or selling on their own account must inform the client of this fact before the bargain is struck. When completing the contract note relating to the transaction, the endorsement (specified in rules) must be stamped on the contract note and the irrelevant parts deleted. This goes further than the requirement in Section 25(3) as it does specify when the disclosure must be made. The earlier conditions for recognition, made under Section 2A of the Companies Ordinance, did require disclosure before conclusion and also confirmation of disclosure on the contract note. The Companies Law Revision Committee in its First Report, at paragraph 6.51(4), having regard to the U.S. practice recommended that disclosure before conclusion was impractical and thus disclosure on the contract note should suffice.

[90] Under Section 77 a dealer is under an obligation to supply a client, and the Commissioner for Securities on request with a copy of the contract note and of the client's account. This could of course be important from the point of view of tracing transactions. The dealer need only keep contract notes for two years, and a client's account for six years. There is a fine of 2000 Hong Kong dollars for violation of this section.

who is a director or officer of a listed company transacting business in that issue.[91] Thus Rule 59 of the Rules and Regulations of the Hong Kong Stock Exchange provides that 'no member who is an auditor or a director of a public company is permitted to act in any-way in share transactions relating to the shares of that company (or any other company in the same group) in which he is a director or auditor. Of course as this is not a statutory provision the provisions in the Ordinance dealing with 'associate' and 'related' persons do not apply. Thus a partner of such a person would be free to deal uninhibited. However it is likely that the Commissioner for Securities would take a careful look at such cases, when considering his powers to refuse, revoke or grant registration to dealers and investment advisers in the Colony. Certainly disclosure of privileged information by such an 'insider partner' to a fellow partner or his firm would be a ground for disciplinary action by the Exchange, and for the Commission to consider whether his registration should be allowed to continue. It would seem unlikely that the Commissioner would resort to the concepts of 'deputization' as developed in American law, in such cases; instead, the determination of 'fitness' to continue as a registered dealer would probably be decided on an individual basis as a matter or administrative discretion.

This particular rule has had a considerable impact on securities dealers in the Colony who invariably held a number of directorships: although it is true that the rule can be relatively easily avoided by the use of nominees and frontmen, and it is doubtful whether it would prevent abuse by a person who had made up his mind to take an unfair advantage of his clients and the market. In some cases this limited degree of 'segregation' is reinforced by internal codes of conduct and procedures in the securities firms.[92] This is particularly so of the American firms that are members of N.A.S.D. and are under the terms of that organisation's rules to have internal supervision and complience procedures. Such internal 'house rules' are not common, however, in non-American firms, with the possible exception of the Japanese houses. It is understood that the Commissioner and his Office are interested in the development of this type of regulation, even though it is unlikely that within the context of the present environment in the securities industry such would have a substantial regulatory impact. An important feature in the developing of 'house rules' is, nevertheless, the educative effect that such have.

Important problems of conflict of interest arise, where a securities or banking house is exercising a corporate advisory and underwriting function simultaneously with that of an investment management or advisory function. In the more developed regulatory systems, and indeed in countries such as Belgium and the United Kingdom, it is generally recognised that there is a need to erect, as the Americans say a 'Chinese Wall' or 'Bamboo Curtain' between the two functions, so that information that is acquired for a certain purpose is not misused in the furtherance of another unrelated purpose. A similar problem arises where a broker or investment adviser acquires inside information, and would seemingly be under a duty to use such in the protection of his client, provided the client, broker or adviser relationship was

91 Section 25(3)e(iii).

92 See Hong Kong Stock Exchange, Rules and Regulations, rules 60 and 70.

existing when the fiduciary acquired the inside information, and there is no other rule of law protecting the confidentiality of that information, entitled to precedence over the existing duty between the broker or adviser and the client. There are certain United States decisions which indicate that a person in such a conflict position is liable to the client if he does not seek to protect his best interests by disclosing material inside information that is in his possession, and yet on the other hand may well find himself liable to the corporation and persons trading with his client or his clients tippees if he does pass on privileged information.

The Securities Ordinance also requires Approved Exchanges to maintain adequate daily records of all dealings on the securities markets,[92] and that such records will be open to the public for inspection on the payment of a fee.[93] These provisions should at least in theory facilitate the detection of insider abuses. The Commission has important powers to revoke or suspend the approval of a stock exchange for misconduct or failure to comply with the requirements laid down in the Ordinance.[94] Furthermore, it should also be pointed out that all alterations of approved stock exchanges' constitutions and rules must obtain the prior approval of the Commission, under Section 30 of the Securities Ordinance.

