THE REGULATION OF INSIDER TRADING IN HONG KONG

[Concluded]

CRIMINAL LIABILITY FOR INSIDER TRADING

The substantive offence of insider trading in the Hong Kong Securities Ordinance follows the recommendations of the Companies Law Revision Committee, in providing that

> Where a person, through his association with a corporation has knowledge of specific information relating to the operations or the securities of the corporation and that information has not been generally made available,[1] whether by public announcement, circular or otherwise, but, if it had been, might reasonably be expected to have materially affected the market price of the securities of the corporation, he shall not —
>
> (a) deal directly or indirectly in those securities in Hong Kong if by so doing he gains an advantage, whether by making a profit or avoiding a loss,[2] for himself or another person; or
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> (b) disclose that information to another person for the purpose of enabling that other person to use the information to deal in Hong Kong directly or indirectly in those securities and thereby gain an advantage whether by making a profit or avoiding a loss,2 for himself or another person (Section 140(1)).

This offence would seem to include at least seven basic elements,[3] all of which must be established by the prosecution before a conviction can be obtained. It must be proved beyond a reasonable doubt that through his association with a company the insider has some specific knowledge of certain facts about the company or the securities of the company, that the information has not been made available to the public, and that he deals in these securities in Hong Kong and by so doing gains an advantage, either by acquiring a profit or by avoiding incurring a loss, or that he discloses the information to another person for the purpose of enabling that person to gain an advantage by dealing in those securities.

[1] Clause 137(1) (the corresponding provision in the Securities Bill) provided that the offence is committed *inter alia* 'when the information is not generally known'. It has been contended that the wording of Section 140(1) suggests that for the offence to apply the information must be such as the issuer is under a duty to disclose. This with respect would seem to be misconceived. The predominant reason behind this amendment was to facilitate clarity. However, it would seem that there is at least one important difference between the wording of the Bill and that of the Ordinance. Under Clause 137(10) it would have been necessary to show that the information was not common knowledge, whereas now it would seem that it is enough to show that the information had not been made publicly available by the issuer.

[2] The Bill did not expressly extend to a 'an advantage whether by making a profit or avoiding a loss', but stated merely the taking of an advantage was illegal.

[3] The Hong Kong Securities Ordinance, by Mr. A.H. Smith, Law Lectures for Practitioners: *(Hong Kong Law Journal* 1974, page 48).

PUBLICLY AVAILABLE INFORMATION

Although we will be looking at these various elements in their appropriate context during our present discussion of the section, one question looms particularly important and requires our immediate attention. This is whether it is sufficient to render the information 'publicly available', and thus no longer inside information, if it has been disclosed by persons other than the corporate issuer. It is important to note that individual disclosure by the insider himself, to the other party to the transaction, provided of course such was possible, would in no way exonerate him from the subsection. That the other party to the transaction was not 'misled' would seem to be irrelevant to the insider's liability, as the information will only cease to be 'inside information' once it has been made 'publicly available'. This is interesting, as it emphasises that the crime of insider trading is a crime against the markets and the public investor and not merely an offence to the person with whom the insider actually traded. This being so, there must be disclosure to the market.

Whether a person other than the issuer can make the information 'publicly available' from the point of view of liability under Section 140(1) remains largely an open question. Certainly, if the offence had been restricted to information belonging to the particular issuer, then it would seem logical to allow the corporation to be the sole judge of when the information should be disclosed, subject of course to the legal and listing requirements that it might be under an obligation to observe. However, the section refers to 'specific information relating to the operations or the securities of the corporation,' and not merely information emanating from inside the issuer, as the Companies Law Revision Committee seemed to recommend. This phrase would seem to include information generated entirely outside the corporation, and over which the issuer has absolutely no control and may not even know exists.

On the other hand, there would be a number of significant advantages in holding that the sole test of whether the information had become sufficiently publicly available is whether the issuer concerned has publicly released or authorised the release of the information. It is certainly very much easier for a person who has acquired what he reasonably considers might be inside information to enquire of the issuer whether the information has been released or not. Likewise from the point of view of enforcement it would be much preferable to be able to determine the status of the information by ascertaining whether the corporation had released it or not. Furthermore, the corporation will have much better resources to effect whatever disclosure is considered necessary than most third parties or, for that matter, insiders. There is also the important factor that the corporation will be in a position to determine whether the information is sufficiently accurate and sound enough to be released. This is a significant consideration, in view of the impact that misguided or only substantially correct releases can have on the market. Thus, if this interpretation is adopted it would seem that an insider in possession of inside information cannot either use it personally or pass it on to others who are likely to deal on the basis of it, unless the corporation renders the information publicly available. In short, disclosure must

come from the issuer, and until this is done the insider must merely abstain from trading or tipping.[4]

A more lenient construction of the provision would be that whilst all that the prosecution has to do is to establish that the issuer neither published nor authorised the publication of the information, the defendant is entitled to adduce evidence that nonetheless the information was publicly available from another source. The burden of proof would of course remain on the prosecution to rebut this and show that, notwithstanding, there was still a failure to make the information publicly available. This, with respect, would seem the preferable interpretation, as the market and investing public might well be completely informed about a corporate development, although the issuer has not announced it.

INFORMATION IN OTHER COMPANIES

The problem of an insider in one company obtaining inside information on another issuer is dealt with by Section 140(2) of the Ordinance.[5] The subsection provides that

> Where a person through his association with a corporation has knowledge of specific information relating to the operation or securities of any other corporation which —
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> (a) has not generally been made available whether by public announcement, circular or otherwise, but, if it had been, might reasonably be expected to have materially affected the market price of those securities; and
>
> (b) relates to any transaction (whether executory or anticipated) invoking both of those corporations or involving one of them and the securities of the other,
>
> he shall not deal in those securities in Hong Kong if by doing so he gains an advantage, whether by making a profit or avoiding a loss, for himself or another person, nor shall he disclose that information to another person for the purpose of enabling that other person to use the information to deal in Hong Kong directly or indirectly in those securities and thereby gain an advantage, whether by making a profit or avoiding a loss for that other person or another.

This subsection grounds liability on proof that through an association with a corporation the insider has knowledge of any material fact or proposed transaction relating to another issuer, with which he has no association. Thus, Section 140(2) covers the situation where director X of X corporation, having knowledge that X corporation is going to make a favourable offer for the equity of Y corporation, purchases Y corporation stock, or discloses this information to another person so that he can do likewise. The Companies Law Revision Committee and the Securities Bill seemed only to envisage an insider dealing in the securities of his own company, or disclosing the inside information, so that someone else could deal in the securities of that issuer. Of course, this particular provision is most likely to be relevant in the context of corporate takeovers, where the insiders of both the offeror and the offeree are invariably in a privileged position with regard to each other's securities, and naturally their own.[6]

[4] Of course, in a number of cases the insider will be in a position to control or at least influence the corporate decision to release the information.

[5] There is no corresponding provision to this in the Securities Bill.

[6] We will be looking at the Colony's regulation of take-overs and mergers later on, in the context of the Hong Kong Code on Take-overs and Mergers.

TIPPEE LIABILITY

The insidious abuse of tippee trading, as distinct from insider trading,[7] is dealt with by the Ordinance under Section 140(3)—

> Where a person obtains, whether directly or indirectly, knowledge of specific information relating to the operations or securities of a corporation from or through a person whom he knowns, or has reasonable grounds for believing, to have an association with the corporation and that information has not been generally made available, whether by public announcement, or otherwise, but if it had, might reasonably be expected to have materially affected the market price of the securities of the corporation, the first mentioned person shall not deal directly or indirectly in those securities in Hong Kong if by so doing he gains an advantage, whether by making a profit or avoiding a loss, for himself or another person.