There is also an obligation on a dealer, both under Section 79 of the Securities Ordinance and also the circular provisions of the Protection of Investors Ordinance, to disclose certain facts when a circular or other written communication is issued by him to more than one other person recommending transactions in securities of a particular company. In such written recommendations, not oral, and whether they be express or implied, it is necessary that the dealer discloses any interest he may have in those securities.[95] However, the interest has only to be stated at the date specified on the circular, and there is no obligation to make a further disclosure if the interest so disclosed is increased or varied. Furthermore, the dealer only has to state whether indeed he has interest, and not its exact nature or qualification. It is submitted that these two defects are serious and should be obviated. The problem of investment advisers 'scalping' their clients by trading personally on the impact of their own market recommendations would not really be covered by Section 79. However, it would seem that Section 136, which we have already discussed in the context of manipulation, should be applicable in such a case, and indeed to the extent that market information can be considered inside information, so should the anti-insider trading provisions.

[93] Rule 60, of Hong Kong Stock Exchange.
Rule 60 reads 'A triplicate copy of all sales slips must be prepared and placed in the box provided. This closed box will only be opened by the Secretary. This record of sale slips will be available for inspection by members of the public on payment of a search fee of Hong Kong $10'.

[94] Section 26. The Commissioner under Section 27 has similar powers of suspension in the case of a natural or financial disaster. There are procedures for appeal under Section 29.

[95] Interest in securities: defined very widely in Section 5.
Section 5(7) (b) provides, however, that for the purpose of Section 79 an interest in securities of a person who holds that interest only by virtue of his having control over the securities as a manager, agent or trustee, or nominee for another is to be disregarded.

The Anti-Insider Trading Provisions

The topic of insider trading was specifically dealt with by the Companies Law Revision Committee in their Second Report on Company Law.[96] The Committee in their First Report on the Protection of Investors pointed out, at paragraph 14, that the matters dealt with in that report had been arbitrarily selected as requiring urgent treatment. As has already been mentioned, it seems strange that the question of insider trading should be included in a report dealing with 'general company law', rather than the First Report dealing with the protection of investors. The Committee did add, however, that the problem of insider trading and the manifold aspects of its regulation required extended deliberations. Before discussing the prohibitory provisions designed to outlaw certain aspects of insider abuse in the Securities Ordinance, we shall first examine, briefly, the question of disclosure of beneficial share ownership in the Colony.

Disclosure of Corporate Insiders Share-ownership and Transactions

The Companies Law Revision Committee were split dramatically on the question of whether a scheme for the disclosure of beneficial ownership of securities by company directors and officers should be introduced or not. The majority of the Committee considered that a mandatory system of disclosure of share holdings and transactions by corporate insiders was unnecessary in the Colony.[97] Mr. P.G. Willoughby, writing in the *Hong Kong Law Journal*[98] agrees with this conclusion, and states that whereas in the United Kingdom the regulation of insider trading has taken the form solely of a disclosure mechanism[99] in the Colony with the introduction of substantive provisions prohibiting the trading by corporate insiders on the basis of inside information, disclosure is unnecessary. With the greatest respect, it is doubtful whether the British provisions requiring the disclosure of directors' shareholdings and transactions in their company's securities were ever intended, except by the most optimistic, to be in lieu of statutory prohibitions on this abuse. Indeed, when the 1967 Companies Act was introduced the Government of the day made it clear that it was only the first instalment and that a second instalment dealing *inter alia* with the outlawing of these abuses would follow, should the Government remain in office, which in fact it did not. Furthermore, and perhaps more significantly, in the vast majority of countries that seek to regulate insider trading both disclosure and prohibitive provisions go very much hand in hand.[1] Mr. Willoughby also maintains that the British disclosure provisions 'have proved administratively cumbersome and when taken to their logical con-

[96] April 1973 (Hong Kong Government).

[97] Chapter 7, Second Report 1973, Company Law.

[98] *Law Lectures for Practitioners* (Hong Kong Law Journal 1974, p. 72). Reference should be made to Mr. Willoughby's most helpful discussion of Hong Kong corporation law, commencing at p. 53.

[99] Sections 27-32 of the United Kingdom's Company Act 1967.

[1] See for instance Sections 16(a) and 16(b) of the United States Securities Exchange Act 1934. Although the requirements for certain corporate insiders to report their transactions was dropped because of administrative difficulties in France, the French Securities Commission (Le Commission Des Operations de Bourse) has recently requested the Government to reintroduce new reporting provisions to reinforce the insider trading prohibitions enacted in the Company Law of 1966.

clusion have been the subject of ridicule' and 'that in practice it has been found not possible to apply them strictly.' Whilst the present author would agree that both the nominee device and the ignorance of some insiders of their obligations to disclose their transactions combine to impede the effectiveness of the mechanism it would in the author's opinion be wholly fallacious to dismiss the disclosure provisions in such a manner as Mr. Willoughby, and the majority of the Committee have done.[2]

It is of some interest that the Commissioner for Securities and his officers consider that the introduction of a system requiring disclosure of insiders share holdings and transactions would not be feasible in Hong Kong and would serve little practical purpose. The present author understands from the Assistant Commissioner that at least for the time being the Commission was prepared to rely upon complaints and to be guided by their own suspicions. How, or upon what evidence, complaints and suspicions are to be based, without a disclosure mechanism, remains to be seen. It is possible that significant price or volume fluctuations on the markets might be picked up by the rather rudimentary market surveillance systems operated by the Commissioner's office and the Stock Exchanges.[3]

As has been pointed out previously, it is both misconceived and dangerous to fail to pay close attention to local conditions, when imposing regulatory mechanisms such as those we are now discussing. The Commissioner quite rightly considers that with the widespread use of nominees, and 'front men', the multiplicity of directorships often held by one person, the diverse capital structures of local companies, and the traditions of the local population[4] it would be extremely difficult, and almost certainly a useless endeavour, to attempt to introduce a scheme of disclosure as is operated in many other countries. Whilst the present author cannot see the logic of the assertion that disclosure is not required because of substantive prohibitions on in-

[2] It is interesting to note that the representatives of the Law Society, the Bar Association and the Association of Chartered Accountants on the Companies Law Revision Committee considered that a disclosure regime was vitally important both as an aid to enforcement of the anti-insider trading provisions, and as a deterrent in itself. It is of some interest that Mr. Willoughby (see *supra* at note 98) considered that it would be beneficial for there to be provisions requiring the disclosure of beneficial ownership of ten or possibly five percent of the securities of an issuer. This would be to indicate possible changes in control and not necessarily serve as an insider trading disclosure provision, although of course such a provision would be relevant to insider trading.

[3] There is no system of regular surveillance, such as is operated on the United States Exchanges and those in Canada and a few other countries. In Hong Kong what surveillance generally amounts to is a retrospective examination of dealings prior to an important corporate announcement. This is basically the same, rather deficient system that is currently operated in London.

[4] It is understood that many married Chinese women hold property completely separately from that of their husbands, and it by no means follows that a spouse would have a detailed knowledge of the property owned by a wife or husband. Furthermore, although the present author must disclaim all knowledge of Chinese property law, it would seem that a relatively large amount of property is held in the form of 'family trusts'.

It would also seem that a far greater use is made of aliases in the Colony than, for instance most Western countries; and there is the problem that because of the limited number of Chinese surnames, it would be most difficult to compile a register of any great utility.

sider trading, or because the British system has not always functioned as well as it should, he has great sympathy and respect for the evident practical problems that the introduction of an effective scheme would face, and the rather dubious advantages such a mechanism could reasonably be expected to yield.[5]

The Recommendations of the Companies Law Revision Committee

Despite the controversy over disclosure of shareholdings the Committee said that they were firmly convinced that 'strong legislation was required to curb insider dealings'[6] which it acknowledged was a serious problem. The Committee 'after the most careful consideration came round to the view that insider dealings should be made a criminal offence, as this in the Committee's own words 'would undoubtedly be the most direct and unmistakable way of conveying the verdict of the society upon these dishonest transactions'.[7] At the same time, because of the multiplicity of interlocking directorships in Hong Kong, the Committee were concerned that due to the difficulties of absolutely clear definition and drafting of the relevant crime, the provisions should be restricted to those 'with a guilty intention'.[8] Furthermore, as a means of preventing 'indiscriminate prosecutions' no prosecution should be instituted without the Attorney General's consent.

The Committee, ever conscious of the drafting difficulties, unfortunately decided not to attempt to formulate precise legal terms, but to content themselves with recommending broad principles. This is to be regretted, as the members of the Committee had an expertise and practical knowledge not generally possessed by statutory draftsmen. The Second Report recommended that the definition of insider should be cast as wide as possible; and to this end 'all directors, officers and employees of a company, and all other persons who in the course of their employment, business or profession acquire confidential information which comes directly or indirectly from within the company' should be regarded as insiders.[9] This definition is extremely wide, and a number of pertinent questions immediately suggest themselves. For instance, how far down the employment hierarchy should the definition of 'insider' extend? Need the 'employment, business or profession' be in some way related to the issuer, or to the acquisition of the information, or is it enough that

[5] Whilst disclosure provisions are in force in a number of other Far Eastern countries, such as Singapore, Malaysia, Japan and the Philippines, there would seem to be a large consensus of opinion in the Colony, both among the Government and business sections of the community, that local conditions would, taken together, prove virtually insurmountable.

[6] Paragraph 7.130, Second Report. This view was unanimous.

[7] Paragraph 7.130, Second Report. The Committee considered that apart from the educative effect 'there could be no more effective way of discouraging anyone inclined to use inside information than to let him know that if he does so he will be subject to severe penalties.'

[8] Paragraph 7.131, Second Report. With respect it would seem an equally difficult task to adequately define guilty intent. The Committee seemed to think that it was easier or preferable to limit the offence to such cases, rather than adequately deal with 'the exceptionally difficult task of drafting provisions which indicate with sufficient clarity the types of dealing covered by them.' Otherwise, the Committee observed, directors especially of interlocking companies 'could find it very awkward'.