It is not without some interest that Clause 137(2) of the Securities. Bill, which corresponds to Section 140(3), did not refer at all to the need for any kind of knowledge of the informant's status on the part of the recipient of the information. The sub-clause merely referred to obtaining of such information 'from or through a person who has an association with the company', This was unsatisfactory for obvious reasons: there would be no justification in imposing liability upon an innocent recipient of information who has no idea that the information was being given in violation of an insider's duties to his corporation. Anti-insider trading provisions should be directed to the unfair utilisation of imbalances of information, and by this it is meant unfair in the sense that those seeking to profit by the informational advantage know or should know that the information was obtained because of some kind of privileged access or relationship to the issuer, or some thing or person[8] that can exert a substantial impact on the price of the issuer's securities.[9]

Another point worth remembering when examining tippee trading provisions is the difficulty that a tippee might have in evaluating the materiality of the information. Unlike the insider, the tippee will not be aware of the context in which the inside information is set, and the surrounding circumstances. For instance, there will be generally very little facility for the tippee to determine whether his informant has given him complete information, or for him to determine its accuracy. The test of materiality adopted by the Securities Ordinance is that of 'substantial market impact' on the securities of the particular issuer concerned. This particular test is not wholly without its faults when applied directly to insiders, and has been largely replaced in the United States by the test of whether the information would in the circumstances of the case be regarded as material by an ordinary reasonable investor. It will be remembered that the Companies Law Revision Committee in its Second Report[10] recommended that the test of materiality for insider trading should be cast in the alternative

[7] The term "tippee" is of course invariably applied to the persons to whom the insider passes inside information. In this context, the insider becomes a tipper.

[8] For instance, such as a large institutional investor which holds or contemplates acquiring a substantial shareholding in the issuer.

[9] Although it has on occasions been argued that anti-insider trading provisions should be directed to the complete equalisation of information on the securities markets, and thus perhaps all imbalances of information are to be condemned, it is doubtful whether this is a practical or desirable notion.

[10] Paragraphs 7.99 and 132.

formations of having a substantial market impact and also being such as to be considered material by a reasonable investor. It is unfortunate that this recommendation was not implemented. Certainly a tippee would be in a much better position to judge whether he as a reasonable investor would consider the information that he has been given is material enough to be relied upon and motivate his investment decision, and indeed his acting on the strength of the information will be some evidence of its materiality, than to determine whether it would be likely to have a substantial market impact.[11]

A tippee will also be in a difficult position to decide whether there has been a sufficient degree of disclosure such as to render the information 'publicly available'. In this respect he will be in a significantly worse position than his insider informant. Even if it is accepted that the corporation is the sole agency through which inside information can be released, for the purposes of liability under Section 140 it will not always be easy for a person who has no 'association' with the issuer to determine whether a sufficient release has been made. Indeed, it is not clear from the wording of the sub-section that the tippee must know or have reasonable grounds for believing that the information is publicly available. From the wording of Section 140(3) it would seem that provided the other conditions for liability are fulfilled, it is irrelevant whether the tippee knows that the information is publicly available or not.[12]

An anomalous feature of the tippee trading provision is that Section 140(3) only prohibits the tippee dealing on the basis of privileged information, in the securities of the issuer of which his insider informant is associated. This means that if an insider informs his friend that his company is about to make a favourable offer to acquire the securities of another company, to which the insider is not associated, the tippee is only prevented, under the terms of section 140(3), from dealing in the securities of the insider's own company, the offeror, and is completely at liberty to trade in the securities of the potential offeree company.[13] Of course, it is more likely that the tippee will be aware of the nature of the information and the consequential restrictions on its use, where the information relates to a particular company of which he knows or has reasonable grounds for believing that his informant is an insider.

To illustrate this last point, let it be supposed that a friend of Mr. A informs him that he would think that XYZ Corporation would be the object of a favourable public offer in the very near future.

[11] In a volatile market such as that in Hong Kong, it would be most difficult to predict with any degree of certainty that anything would have a substantial market impact. Of course, as the market impact contemplated will be a reflection of the individual investment decisions of a number of presumably reasonable investors, it could be argued that the substantial market impact test is merely the next stage of the reasonable investor test.

[12] In Clause 137(3) of the Securities Bill, it was provided that it was no defence to a charge under sub-clause (2) the equivalent of Section 140(3) of the Ordinance, that the information was obtained with the knowledge or consent of the person from or through whom it was obtained. This was omitted from the Ordinance apparently as it was self-evident.

[13] Mr. A.H. Smith; *Hong Kong's Securities Ordinance:* Law Lectures for Practitioners, *Hong Kong Law Journal,* 1974, page 49. Of course, it would be an offence under both subsections (1) and (2) for the insider to have disclosed this information, and the insider is barred from dealing in both cases.

Mr. A is aware that among his friend's numerous directorships he is associated with a large corporation in the same line of business as that of the much smaller XYZ Corporation. Whereas Mr. A would be aware that any information given to him by his friend relating directly to the large corporation might well be inside information, he would not, or would at least be less likely to realise, that any information given to him concerning the small XYZ Corporation by his friend, who he is sure is in no way associated with that company, is inside information. Thus, the distinction between the tippee being prohibited from dealing in such a case in the securities of the larger corporation and yet being at liberty to deal in the securities of the smaller issuer, might to some extent be justified on these grounds, especially in Hong Kong where as we have seen business connections are often very confused and there is no system of disclosure of insiders shareholdings. On the other hand, the present author cannot but help feeling that the distinction is more a matter of oversight on the part of the draftsman and the legislature, than anything more subtle.

It is understood, however, that the Commissioner's office considers that a number of these loose ends and uncertain perimeters to liability can be satisfactorily dealt with by administrative guidelines and interpretation, once the provisions come into force.[14] It is also of some interest that it is the view of the Assistant Commissioner, and also it is thought that of the Commissioner, that provided the necessary conditions are satisfied the liability imposed on tippees under Section 140(3) could be extended to at least first and second hand tippees, and possibly further. Certainly the wording of the provision would not seem to prevent such a liberal construction, as the offence is committed by any person who 'obtains' information 'from or through' a person he knows or has reason to believe is an insider. The phrase 'from or through' an insider clearly indicates that it is enough that the information initially came from an insider, and that it is not necessary that the tippee, to be liable under the terms of Section 140(3), actually receive the information from the insider personally.

The penalty imposed under Section 140(10) of the Ordinance for violating Section 140(3) is the same as that imposed for violations of the first two subsections, namely a fine of 50,000 Hong Kong dollars and imprisonment up to two years. Although the wording of Section 140(10) is not particularly clear, these are maximum penalties and could be used as alternatives. It is noticeable that all the anti-insider trading offences under Section 140 are punishable only upon indictment. This is an important consideration, as apart from underlining the seriousness of the offence, this means that the offence will not be tried summarily before a Magistrate's Court but before a superior court, which will more properly be able to deal with the relatively complex elements required to be established.

GUILTY INTENTION

The Companies Law Revision Committee in paragraph 7.131 of

[14] Furthermore, it is quite possible that the anti-insider trading provisions could be modified before they are implemented. This would seem to be implicit in the decision to wait and see what form the legislation takes in the United Kingdom.

its Second Report was anxious that, because of the inherent difficulties in drafting and because of the complex local conditions, to present unjustified convictions there should be a requirement of guilty intention in the offence of insider trading. However, as has already been seen, the three offences in Section 140 do not incorporate the specific requirement of intention. All that is required for a conviction is that an associated person has knowledge of specific information, which it would appear he does not have to realise is such; which has not been made publicly available; which it would seem he does not have to know, but that if it had been made publicly available that it might reasonably, that is objectively, be expected to materially affect the market price of the securities; and that he deals in the securities to his advantage, whether he intends to profit or not. Similarly, where the information relates to the securities or the operations of another company, the provisions make no mention of the insider having an intention to use the privileged information unfairly to his or another's advantage, merely that this is what happens. Where the associated person makes an unauthorised disclosure, this must be for 'the purpose of enabling that other person to use the information … and thereby gain an advantage'. Here the information should be given with that intention on the part of the insider, for that purpose. As far as tippee's dealings are concerned, although there is still no requirement that the dealings be with the intention to unfairly make a profit, by virtue of the use of the inside information, the tippee must be aware that the information comes from an insider, or at least have reasonable grounds for believing this. But then again, this provision does not specifically say that he should know that the information has not been made public, although in all offences this is the clear implication.

WHO IS AN INSIDER?

The offences are conditioned upon the fact that the information has come into a person's possession through his association with the issuer, or that it has come 'from or through' a person who is associated with the issuer. The concept of a person 'associated' with the issuer is thus at the heart of the offence. The 'associated person' is of course the insider. The degree of association required to render a person an insider for the purposes of the offence is defined in Section 140(9). A person will be associated with a particular issuer if he is a director or secretary, or a former director or secretary, of the company.[15] No indication is given however, as to how long the insider status endures, once a director or secretary resigns from the office. Whilst there have been cases holding that a director's fiduciary duties can endure after his resignation, they invariably involve circumstances where the resigning director resigned to facilitate a fraud upon the corporation. Certainly the duty not to utilise inside information that a director or secretary had access to whilst in office should extend for such period after the termination of that office as to deprive the information of its investment value. An officer who is or has been concerned in the management of the issuer is likewise subjected to insider's duties.[16] Again, the provision extends the prohibition on trading with inside information to those persons who are, and have

[15] Section 140(9) (a) i.
[16] Section 140(9) (a) ii.

been officers. It is submitted that the same test as with regard to former directors and secretaries should be adopted, and the obligation not to use the privileged information should endure to such time as the information loses its investment value, whether it be by the effluxion of time or public disclosure.

An employee of the issuer will also be an associated person, with insider responsibilities under the Securities Ordinance.[17] However, the use of the word 'employee' without any kind of qualification would seem to create an extremely wide ranging liability. It is understood that the Commissioner and the Assistant Commissioner would both be in favour of the word being given its full legal meaning, and thus extending the net over all those persons working other than as independent contractors for the corporation. Indeed, the Commissioner for Securities is reported as saying that 'to really clamp down on insider trading we would have to cover everyone from a company chairman to the office cleaner rummaging through a wastepaper basket for information.'[18]

The anti-insider trading provisions do not only cover directors, secretaries and officers past and present, and employees, of only the issuer about whose operations or securities the information relates; but also the directors, secretaries, and officers past and present, and employees of any corporation deemed under Section 4 of the Ordinance to be a 'related corporation'.[19] Section 4(1) of the Securities Ordinance provides that where a company is the holding company of another corporation, the subsidiary of another company, or is the subsidiary of the holding company of another corporation, the first mentioned company and that other corporation will, for the purposes of the Ordinance, be deemed to be related to each other. The term 'subsidiary' is expansively defined in subsection (2) of section 4; a company will be the subsidiary of another issuer, where that other company controls the composition of the board, controls more than half the voting power, or holds more than half of the issued share capital.[20] Furthermore, a company that is a subsidiary of one company that is itself a subsidiary of some other issuer will be a subsidiary of the ultimate holding company. The power to control the composition of a subsidiary company's board of directors means merely that the other issuer can appoint or dismiss a majority of the subsidiary's directors, without the consent or concurrence of any other person.[21] Whether these provisions can operate to any effect, given the situation in the Colony, is open to some doubt.

17 Section 140(9) (a) iii.

18 *South China Morning Post,* 17th January 1975. The provisions would however seem only to extend to present and not former employees, unless such had been officers or directors of the issuer.

19 Section 140(9) (a).

20 Section 4(4) provides *inter alia* that in determining whether one corporation is the subsidiary of another, any securities held in a fiduciary capacity shall be disregarded. However, any securities held by a nominee of the corporation, or one of its subsidiaries (except where such are held in a fiduciary capacity) are to be counted. Securities held or powers exercisable pursuant to a debenture deed of security for a loan entered into in the ordinary course of business of the corporation or its subsidiaries are to be disregarded.

21 Section 4(3). Another corporation will be deemed to have this power if a person cannot be appointed as a director without the exercise in his favour by that corporation of this power of appointment, or a person's appointment as a director follows necessarily from his being a director or other officer of that corporation.

A person is also an insider under Section 140(9) if he acts or has acted[22] in the capacity of banker, solicitor, auditor, consultant or professional adviser, or indeed any other capacity, whether similar to any of the foregoing capacities or not, for or to the corporation.[23] This provision is wide, and would embrace most of those 'outsiders' who because of their professional services to the corporation are in a position to acquire privileged information. The phrase 'or in any other capacity' remains largely uncertain in its scope and application; it would certainly seem to include many independent contractors rendering both professional and other services to the corporation and outside the employee provision. It is respectfully submitted that, in accordance with the recommendations of the Companies Law Revision Committee, the provisions defining insiders should be cast as wide as possible and this particular phrase should be liberally construed. The appropriate degree of justice can be assured by the proper exercise of the discretion to prosecute or not.

It is unfortunate that the definition of 'insider' does not extend to bankers, solicitors, auditors, consultants and other such persons in related corporations, as is the case with directors, officers and employees. The failure to extend the regulatory scheme to such persons could result in serious anomalies. For instance, if a very junior employee, perhaps even an office cleaner, of X corporation, which may be a subsidiary of Y corporation, is to be regarded as an insider of not only X company but also Y corporation, by virtue of Section 140(9) (a), one can see little logic in providing that a banker, solicitor, auditor or professional adviser, or indeed any other person acting for X corporation who is not a director, secretary, officer or employee of such, is an insider only of X corporation and not of Y corporation. This omission in Section 140(9)b is all the more surprising when one considers that it is these very persons who are much more likely to have inside information on X corporation and its dealings with related companies than most of the directors, and certainly most of the employees. Given the fact that in Hong Kong most directorships are completely non-executive appointments, and the running of commercial companies is largely in the hands of managers and a few executives, the deficiency in the regulatory pattern is obvious and serious. The company banker and auditor, not to mention the company solicitor, are likely to be better informed of the company's relative position in a group structure than the board, and would by virtue of their training and expertise be in a much better position to evaluate and probably use inside information about other related companies.[24]

The professional advisers of one company would of course be liable if they received inside information as tippees, through a person who was associated with the other related company. Indeed, it might

[22] The same considerations would seem to apply here with regard to how long the duty should endure after the termination of the office or position, as with directors and officers.

[23] Section 140(9) (b).

[24] Although it is quite true that in Hong Kong there is a very high proportion of professional persons occuping places on boards of directors, and thus to this extent they might be inhibited from dealing in the securities of related companies on the basis of inside information, this hardly compensates for the present gap in the regulation of this type of abuse.

be possible to regard a professional adviser of a company, which itself is an insider of another company, as a tippee of information when he receives 'through' the company with which he is associated. It would seem clear that the information need not be given to the tippee to render him liable, it is enough that he takes it from an insider.[25] Of course, it would be necessary to establish that the corporation with whom the tippee was associated was an insider of the other corporation. This it is submitted could be shown where the issuer acts as a director or professional adviser, or even possibly an independent contractor, of the other company about whose operations or securities the information relates.[26] Certainly, where the conditions in Section 140(9) (c) relating to insider status through shareownership are met the owner of the requisite number of securities would 'be associated' with the issuer concerned.[27]

Section 140(9) (e) extends the scope of paragraph (b) by providing that the employee of a person who is or has been a banker, solicitor, auditor consultant or other professional adviser to the corporation, or the employee of any other person who acts or has acted for the corporation in any capacity, is an associated person for the purposes of Section 140. This is a wide provision that would probably, in view of what has already been said, extend to all employees no matter how minor their position. As we have already indicated, insider status can be acquired through ownership of a substantial shareholding. Section 140(9) (c) provides that a person can also be associated with an issuer if he has a beneficial interest in any shares in the corporation and the aggregate of the nominal amounts of those shares is not less than one-tenth of the aggregate of the nominal amounts of all the issued shares of the corporation.