[9] Paragraph 7.133, Second Report.

a person simply is at work and overhears confidential corporate information? Moreover, if this last point is correct why should it be relevant that the recipient of the information is at work in the first place? The requirement that the information should be confidential is also rather obscure; certainly the insider trading provisions in a number of other countries extend far beyond information that is 'confidential', in that it would be protected in law and equity as such. Also the requirement that the information 'comes directly or indirectly from within the company' would seem to restrict the scope of the definition of insider to persons holding rather than seemingly merely having access to information generated within the particular issuer concerned. In other words, it would seem that the acquisition of market information or information about another corporation would not be comprehended.

Given this rather uncertain 'definition' of insider, the Committee considered that it should be an offence for an insider for his own benefit, in a transaction relating to the shares of a company, to make use of information about it which has come directly or indirectly from within the company, which he knows [10] has not been disclosed generally to its shareholders or the public and the disclosure of which is likely to effect the price of its shares or to be considered important by reasonable investors.[11] Again, it is strange that the Committee should exonerate the insider who trades, and abuses his position for the benefit of someone else. However referring to the possibility that an insider may pass on relevant price-sensitive information to another person, who might then deal, the Second Report affirms that 'since both the passing on of the information, and the dealing by the recipient would be scarcely less reprehensible than a dealing by the insider himself it should also be made a crime for an insider to pass on inside information about a company and for any person, in a transaction relating to the shares of a company (presumably the one concerning which the information was given) to make use for his own benefit, information about it, which he knows has come directly or indirectly from within the company, and which has not been disclosed generally to its shareholders or the public, and the disclosure of which is likely to affect the price of its shares or to be considered important by reasonable investors.[12] The Committee also pointed out corporations should be comprehended within the provisions to the same extent as a natural person, under the terms of Section 84 of the Interpretation and General Clauses Ordinance.

The recommended penalties for violation of the main and tippee trading provisions were two years' imprisonment or a fine of 50,000 Hong Kong dollars, on indictment, and six months' imprisonment

[10] 'Which he knows': this seems to be a subjective test and one the prosecution in some cases, especially of the more minor employee, or perhaps non-executive directors, could have great difficulty in establishing. More is the problem when adequate disclosure to the shareholders or public is left undefined. It is submitted in this case that the burden of adducing evidence, if not of proof, should be on the accused to show that he thought the information had been disclosed.

[11] It is interesting that the Committee adopted the market impact test and the reasonable investor test of materiality, which has been developed in the United States in cases under Rule 10b(5). Of course, there are difficulties in the determination of what is a substantial impact on the market and what is the reasonable investor.

[12] Paragraph 7.134, Second Report.

and a maximum fine of 10,000 Hong Kong dollars on summary conviction.[13] Whilst these penalties are reasonably severe they might not come anywhere near acting as a deterrent in those cases where the profits contemplated by illicit insider dealings are far in excess of these amounts.

It was recognised that the mere fact of providing that insider trading is illegal, apart from its educative effect would be of little practical effect without a viable means of obtaining evidence. The Committee assumed that the Commissioner for Securities would have sufficient powers to call for and obtain 'full details of the transaction including the names of the clients' from the various brokers.[14] The real problem, however, is that in a number of cases the client will be a mere nominee or frontman. The Committee, to deal with this paramount difficulty, stated that there should be some convenient statutory means' of getting behind the nominees. However, perhaps not very surprisingly, it was thought that information which by its very essence is normally private should only be available under the courts' control.[15] It was thus recommended that there should be a statutory procedure under which an application can be made to a Judge of the Supreme Court in chambers, by the Attorney General or the Securities Commissioner, where there is a showing that there is reasonable cause to believe that any of the proposed offences have been committed, whereby the Court may order any person who has information relevant to the transactions in his possesion to hand it over to the applicant.[16] The Committee was under no illusions, that the recommendations they had made would eliminate insider dealing altogether, 'just as other crimes continue to be committed in spite of severe penalties imposed, so insider dealings may be expected to continue': although, in the view of the Committee making insider dealings a criminal offence would help to create the right climate of opinion. Violators would 'receive the public stigma they deserve'.

Before discussing the question of civil liability it is perhaps worth mentioning that the Committee did not consider that any special provisions were necessary with regard to insiders dealing in options of their own corporations[17] or indeed with regard to short sales.[18] In these matters the Committee considered that insiders were in no different position from other investors, with the exception of dealers. It is respectfully submitted that this is doubtful.[19]

[13] Paragraph 7.135, Second Report,

[14] Paragraph 7.136; and in cases where there was a reasonable suspicion of abuse, such as heavy buying in advance of a bid, the Commissioner could set up an investigation on his own initiative.