[25] Support for this proposition, if any is needed, is found in the Securities Bill, Clause 137(3), which has already been referred to at note 58 to Part I of this article. There it was expressly said that it is no defence to a charge against a tippee, that the tipper gave the information with knowledge or consent. This was omitted as superfluous; thus *ex hypothesi* there would be no defence if the insider did not consent or know of the obtaining of the information.
[26] For support of this proposition see Section 140(9) (d). This section provides that where the person who has such an association with a corporation as is referred to in Section 140(9), paragraphs (b) or (c), is itself a corporation, any director, manager or secretary, but not agents or professional persons, of that corporation are associated with the first mentioned company, as well as of course their own company. Section 147 of the Ordinance provides that where an offence is proved to have been committed by a corporation with the connivance, or due to the neglect of its directors or officers, but not professional advisers, such can be charged and punished with the corporation
[27] There is nothing to prevent one company being the insider of another, and with the degree of cross-holdings in the Colony this is likely to be a common occurrence. Section 48 of the Hong Kong Companies Ordinance prohibits issuers giving financial assistance for the purchase of their own shares, subject to three narrowly defined exceptions. There would appear to be a high degree of evasion of this provision, as there probably is in Britain with regard to the analagous provision in Section 54 of the 1948 Companies Act. Until the recent amendments there was no provision prohibiting subsidiary companies holding securities in their holding companies, and the Companies Law Revision Committee (Second Report 1973 at paragraph 7.134), concerned about the abuses that had been facilitated by this gap in the law, recommended the enactment of a prohibition, similar to that in Section 27 of the British Act of 1948. We have already referred to the new disclosure requirements that compel the disclosure of certain corporate shareholdings and cross holdings in the accounts: *supra,* at note 29.

The definitions of associated persons are both wide and complex, and whilst the approach of the Companies Law Revision Committee and the Legislature in 'casting the net' so widely is to be welcomed, it would be optimistic to consider that they will not bring a considerable degree of confusion, should they ever be implemented. The provisions must be considered in the context of the local environment, where as we have seen there is a most involved and complicated corporate community, where multiple directorships and the use of nominees abound. Given this, it is interesting to consider the definition of 'insiders' in the Ordinance in the light of the Financial Secretary's statement to the Legislative Council on the 12th December 1973:

> I am only too well aware that the emotive phrase 'insider trading' is fraught with difficulty as regards adequate definition. In principle I am sure Honourable Members will welcome the proposed restrictions, but it must be accepted that there is considerable difficulty in compiling an exact definition of what it includes and in suggesting means of averting it. A representative of the American Securities Exchange Commission once remarked, 'we don't know how to define an insider, but we sure know one when we see him'. It has always been easier to recognise insider trading than to define it. Thus there is a danger that in attempting to deal with the problem, the definition will be cast so wide as to hamper legitimate activities without preventing the objectionable abuse. This I am most anxious to avoid.

With the greatest of respect one wonders whether the present legislation does just what the Financial Secretary did not want it to do.

The Question of Enforcement and the Securities Commission

We have already examined, albeit briefly, the recommendations of the Companies Law Revision Committee on the question of whether it was necessary to establish a new regulatory agency in the Colony to administer the Securities Ordinance and generally supervise and 'police' the securities industry. We will now look at the provisions contained in the Ordinance relevant to these matters.[28]

Under section 6 of the Ordinance the Governor may appoint a Commissioner for Securities, who by virtue of Section 7 shall carry out the directions of the Securities Commission in relation to the exercise of its functions and shall have and may perform such other powers, duties and functions as are conferred upon him under the present or any other Ordinance. The Securities Commission is created by Section 9 of the Ordinance, as a body corporate with perpetual succession. It consists of seven members.[29] The Commission has a number of functions, some of the more important being laid down in Section 13. These include, to advise the Financial Secretary on matters relating to securities; to ensure that the relevant laws relating to securities are observed and upheld; to supervise the activities of the Federation of Stock Exchanges; to promote and maintain integrity in the securities industry and ensure that informed and balanced advice and information is given to the client and to the public; and to suggest reforms in the securities laws. Perhaps the most important

[28] Securities Ordinance 1974, Part II.

[29] Section 10 provides that one shall be the Commissioner, another shall be the Registrar of Companies, the remaining five being appointed by the Governor for a renewable period of two years. Section 10(2) provides that at least one of these five persons must be a person qualified in law.

function, from our present point of view, is 'to suppress illegal, dishonourable, and improper practices in relation to dealings in securities whether on stock exchanges or otherwise'. This would certainly include insider trading.[30]

Apart from supervising and encouraging a proper standard of conduct among members of the Federation of Stock Exchanges, the Commission is given the power, under Section 14, to make rules and regulations, after due consultation, on a number of important matters pertaining to the running and business of the exchanges. Of particular interest from the point of view of the regulation of insider trading and manipulation are the Commission's powers to prescribe rules with regard to —

(b) the conditions subject to which and the circumstances in which any stock exchanges may suspend dealings in securities;

(f) the amount of information to be given, and when to be given by listed companies;

(g) anything which is or may be prescribed by rules.[31]

These particular provisions are very wide and could provide a most useful supplement to the legislative prohibitions on fraud and insider abuse in the Ordinance. Furthermore, the Federation itself has the power to make rules and regulations on these and other matters, subject to the approval of the Commission, and provided that such are not inconsistent with those of the Commission.

By virtue of Section 15 the Securities Commission is given such powers as may be necessary to enable it to carry out its functions, and in particular it can refer complaints relating to the activities of stock exchanges to the Disciplinary Committee,[32] and if it thinks necessary conduct a preliminary investigation; and it can acquire and dispose of property and authorise mutual funds and unit trusts under the law, subject to such conditions that it considers fair and reasonable. These conditions might well include additional disclosure requirements. It is understood that the Commission will carry out a considerable amount of its more detailed work through the medium of a number of committees, which it is empowered to constitute under Section 16 of the Ordinance.[33]

The Financial Secretary can give mandatory directions either specifically or generally, and he can also require statements of policy,

[30] Section 13(f).
[31] Section 14.
[32] The Securities Commission Disciplinary Committee is appointed by the Commission, and consists of five persons, three of whom are members of the Commission itself, the unofficial lawyer member being the Chairman. The two non-Commission members are appointed by the Federation. The Committee has extensive powers over stock exchanges and their committees including the power to fine. Mr. A.H. Smith, *op. cit.*, p. 33.
[33] By Section 16(2) the Commission can delegate any of its powers, functions and duties, other than the power to make rules under Section 14, or delegate, to any Committee, whether standing or special, set up by the Commission under subsection 1. The Commission can appoint any person who appears to be qualified to these committees. Naturally the Commission retains powers, to dismiss and direct.

on certain aspects of their administration, from the Commission.[34] It is thus important that, especially in controversial areas such as insider trading, there should be a genuine desire on the part of both the Government and the Securities Commission that effective action should be taken. Unfortunately, with the delay in implementation of the anti-insider trading provisions, this desire would appear to be not particularly strong. It is perhaps regrettable that a Minister who has much broader interests and responsibilities than the regulation of the securities industry should be possessed of so much authority over the Commission.[35] Indeed, this problem is even more pronounced in the Colony, because so many of the reasons for Hong Kong's importance as a financial and commercial centre have resulted because a relaxed approach to regulation has generally been accepted by the Government as in the Colony's overall interests.

Of course the Financial Secretary has always possessed considerable powers over the regulation of corporations in the Colony, under the various Companies Ordinances. Furthermore, as a general rule the Minister's powers have been exercised in an unobjectionable manner. For instance, the Financial Secretary last year sought the advice and cooperation of the Commissioner's Office in the appointment of an official inspector, under his powers contained in the Companies Ordinance' to investigate the affairs of several companies.[36]

As the Companies Law Revision Committee[37] pointed out, 'the mere making of insider trading an offence will be of little value unless there is some means of obtaining evidence that an offence has been committed.' To this end the Commission has been given special investigatory powers, in addition to the usual powers of appointing inspectors under the Companies Ordinance, in conjunction with the Financial Secretary. Under Section 127 of the Ordinance the Commission, where it appears to them that it is desirable for the protection of the public or of holders of securities, or it is in the public interest because fraud or misfeasance or other misconduct by a person who has dealt in securities or given investment advice is alleged, can appoint an inspector, by instrument in writing, to investigate and report on any such matters as are stated in the instrument of appointment.[38] The inspectors, who are seemingly not required to have any particular qualifications, have the usual powers of obtaining evidence and receiving testimony on oath.

[34] Section 17. This means that the Government can at any time step in and take over a specific case or investigation, or de-limit the Commission's authority by requiring the issue of a policy statement on a given matter Although this degree of power and the discretion that the Colonial Government exercises over the Commission's budget might appear undesirable, it is difficult to see what alternative mechanism could be adopted to ensure a responsible administration, in a democracy.

[35] It is not always possible that the roles of policeman and that of promoting an industry's commercial and business interests can be satisfactorily reposed in one individual, or indeed a single organisation. The American Securities Exchange Commission and the British Department of Trade have both been criticised on this ground.

[36] The Commissioner for Securities ensured the suspension of dealings in the companies until the completion of the investigation.

[37] Second Report 1973 at paragraph 7.136.

[38] The Assistant Commissioner considers that facts that would amount to a violation of the insider trading provisions, if such had been implemented, would in his view be sufficient to justify an inspection.

Under Section 128 there are provisions enabling the inspector to have notes of the examination made, and in certain cases such can constitute evidence. It is provided that the notes of the inspection can be made available to a person who satisfies the Commission that he is acting in good faith and requires the notes in furtherance of actual or contemplated litigation, concerning the matters referred to in the notes. This could provide a most useful source of evidence for persons wishing to bring a civil action against the insider. Much criticism has been levied at the inspection provisions,[39] and in particular this section which allows a private litigant to obtain possession and use for his own benefit the inspector's notes.[40] Certainly it is true that the provisions allow only a very limited right to legal representation on the part of the person being questioned by the inspector. Under Section 127(7) legal representation is allowed only to such extent as the inspector in his discretion permits. There is only a right to reply on matters expressly brought up by the inspector, which naturally restricts the opportunity of the person under examination to bring to view other considerations which might be relevant, although not necessarily connected with the matters raised by the inspector. Although the traditional privilege against self-incrimination is over-ridden, any evidence adduced in the inspection that would have been covered by such a privilege cannot be used in subsequent criminal prosecutions against that person. However, it would seem that there is nothing to prevent such evidence being used in subsequent civil cases.[41]

In Section 133 there are also provisions making it an offence to conceal evidence or mutilate such evidence, subject to the inspector's investigation. Furthermore, under Section 129 an inspector may by an instrument in writing delegate all or any of his powers and functions, revocably. This procedure, provided it is used with flexibility, can provide a most effective means of obtaining evidence. Although in the first instance the costs of the inspection are borne by the Commission there is a provision in Section 132 for the courts to provide that all or some of the expenses be reimbursed by persons convicted or being proceeded against by virtue of the report and evidence obtained by the investigation. Such an order could itself be a serious penalty, in view of the cost that some inspections involve. It is provided that if no proceedings are instituted against the person for whom the inspection was prescribed within a period of six months, he is entitled to reimbursement of his expenses, provided that the Court considers that the investigation was unwarranted, which would of course be an extreme finding for a court to make.

Another important enforcement mechanism is found in Section 134. This section empowers the Commission, where it appears to

[39] See, for instance, Mr. A.H. Smith, *op. cit*.

[40] Mr. Smith (*op. cit*., p. 34) writes that Section 128(5) allows 'fishing expeditions to see the strength of the case… at the public's expense, under oath where a person is compelled to answer the results of which are given to potential litigants'.

[41] On completion of the investigation under Section 127 the inspector must file a full report with the Commission and the Attorney-General (Section 130). The report can be furnished to persons concerned with the subject matter of the inspection, and can even be published. If an offence is disclosed, Section 130 requires the Attorney-General to take the appropriate action.

them that the facts concerning securities to which the investigation relates cannot be ascertained because a prescribed person has failed or refused to comply with the inspector's requirements, to make a number of specified orders.[42] Including an order restraining a person from disposing of or acquiring specified securities. Under Section 144, where on the application of the Commissioner it appears to the court that a person has contravened the Ordinance, or is about to do an act with respect to dealings in securities that would if done be a violation of the provisions of the Ordinance, it can without prejudice to its usual powers make certain special orders, if it is reasonably satisfied that the order would not unfairly prejudice anyone. These orders include one restraining a person dealing in securities or declaring a securities contract void or voidable; or an order directing a person to do or refrain from doing a specified act for the purpose of securing complience with any other order under the section; and in the case of a registered dealer a person can be appointed to administer his property. Further, any ancillary order which the court considers necessary can be issued. These are most useful provisions and would greatly facilitate inspection or investigation in securities fraud cases, where the conditions and circumstances are likely to change quickly.[43]

The Commissioner and his officers also have extensive powers of inspection with regard to the books and records of registered dealers and investment advisers in the Colony, under Sections 122 and 123. Of particular interest from the point of view of insider trading regulation is Section 123, under which the Commissioner may require registered or exempted dealers, authorised trustee companies and any 'person whom the Commissioner reasonably believes to have bought or sold securities as trustee or nominee for another person', to disclose to him, in relation to any purchase or sale of those securities, the name of the person from or to or through whom, or on whose behalf the securities were bought and sold and the nature of the instructions given to that person in respect of the particular transaction. Moreover, it is provided that for any failure to comply with Section 123 there will on conviction be a penalty of a fine of up to 5,000 Hong Kong dollars and imprisonment for a period up to three months. This section is obviously most important in the light of what has already been said on the prevalence of nominee trading in Hong Kong. It is unfortunate that the practical importance of this provision was not reinforced with stricter penalties, however.

Moreover, under Section 124 where the Commissioner has reason to suspect that any person has contravened a provision of the Ordinance or has been guilty of fraud or of an offence against any other law with respect to trading or dealing in securities, he may make such investigations as he thinks expedient for the due administration of the Ordinance. This is a very wide provision, and provides a useful hub for the Commissioner's investigatory jurisdiction. The Commissioner's general authority and powers are further reinforced by a provision which renders any person who obstructs the Commissioner

[42] A copy of the order is to be given to the issuer, Section 134(2). A person aggrieved by such an order can appeal to the court, whereby the court can alter, revoke or affirm it. Anyone who contravenes an order under Section 134 is liable to a fine of HK$5,000.

[43] This can be a most effective means for forcing insiders, who are hiding behind nominees, out into the open.

or any other public officer, or indeed anyone exercising or performing any power or duty under the Ordinance, or who fails to produce any required document to the Commissioner or a duly authorised person, liable to a fine of 5,000 dollars and three months imprisonment. It is also relevant to mention Section 125 whereby, if a magistrate is satisfied by an information on oath that there are reasonable grounds for suspecting a person is in possession of any document or article which relates *inter alia* to improper securities trading, insider trading, manipulation, etc. at premises specified in the information, he can issue a warrant empowering the Commissioner or a police officer to enter, using necessary force, the premises, at any time within one month of the warrant's issue, and to search, seize and remove any document or article the Commissioner or police officer has reasonable grounds for believing may be evidence of the alleged offence. The evidence so obtained may be kept until a period of six months has elapsed or, where proceedings are in fact commenced within that period, until the culmination of such.[44]

Whilst these provisions, and those powers already possessed by the authorities under other Ordinances (in particular the Companies Ordinances) present a powerful array of anti-fraud weapons, it is of some interest to note that the view has been expressed that 'the powers and machinery at the disposal of the Securities Commissioner are inadequate'.[45] This sentiment probably reflects the vast difference in the theoretical powers provided in the Ordinance and the very real, practical problems that would have to be faced by a Commissioner seeking to utilise such. It is most important to realise that at present the Hong Kong Commission's staff is exceedingly small, numbering in all only some twenty-five employees.[46] Furthermore, most of these employees are clerical officers and clerical assistants, who whilst performing an extremely valuable service are concerned almost wholly with routine matters. The more senior officers are more experienced; and indeed, the present author has been impressed by the ability and knowledge that these officers possess, when compared with their opposite numbers in much larger and wealthier securities commissions in other countries.[47]

Of course, the Commissioner is not the only enforcement agency concerned with the detection of securities frauds in the Colony, and the importance of the Royal Hong Kong Police Force should not be

[44] Section 125(2). There are also provisions directed at the destruction of materials seized and their status as property in the hands of the police or Commissioner: see Section 125(5) and (6).