[15] Paragraph 7.137, Second Report.

[16] If the disclosed information indicates that a crime has been committed, those who have the information are compellable witnesses in any relevant criminal proceedings, or in any civil proceedings based on the same material facts, in the Committee's view. If, on the other hand, the disclosed information is not suggestive of violation, the information is to remain confidential. This would seem to restrict the use of this procedure, for civil cases, to only those where a crime has been committed. This is a problem as, for a criminal violation, it is necessary in the Committee's view to prove a guilty intention; and in any case the degrees of proof would be much higher.

[17] Paragraphs 7.75 and 7.139, Second Report.

[18] Paragraph 7.140, Second Report.

[19] See *supra,* note 83 *et seq.*

Turning to the question of civil liability, the Committee decided to follow the recommendations of the Jenkins Committee, which whilst acknowledging that it might will be very difficult for the other party to a transaction to establish that he was dealing with an insider and thus establish his case, or even for that matter know he has one, there should nevertheless be a civil action provided for in the statutory provision. The Companies Law Revision Committee examined in detail the recommendations of the British Justice sub-committee on company law, in their 'Report on Insider Trading' (1972). The Justice Committee considered that the problems of tracing and establishing a privity relationship in stock exchange transactions were so great that a civil remedy should only be provided in face to face transactions. The Justice Report also pointed out that even if a person could establish that he had traded with an insider who was in possession of material inside information, in an exchange transaction, his recovery would be substantially fortuitous and in the nature of a windfall profit.[20] The Jenkins Committee, whilst admitting the difficulty of tracing on the London Exchange, considered that in those cases where it was possible to identify an insider transaction on the basis of privileged information and to establish privity the innocent party should be entitled to a compensatory remedy, regardless of the fact that in ninety-nine cases out of a hundred it would be impossible to utilise the civil remedy provisions.[21] The Companies Law Revision Committee observed that in Hong Kong, although the settlement system was less complicated 'owing to the widespread use of nominees and the practice of shares passing through many hands by delivery of the certificate with signed transfer attached', it would be most difficult to establish a case. Nevertheless, the Committee it is respectfully submitted rightly, saw no reason why if a case of insider trading did materialise (as for instance in the case of a prosecution) a person injured should not have a civil remedy,[22] to compensate him for his loss.

ENACTMENT WITHOUT IMPLEMENTATION — A WAY OUT?

Thus, whilst the Hong Kong Companies Law Revision Committee relied to a considerable extent on the Jenkins Committee Report, it is evident that its proposals represented a major step forward in the protection of investors in the Crown Colony. Indeed, in many respects the recommendations went a good way further than those of

[20] The American Courts, whilst admitting these difficulties, have considered that the compensatory, remedial and deterrent purposes of the anti-insider trading provisions are so important that it is not necessary to establish privity in order to recover compensation. This of course itself causes substantial problems, in that the result would seem to be the creation of almost unlimited liability: see *Shapiro* v. *Merrill Lynch Pierce Fenner & Smith Inc.,* 495 F.2d 228 (2d. Cir. 1974).

[21] See Report of the Company Law Committee (Cmnd 1749) paragraphs 88 and 99(b), and see also Clause 15 of the United Kingdom Companies Bill 1973.

[22] The proposed right of action would lie against 'any insider who for his own benefit in a transaction relating to the shares of a company makes use of information about it, which has come directly or indirectly from within the company, which he knows has not been disclosed generally to its shareholders or the public, and the disclosure of which is likely to affect the price of the shares or to be considered important by reasonable investors' (para. 7.142); the remedy would be purely compensatory, and would lie only if the other party was not aware of the information. A similar right of action is recommended against any injury caused by a tippee dealing with inside information.

the British Company Law Reform Committee and existing British legislation.[23]

Whether the recommendations of the Committee would have been so rapidly enacted had not the Hong Kong stock markets collapsed in the way they did is open to question. Certainly with the financial turmoil there was considerable pressure, from a number of diverse sources on the Colonial Government, 'to bring to fruition its long promised legislative controls over the operation of the stock markets.'[24] It had originally been intended to introduce the Securities Bill in late January 1973 even, before the publication of the Companies Law Revision. Committee's Second Report; however, the Hong Kong Government experienced considerable difficulties in finalising the proposals and drafting the Ordinance. In the result the Protection of Investors Bill and the Securities Bill were not introduced into the Legislative Council until September 1973, although earlier drafts had been in circulation.

Both the Protection of Investors Ordinance,[25] which we have already discussed, and the Securities Ordinance were highly controversial measures.[26] Whilst a considerable amount of the hostility that the legislative proposals engendered was misconceived, there were a number of factors evident in the securities industry's structure in the Colony which were directly contradictory to the proposed requirements of the Ordinances. For instance, it has already been pointed out that a large proportion of Stock Exchange members considered that the position in the securities industry was similar to that of any merchant or retailer, who could quite correctly place his own personal interests above those with whom he dealt. The fiduciary aspect of the relationship was in many instances ignored.[27]

Another very important factor that has to be considered when looking at the criticism that was levied, against the Securities Ordinance in particular, was the very poor state of corporate disclosure

[23] It is interesting to note that at a lecture in the University of Singapore and Kuala Lumpur in 1962 Professor Gower referred to the laws and legal developments on certain Commonwealth countries overtaking Britain, and he envisaged a time when the United Kingdom might well find itself looking to these countries for the lead: (1962) 4 Mal. L.R. Company Law Reform, page 36.

[24] Phillip Bowring, *Financial Times* (London) 4th February 1974. Of course, as one might expect in the beginning the securities industry was less than sympathetic to the attempts by the Government to calm down the excesses of the boom. However, when the market began to topple the Exchanges themselves appealed to the Colonial Government to intervene. A Securities Advisory Council was immediately set up and a number of short-term expedients, such as a temporary halt on new issues and half day trading, were resorted to.

[25] Published in Legal Supplement No. 3 to the Hong Kong Government Gazette; Sup. to Gazette No. 39, Friday 28th September 1973; vol. CXV.

[26] The Hong Kong Bull Street, October 1973, published by White & Co., referred to 'the general howl of protest' which followed the publication of the two Bills.

[27] This is in no way intended to depreciate the many completely honourable and professional broker-dealers operating in the Colony. The present author is merely attempting to point out that many of the 'new' brokers, whose numbers increased by ten fold, although having a code of ethics were not necessarily attuned to the rather sophisticated notions of responsibility to clients and the market, found in longer established centres.

in Hong Kong.[28] Although it is true that recent amendments to the law have brought the Colony's requirements broadly into line with the British Companies Act of 1948, and in some respects with the Companies Act of 1967[29] the former state of the law in this respect was exceedingly defficient. It is therefore hardly surprising that the local capital markets operated almost wholly on rumour, and what little disclosure was in fact made was, probably in most cases, correctly viewed with suspicion.[30]

Associated with the poor information flow in the Colony was the fact that brokers, dealers and professional speculators often occupied or had representation on a number of company boards.[31] This allowed a check to be maintained on the running of the corporation, and yet at the same time allowed for a private source of information. Thus, Phillip Bowring writing in the *Financial Times,* observes that many Hong Kong brokers' 'primary objectives lie with protecting as they see it their companies' and their own interests in nondisclosure' rather than fighting for the sort of information that would make broking less of a guessing or inside knowledge game'.[32] Although it is quite true that many business men in the Colony hold a considerable number of multiple directorships, sometimes amounting to forty or fifty,[33] it

[28] Until the Companies (Amendment) Ordinance 1974 the Colony's disclosure requirements were largely based on the British Companies Act of 1929, although there had been slight amendments under the Companies Ordinances of 1964, 1972 and 1973. Until recently the main problem has been that company accounts were unconsolidated, and the 'endless shifting of assets within groups' completely confuses the true state of affairs: see, for instance, the *Financial Times* (London) 4th February 1974.

[29] Under the requirements of the 1974 Ordinance the amount of disclosure required of public companies is more or less the same as that in the United Kingdom. Of particular interest are the provisions requiring the disclosure of holding company relationships and corporate shareholdings in other companies: see on this generally P.G. Willoughby, Company Law 1974 (Law Lectures for Practitioners) (Hong Kong Law Journal, 1974). There has been criticism of the fact that the disclosure regime might be by-passed by the creation of 'interweaving relationships' between public and private companies, which incur far less obligations under the disclosure requirements. On the question of disclosure in the Colony reference should be made to the Second Report of the Companies Law Revision Committee (1973), Chapter 3. The recommendations of the Committee have now been largely enacted. The Committee's recommendations on disclosure with regard to public issues in Chapter 8 of their First Report on the Protection of Investors, were largely implemented under the Companies (Amendment) Ordinance 1972: see Field, 'The Law Relating to the Flotation of Securities in Hong Kong', (Volume 3, *Hong Kong Law Journal,* at p. 147).

[30] As Mr. Field points out in 'The Law Relating to the Flotation of Securities in Hong Kong,' (Volume 3, *Hong Kong Law Journal* 147 at p. 166) it is only recently that prospectuses in the Colony have been required to be printed in Chinese as well as English; see also Goodstadt, 'Bull in a China Shop' *(Far Eastern Economic Review,* 21st October 1972. The new disclosure requirements are having a sanitary effect on the self-dealing aspects of the Colony's commercial life.

[31] This problem is of course not confined to Hong Kong and is an important aspect of the so-called 'Chinese wall' concept already alluded to. Where a person owes responsibilities to two or more persons or organisations inevitable questions of conflict of interest arise.

[32] *Financial Times* (London) 4th February 1974.