[45] Phillip Bowring, *Financial Times (London),* 11th December 1974. The problems involved with adequate enforcement of the securities provisions were shown in the failure of a very large number of dealers to register, as required by the Securities Ordinance. Indeed, the registration period had to be extended: *South China Morning Post,* 17th January 1975.

[46] This figure was obtained in December 1974, although it is understood that the Commission's staffing has remained more or less static. Of course, the size of the staff employed is only one factor and in certain instances, where for example there is automated market surveillance or an effective degree of self-regulation, very few officials can cope adequately. For instance, only three junior officers run the whole insider disclosure mechanism in the Ontario Securities Commission, and only one Exchange official the market surveillance system in the Toronto Stock Exchange.

[47] The annual budget for the Commission and the staff of the Commissioner's. Office is only in the region of about 1 million Hong Kong dollars.

underestimated. Officers from the Force's Commercial Crimes Office[48] carry out a high proportion of the general investigatory work, and work in close cooperation with the Commissioner and his officers. Indeed, it has been suggested that it would be beneficial for both the police and the Commission if police officers in the Commercial Crimes Office could serve some time on secondment with the Commissioner's Office. In this way the Securities Commission would have the benefit of experienced investigators, and at the same time the Police Force would have the benefit that a small number of its officers received training in securities law and practice.[49]

Before we examine the statutory civil action for insider trading, it is perhaps of some relevance to briefly mention the approach of the Commissioner and his office to the role of the Securities Commission in Hong Kong. It has been evident that from the onset both the Commissioner and his senior officers have been in favour of a conciliatory approach, and have consistently tried to play down their regulatory function and wide administrative powers. This has obviously been the wisest and most expedient course of action, and by this approach, and the high degree of consultation that the Commissioner and his staff have facilitated, the Hong Kong Securities Commission has been able to make a great impact on the securities industry. The local financial community, both Chinese and European elements, would have resented a high-handed approach, and hardly have provided the degree of cooperation that has in fact given to the administrators. The Commissioner has always been at pains to point out that his office was never intended to be, and is not, a Securities Exchange Commission on the American pattern. The main aim throughout has been to educate the local securities industry, with a strong emphasis upon the fact that the new regulations are in the long term for the benefit of both the Colony as a whole and the industry itself. In this way the Commissioner's Office has invariably adopted a lenient view of the regulatory provisions and has not been so concerned, where the spirit of the law has been obeyed, to insist on the strict observance of all the technical and, in some cases artificial rules.

This is not to say that the Commission has been at all lax in its administration of the Ordinance. Indeed, the Assistant Commissioner is of the view that the conciliatory approach currently adopted will be tightened up with the passing of time, once there is no doubt that the requirements of the law are both known and appreciated. Furthermore, he also considers that the present approach could not have succeeded in the way that it evidently has without a strong statutory framework, and powers such as are contained in the 1974 Ordinance. The fact that the Commissioner's considerable powers are always available must inevitably make the local industry more conscious of its position, and argue in favour of a degree of caution and restraint

[48] The police officers in this particular office do not as such have any special training or expertise. This is indeed a strange aspect of British and Commonwealth Fraud Squads, which invariably neither receive nor in fact seem to require specialised training, other than in the most elementary financial matters.

[49] There are also other officials concerned with the conduct of corporations and persons engaged in the securities industry in the Colony.

that was sadly missing before the stock market collapse.[50] Another factor that has no doubt played a major role in the viability of the relaxed approach that has been adopted is the personal experience and reputation of the first Commissioner, who had previously occupied a senior position in the Bank of England, and the fact that some of the most senior officers in his office had considerable financial experience under the Colonial Government, prior to the creation of the Commission. These officials have managed to create many highly useful personal contacts with leading persons in the securities industry, and upon these relationships a sound basis of mutual respect and cooperation has been fostered. Indeed, one of the present problems, yet to be faced, is what might happen if new officials arrive on the scene and attempt to enforce the strict letter of the law without the benefit of conciliation on either their own or the industry's part.[51] It is to be hoped that before such a day arrives the Commission's educative approach will have gone a considerable way to smoothing out some of the more controversial problems.

CIVIL LIABILITY FOR INSIDER TRADING

The Securities Ordinance adopts the recommendations of the Companies Law Revision Committee by providing that a person who has dealt with an insider and been damaged by the insider's use of privileged information is entitled to seek compensation from the insider, and that the corporation should in certain circumstances be allowed to recover the insider's profit. Whilst the threat of criminal prosecution is an obvious deterrent, the fines imposed under the criminal anti-insider trading provisions are relatively small. In view of the fact that imprisonment is very rarely used in cases of so-called 'white collar crime', the insider might feel that the expected profits that he could make by indulging in insider trading are so far in excess of the maximum fine that he could be required to pay, that it is well worth his while to take the risk — which is quite a remote risk provided nominees are used — of his abuse being detected and enough evidence being found to prosecute him. Compared with some of the profits that have been made by insider trading, the maximum fine under Section 140(10) of the Ordinance, of 50,000 Hong Kong dollars, would hardly act as a deterrent. Thus, the importance of providing a civil right of recovery against the insider is that it makes the abuse substantially more unattractive, as the insider could in fact emerge with not only a criminal conviction and a fine, perhaps even serving

[50] Although the Commissioner possesses considerable powers to refuse and revoke dealers' registrations under Part VI of the Ordinance (especially under Section 53) it has been made clear that the resort to these provisions would be unlikely in the absence of fraud or bankruptcy: *South China Morning Post,* 17th January 1975.

[51] This is a serious problem and one that should not be underestimated. Apart from the local conditions causing considerable enforcement problems and rendering many provisions at least in the present and immediately foreseeable future of largely academic interest, it is obvious that the present resources of the Commission could not adequately extend to a strict regulatory approach with regard to the whole Ordinance. A fully effective enforcement of the law in this field would require a disproportionate expenditure that no Government would be likely to sanction. This problem is not restricted to Hong Kong; the American Securities Exchange Commission admits that the insiders that they can catch are the mere 'tip of the iceberg', and then in such cases because of a shortage of resources the Commission will be satisfied with a mere 'consent injunction'.

a period of imprisonment, but also having lost all that he gained from his abusive transactions, in the first place.

The civil action is provided for in Section 140(4). The subsection states that where there has been a contravention of the provisions in Section 140(1), (2) or (3), and an advantage referred to in any of those subsections is gained from a dealing in securities to which the contravention relates, a person who gained the advantage shall, whether or not a person has been prosecuted for or convicted in respect of the contravention —

> (a) be liable to any other person for the amount of any loss incurred by that other person by reason of the gaining of the advantage, and
>
> (b) be liable to the corporation which issued those securities for any profit accrued to the first-mentioned person as a result of the gaining of the advantage.

INDIVIDUAL INVESTOR'S RIGHT TO RECOVER COMPENSATION

The provision of civil remedies to investors in the case of insider trading is as we have already seen controversial. In the case of market transactions the innocent party to the transaction was a willing seller or purchaser at the price the transaction was effected, and if in fact he had not dealt with the insider at that particular price, he would have dealt with someone else. Furthermore, as we have noted, there is the problem of establishing privity in market transactions or, where such is dispensed with, determining who can legitimately recover. In all cases recovery is very much of a windfall. With regard to Section 140(4) (a) it is not made clear whether privity is required. It would seem from the wording of the section that a showing of privity between the person seeking recovery and the insider trading on the basis of inside information is not required. There is certainly no mention of a privity requirement in the definition of the offence of insider and tippee trading, and as this is made the basis of the civil action it would seem that none is required there either. Furthermore, it is interesting that there is no mention of the knowledge of the other party to the transaction. If the insider was trading with another person who should or indeed was aware of the information, although it had not been made 'publicly available', it would seem anomalous to afford that person a remedy. Of course, if the 'innocent' party was in possession of the same information as the insider it would be strange that he should come to a directly contradictory investment decision to the trading insider. It is submitted that there should be no recovery in such a case, although from the wording of the provision it would seem hard to find a plausible basis upon which recovery could be refused.[52] It might be possible to consider that

[52] From the prophylactic point of there may well be very good reasons for still holding an insider who has traded on the basis of inside information criminally liable, and indeed civilly liable. This is of course a policy decision, and as such can discount the normal objections to a person having access to the same kind of information as the insider being allowed to recover, in effect for his own negligence. Indeed, the so-called 'innocent insider' could in such a case be as morally blameworthy as the insider obtaining the advantage, as he has traded whilst in possession of inside information, and has compounded his wrong by incompetence. Recovery would act as insurance of his own negligence.

the information was not sufficiently material, if a person in possession of it completely discounted it or interpreted it in a paradoxical manner; but this would of course affect the position of other 'innocent traders' on the market who may not have been in a privileged position and would seem to have a viable cause of action against the insider.

Provided that the courts accept the wording of the section at its face value and do not seek to imply a privity requirement, the problem arises as to how the liability of the defendant insider is to be properly delimited. This problem has not been finally resolved in the United States yet, although there it would seem that any person who traded in the relevant securities between the time that the insider dealt and the information became publicly available[53] can recover. Thus by adopting the requirement that the plaintiff need only show that he could have dealt with the defendant, or that he was in the same position as one who could have dealt with the defendant instead of requiring that only those who could establish that they were in fact in privity with the defendants,[54] the possible liability of the defendant insider is enormously increased.[55]

A serious problem with regard to both the criminal and civil liability provisions is that of identification. Even if it is accepted that it is not necessary to establish an element of contractual privity in civil cases, before any question of liability arises it must be possible to identify insiders trading in the market. If it is not possible to see that insiders are in fact engaging in transactions in securities, the liability provisions are irrelevant, as the other parties to the transaction, or for that matter anyone else, including the authorities, will not be aware that there is even the basis for a case. The difficulties of identifying insider transactions are aggravated by the widespread use of nominee names and aliases. Furthermore, the absence of any mechanism requiring the disclosure of directors' and officers' shareholdings and transactions makes the problem of identification that much more difficult. Where the abuse of inside information is by the tippee or for instance an employee of an associated person, the possibility of identification merges with the impossible. Thus in the vast majority of cases there is more than a probability that the innocent party to an insider or tippee transaction would be totally unaware that he has been the object of a fraudulent transaction; and even if he suspected he had, he might in practice find great difficulty in being able to match himself with anything more than a nominee

[53] The Securities Ordinance does not require in either the criminal or civil offence that the insider forbears from trading until the information that is publicly available has had time to be digested by the public. Of course, Hong Kong is a relatively close knit financial community and information would tend to travel very rapidly through the markets, and there is not the geographical problem with regard to communication that obtains for example in Canada or Australia or even Japan. Nevertheless it is submitted that there should be a requirement that the duty to abstain from trading continues until the information has had a reasonable time to be digested by its recipients.

[54] As we have seen, the problems of tracing nominees and the fact that dealers often trade on their own account would combine to render it exceedingly difficult to ever establish privity.

[55] As we shall see later on, the measure of damages is the difference between the price of the security at the time of the transaction and the price that it would have been had the information been generally available. This is the tortious 'out-of-pocket' measure of damages.

or numbered bank account. It must also be remembered that a private litigant does not have the means available to him for inspecting dealers' transaction books and records, so as to enable a viable trace to be conducted. Absent, obtaining notes of inspection under Section 128(5), he only has the discovery process available to him, and this would probably not be able to cope with the type of investigation needed. In addition, it must be remembered the litigant claiming discovery, at this juncture, when he initiates the trace is far from sure he will catch an insider.[56] Of course, if there has been an inspection or investigation by the Commission, leading to prosecution (even perhaps an unsuccessful one) the innocent party to an insider transaction might well be able to rely upon the evidence presented there.[57] However, the civil action is completely independent and in no way conditioned upon a prosecution, let alone a conviction.

THE COMMISSIONER'S ACTION ON BEHALF OF THE INVESTOR AND ISSUER

No doubt due to the difficulties facing a private litigant, where there has been no prior administrative or criminal action Section 140(7) provides that the Commissioner may, if he considers it to be in the public interest to do so, bring an action in the name of and for the benefits of the corporation or other person for recovery of a loss or profit referred to in subsection (4). It is to be hoped that when the provisions are implemented the Commissioner will make a genuine attempt to utilise these powers for the protection of investors,[58] especially when one considers the powers he has been given to obtain the necessary evidence. Of course the corporation, in seeking to enforce any remedy that it might have under the Ordinance, will be in a better position then an individual investor. The issuer will have much easier access to the relevant evidence; indeed most of it is already in its possession. Furthermore, a corporation will generally be in a better financial position to pursue an insider than a private individual. The main reason for the Commission's powers with regard to the corporate right of recovery would seem to be that in some cases where the insiders are in effective control of the issuer they may be able to successfully prevent the bringing of an action in the name of the company. The position in the Colony with regard to the right of minority shareholders to assert corporate rights through a derivative action is restricted by the rule in *Foss* v. *Harbottle*;[59] and although it might well be that a refusal to pursue a viable corporate action in such a case may come under the fraud on the minority exception to that rule, the Commissioner's power to bring

[56] Perhaps he could obtain the assistance of the Federation or a specific exchange but this is unlikely in view of the Commission's powers and the reluctance of the exchanges to become involved with private litigation.

[57] See paragraph 7.137 of the Second Report on Company Law, 1973. See also Sections 128 and 130, which deal with the inspector's notes and reports. However, under Section 122, which deals with the Commissioner's powers to call for production of registered dealers' and advisors' books and records, subsections (3) and (4) make it a punishable offence for the Commissioner to disclose to any other person the information he acquires during an investigation under this section, except in the course of criminal proceedings.

[58] Whether the Commissioner could proceed in such an action on behalf of an individual investor, and also the company, is an open question. From the wording of the section there would appear to be nothing to prevent this.

[59] 1843, 2 Hare 461.

an action, circumventing the rule in *Foss* v. *Harbottle,* will be most helpful. In passing, it might be pointed out that Mr. Smith writing, in 'Law Lectures for Practitioners 1974', refers to the fact that no provision is made in the Ordinance as to who bears the costs of the action if the Commissioner loses his case. However, with the greatest respect, this would hardly seem to be a problem as the Commissioner's Office is provided with its funds by the Government and can thus have costs awarded against them as in any other litigation.[60]

The problems inherent in private litigation may also be avoided under another provision in the Ordinance, namely Section 130(8). This subsection provides that if it appears from an inspector's report to the Commission or the Attorney General that proceedings ought in the public interest to be brought by a prescribed person[61] for the recovery of damages in respect of fraud, misfeasance or other misconduct in connection with the affairs of the prescribed person, or for the recovery of property of that person, either the Commission or the Attorney General may cause proceedings to be instituted in the name and on the behalf of the prescribed person.

THE ISSUER'S RIGHT TO RECOVER THE INSIDER'S PROFITS

The Companies Law Revision Committee did not make any specific legislative proposals on the right of the corporation to recover the insider's illicit profit. The possibility of liability in the Colony for insider trading under the common law is the same as that in the United Kingdom and all common law jurisdictions, with the exception of the United States — where the Courts have since the turn of the century taken a much bolder position. Whilst it has generally been considered that corporate insiders owe no fiduciary duties to the members of the corporation individually, or indeed in some cases to anyone, and certainly none to those persons who were not members before the relevant transaction, it has been advocated that in certain instances the corporation itself may be able to call its insiders to account for the profit that they have made because of their corporate position. This principle would be an illustration of the fundamental rule prohibiting insiders placing themselves in a position where their interest and duty conflict. It would seem that the corporate action calling such insiders to account for the secret profit could be prevented or defeated where the shareholders after full disclosure approved the transactions and renounced the corporation's claim to the resultant profit. Where, as is often the case, the insiders can control the corporation, either directly or through control of the publicity and proxy machinery, the right of corporate recovery would be meaningless. It would seem however, where the inside information can be regarded as the property of the issuer, at least in equity, the controllers will not be allowed to misappropriate the company's assets by failing to

[60] See Section 18. The present author hastens to add that this particular view was endorsed by a senior official of the Hong Kong Securities Commission; it would thus appear unlikely that the Commissioner would make any objection in such a case.