[33] In a few instances the number has risen to 150 and 210. Apart from directly holding corporate directorships there is the widespread use of 'front men' and nominees, often representing syndicates or individuals who do not wish to show their identity. Moreover, it is a common practice in the Colony to find a number of local and foreign companies, both private and public, woven into incredible and incestuous webs.

would be wrong to consider that the sole or even predominant purpose of this was to tap private sources of inside information. Obviously business skills and financial expertise are a relatively scarce commodity in a society of the dimensions of Hong Kong, and thus it is necessary and arguably desirable that the maximum use should be made of the managerial talent available locally.[34] Furthermore the vast majority of persons holding multiple directorships are non-executive directors of the vast bulk of their companies, and would hardly be in the main flow of corporate news and developments in those issuers.[35]

Given the situation in the Colony and the profound changes in the mores and conduct of the securities industry that the Ordinances were intended to effect, it is not hard to understand why the opposition reached the vehemence that it unfortunately did;[36] and as one might expect, one of the main areas of controversy, particularly between the expatriate houses and the local brokers, concerned whether the proposed scheme should be consultative or regulatory, or mid-way between the two.

In the result the Securities Bill had a relatively short but rough ride through the Legislative Council. Apart from dealing with insider trading in Part XII, it also, as we have already mentioned, sought to establish a Securities Commission and to increase the viability of the self-regulatory framework by the setting up of a Federation of Stock Exchanges.[37] Considering the amount of criticism and allegations of 'overkill' that the Bill provoked, it suffered only two amendments and passed into law on the 20th February 1974.[38]

One of the amendments concerned the amount of the compensation fund, and is thus is from our present view point of little consequence; the second amendment was however of major import. The provisions dealing with insider trading, which to all intents and purposes implemented the recommendations of the Law Revision Committee, were postponed, although passed as law, indefinitely.[39] The Colonial Financial Secretary in his speech before the Legislative Council stated:[40]

[34] This problem is apparent in most countries, and has been a source for concern in the United States of America and Canada. Associated with this problem is the difficulty that many countries face in erecting a proper audited disclosure system for companies, due to the relative shortage of adequately qualified accountants. This has been a considerable problem in India, and to a lesser extent some European countries.

[35] The ability of directors to exercise a proper degree of care in the management and supervision of their companies is naturally a relevant consideration here, and concern over this has resulted in calls for the limitation on the number of directorships that a single person should be able to hold.

[36] In retrospect the Colonial Government should undoubtedly have sought to explain the proposed legislation and the purposes behind the various provisions to the local community, to a much greater extent than was done.

[37] In addition, there were provisions requiring the registration of broker-dealers and investment advisers, the establishment of a statutory compensation fund as well as the provisions dealing with manipulation and short and forward selling that we have already discussed: see Securities Bill 1973, Sup. to Gazette No. 39, 28th September 1973, Vol. CXV.

[38] Legal Supplement No. 1 to the Hong Kong Government Gazette; Friday 22, February 1974 Sup. to Gazette No. 8. Vol. CXV 1.

39 Malcolm Surry, 'Permanent Exception; Hong Kong's insiders can breathe again': *South China Morning Post,* 17th January 1975.

[40] Legislative Council, Hong Kong, 12th December 1973.

> As Honourable Members are aware the United Kingdom has not, as yet, formally defined insider trading in legislation, but proposals on the subject will be included in the new Companies Act which should soon be published. In view of this, I intend to recommend that the implementation of this clause should be deferred until such time as we have been able to assess the proposed United Kingdom legislation.

This reflected not only the concern of the Colonial Government to forge ahead in this area, but also that of the securities industry, particularly the expatriate securities houses and banks, who considered that it would be imprudent to pioneer the question of insider trading in the absence of a lead from the United Kingdom.[41] Whilst at the time that the Government decided to postpone the implementation of the insider trading provisions there was insider trading legislation pending in the United Kingdom, in the Companies Bill of 1973,[42] this was never passed; and although the present British Government is working upon the matter, it is to be doubted whether any legislation on this abuse will be forthcoming for a year or so.[43]

Although the Colonial Government did not contemplate that the delay in the introduction of legislation in the United Kingdom would be so great, it is the view of the Commissioner for Securities that the present anti-insider trading provisions should not be implemented in the Colony until British law has been passed, and reasonable experience of its operation acquired.[44] The Legislative Council are thus in the happy position of having accepted the recommendations of the Companies Law Revision Committee, and have by legislating against insider trading shown it to be wrong and criminal and thereby have provided the necessary social condemnation which many have considered to be so important, whilst saving themselves from the admittedly great practical, and indeed political problems, created by any implementation. To this extent the 'buck' has been passed back to London.

Whilst it is true that other countries, in particular Singapore, have been prepared to adopt a bold stance against this particular type of abuse, with many of the same sort of problems that face the Colonial Government, the present author, with the greatest respect, on balance would agree with the Commissioner and his officers that there are certain almost unique considerations in the Colony which dictate a high degree of caution.

[41] See for instance, Hong Kong Bull Sheet No. 8, and Hong Kong Bull Sheet — Securities Bill 1973 — Second Reading, published by White & Co.

[42] Companies Bill 1973 (Bill 52): see Clauses 12 to 16; reference should also be made to the White Paper, 'Company Law Reform' (Cmnd 5391) (HMSO) paragraphs 15 to 20.

[43] The present Labour Government, although intending to introduce anti-insider trading legislation as soon as possible, want to do so in the context of a wide ranging reform of British company law; letter to the author from the Rt. Hon. Peter Shore, Secretary of State for Trade, 6th December 1974. The Conservative Opposition are still pledged to the enactment of anti-insider trading legislation along the lines of their Companies Bill 1973: letter to the author from the Rt. Hon. Edward Heath, then Leader of the Opposition, 20th January 1975, and letter to the author from the Rt. Hon. Peter Walker, Shadow Secretary of Trade, 24th January 1975.

[44] There is of course a certain degree of liaison between the Department of Trade in the United Kingdom and the Colonial administrators, although probably not as much as is generally thought.

Among these factors the Commissioner has pointed out that commercial and financial interests in the Colony are very closely interlocked, probably far more so that in other Far Eastern countries such as Singapore and the Philippines, both of which of course operate insider trading regulation of a relatively sophisticated nature. The number of businesses that have originated as private concerns and then sought public funds, whilst the original owners maintain effective control, is another highly significant factor.[45] In addition there is the problem already referred to of the common practice of businessmen and financiers holding an excessive number of directorships[46] in a wide variety of companies. Unless this practice is discouraged there are obviously going to be a number of instances where, whilst a particular person could in theory have had access to inside information, because of the number of directorships that he held it is as a practical matter highly unlikely that in actual fact he was in receipt of privileged information. It would seem practically impossible for a single man to be consistently tapping and evaluating fifty or more different informational imputs. Thus, there would appear to be a great need for an approach that would investigate and examine every case of alleged abuse on its particular facts. Another point worthy of consideration is the extremely widespread use of nominees in Hong Kong. In some cases it would seem that a whole line of nominees is used, with the first nominee in the chain invariably being under the impression that the second link in the chain is the actual principal. Of course, this line will in many instances end in a numbered bank account outside the Colony. The problem of nominee holdings is a serious problem under all anti-insider trading systems, and is in no way restricted to Hong Kong. The overwhelming difficulty in the Colony is however, the probable extent of the use of the device and the ease with which money can be moved in and out, often without any form of official clearance. Perhaps another point worth mentioning is that there are a number of practices carried on in Hong Kong which, whilst considered unobjectionable by local standards, would be frowned upon in more sophisticated financial centres.[47] In this respect it might not necessarily

[45] This is not a unique problem to Hong Kong, and applies throughout the world; but what is probably different in the Colony is the degree to which 'founding interests' manage to perpetuate their control once the business has gone public.

[46] The problem has been aggravated by the fact that under the Colony's tax laws there is a strong incentive to form a separate subsidiary company to hold property, rather than to vest all property in a single corporation. This naturally increases the number of directorships that persons in the property-business will be likely to hold. Naturally the local conditions would render an equivalent provision to Section 16(b) of the United States Securities Exchanges Act 1934 impossible. Although it would be desirable to restrict the quantity of directorships held by any one individual it has to be realised, as we have already pointed out, that because of the limited number of persons able to provide such services in the Colony it would be difficult and dangerous to unduly restrict individuals in this manner. See generally the Companies Law Revision Committee, Second Report 1973. To outlaw multiple directorships would probably only aggravate the problem by increasing the use of nominee directors.

[47] This is not of course to say that there is any greater degree of fraud or abuse in Hong Kong than in other major capital markets. Nevertheless there is evidence to suggest that business and political ethics in the Colony might not always correspond to those generally accepted, at least publicly, in the West, as desirable. It would be wrong not to point out the serious problem of corruption in the Colony, however, and the work of the Anti-Corruption Commission in this respect.

be thought that use of inside information in personal investment decisions was wrong or immoral. Indeed it is only in recent years that the City of London has acknowledged that insider trading is a problem in the British securities markets; and even then there are a number of surveys which indicate that businessmen are not wholly convinced that such is dishonest.[48] Thus it is probable that the Colonial Government would prefer to clean up the markets in a gradual manner, attempting to educate the industry along the way.

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[To be concluded]

[48] See 'British Businessmen's Behaviour' (Industrial Educational and Research Foundation); 'Towards a Code of Business Ethics Consultative Document' (Christian Association of Business Ethics) and 'How Ethical Are Businessmen?' (Harvard Business Review July/August 1961).

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