[61] The term 'prescribed person' is defined in Section 126 to 'mean a person suspected or believed by an inspector, on reasonable grounds, to be capable of giving information concerning any matter to be investigated by the inspector.'

recover the property and the illicit profits that have been wrongly taken and made.

The Colonial Government considered that the position under the common law was sufficiently uncertain to justify the provision of a statutory remedy. The trouble is, that the present statutory right of recovery, apart from extending to persons who were never and could not ever be held subject to fiduciary responsibilities under the common law,[62] affords a remedy to, arguably, the wrong person. The plaintiff under Section 140(4) (b) is the issuer whose securities have dealt in by the insider, on the basis of privileged information. As we have seen, at common law the duty to account would be based on the rule that a fiduciary should not profit from his office and that if he does so he must surrender the profit to his principal — which is of course the corporation with whom he is associated and to whom he is in a fiduciary relationship. Liability to another corporation would only arise where the insider information is in fact that corporation's property. Whilst the Securities Bill did speak more in terms of 'confidential information' obtained from the issuer, which is perhaps suggestive of proprietary notions, the Ordinance drops this wording in favour of the much wider 'association' test. Thus logically it is hard to see why the issuer of the relevant securities should have a remedy under the Ordinance and the corporation with whom the insider was in 'association' with should not. Indeed, it would seem that where the insider trades in the securities of another issuer to that which he is associated, he would be under a duty to account to that particular issuer under Section 140(4) (b), and also to his own corporation, provided he was in fact in a fiduciary relationship with such, under the general law,[63] for the full profits that he received by using the privileged information. This double liability would appear to be unavoidable, as the right of action in both cases is entirely independent and based on totally different principles of law. It is interesting that the American cases on the right of corporations to recover in such instances attach considerable importance to the damage that such behaviour by insider does to the company's image.[64] On the other hand, it is true that a corporation does have an interest in its securities being dealt with fairly and honestly. To this extent the right of recovery of the issuer of the particular securities is justified and understandable. In the vast majority of cases that are likely to be discovered, the trading will be in the securities of the issuer with whom the insider is associated.

MULTIPLE LIABILITY

The insider could be in a most unenviable position should he be caught under these provisions, as he may be liable to persons who dealt the opposite way to him in the market during the time period between when he traded and the information became publicly

[62] At common law only those persons occupying a fiduciary relationship with the plantiff, or those who assist in the breach with actual or constructive knowledge, would be susceptible to liability.

[63] Although there is no express provision, it would seem that the remedies provided in Section 140(4) are in addition to those already existing, such as they might be.

[64] *Diamond* v. *Oreamuno* 29 A.D. 2d 285, and *Schein* v. *Chosen* 478 F.2d 817 (2d. Cir. 1973).

available, as well as to the issuer of the securities in which he traded, and also the corporation with whom he is associated, and through which relationship he acquired the information; and then of course he may well be subjected to the criminal penalties. Moreover, the Commissioner has a wide administrative jurisdiction over both registered dealers and advisers. For offences involving fraud, or indeed any other violation under the Ordinance, or improper conduct by the registrant or applicant for registration, or anyone employed or associated with such, the Commissioner can refuse an application for registration, refuse to renew a registration, or revoke or suspend such.[65] These administrative sanctions could provide a most potent weapon in the hands of the Commission, and would certainly be available in cases of insider trading. Indeed even now, before the anti-insider trading provisions have been implemented, it would seem that such conduct would be sufficiently improper to justify the use of these powers.[66]

The possible degree of involvement in a particular case of insider trading that the Commissioner could find himself in is quite surprising. For instance, we have already seen that the Commissioner can proceed on behalf of the issuer and the other parties to the insider's transactions, and the Commissioner will also play an important part in the investigation and prosecution of offenders under the criminal provisions of the Ordinance. Moreover, there are also the administrative provisions, the enforcement and application of which rests primarily upon the Commissioner and his Office. Whether the Commissioner's Office, at least under present conditions, could even begin to cope with such a degree of regulatory involvement is to be seriously doubted. Certainly, much larger Commissions in other countries have not sought to become so involved, and it would be unlikely that the Hong Kong Commission would be involved in civil, criminal and administrative enforcement simultaneously.[67] Nevertheless this is not to say that the existence of these provisions and the vesting of such powers in the Commissioner will not have a salutary effect and does not represent a major step forward in the protection of investors.

THE MEASURE OF DAMAGES

The measure of damages in Section 140(4) is laid down in subsection (5). This provides that the amount of the loss or the

[65] Sections 53, 54 and 55.

[66] Under Section 56 the Commissioner may inquire into any allegation that a registered person has not furnished necessary information, is or has been guilty of any misconduct in relation to the conduct of his business, or is no longer a fit and proper person to be registered, by reason of any other circumstances which have led or are likely to lead to improper conduct of the business by him or reflect discredit on the method of conducting his business. If the Commissioner after enquiry concludes that the allegations are proved he can revoke, suspend or reprimand the person concerned, after giving such a person an opportunity to be heard. The term *misconduct* is defined in subsection (5) and would certainly include insider trading. Appeal from a determination of the Commissioner lies to the Disciplinary Committee (Section 58) and then to the Court, under Section 59.

[67] It is understood that the Commissioner and Assistant Commissioner would both favour private enforcement of the anti-insider trading provisions by civil actions under Section 140(4) (a) and (b), once the anti-insider trading provisions are implemented. However, it is respectfully submitted that a civil action would be exceedingly difficult to maintain and establish without a prior criminal prosecution, inspection or some kind of administrative action.

advantage that the defendant received is the difference between the price at which the transaction was effected and the price at which, in the opinion of the Court, the dealing would have been effected at the time when it was effected if the specific information used to gain that advantage had been generally known at that time. This determination will inevitably be a matter of informed guessing, probably upon the basis of expert witnesses. Of course, the price of the particular security after disclosure has finally been made may be a helpful indicator, but it should not necessarily be used without qualification, as there may well have been a host of other factors that affected the market in the interim, and the relevant date for the court is that upon which the transaction was effected. This would seem to indicate that recovery is limited to those who traded with or at least traded at the same time as the defendant. However, as we have already seen the Ordinance does not make it at all clear who is to be accorded a right of action.

The tort measure of damages adopted by the Hong Kong Securities Ordinance is that which has been most widely applied by the United States courts. It is not so generous as the contractual measure or that based on restitutionary relief. Nevertheless, provided a realistic approach is followed by the courts in arriving at the estimated price of the security on the day of the transaction in question, if the material inside information had been publicly available, the out of pocket measure should adequately compensate the innocent investor. It should perhaps be pointed out that the American courts have recently adopted a test that fixes the 'true' market price at the highest price that the securities reached within a period of nine days after the information has been publicly released.[68] This allows the innocent investor an opportunity to cover his mistaken transaction with a reasonable time in the open market at the worst possible conditions during that reasonable time.

The right of the company to take away an insider's profits under subsection (4) (b) is qualified by subsection (6), which provides that a profit shall be deemed not to have been made where the price at which the dealing was effected was higher than the Court determining the case regards would have been the price had the insider's knowledge been publicly available at that time. Although this might have been thought to be superfluous, depending upon how the calculations are made, it is possible to arrive at a profit figure in such cases. For example, if a director knew that his company had just lost a very favourable contract he might be able to estimate that whereas the company's securities were then selling at 20 Hong Kong dollars, after the announcement of this bad news the market would be likely to drop. If the insider, on the basis of this information, sold out his holding before the information was publicly available he would be liable was publicly available he would be liable under Section 140, *inter alia* to the issuer of those securities. The court might consider that the market would have dropped to 15 Hong Kong Dollars a share, had the information been released at the time of the insider's transaction. Thus, the director realised a notional 'profit' of five dollars on every share that he sold. It is this notional profit for which the insider will not be accountable to the issuer. Whether this

[68] In some cases a period of twenty days has been used.

excludes the possible application of the general law on accounting for secret profits is an open question. If the obligation to account for profits under the Ordinance is supposed to be really prophylactic, the present author can see no reason why the insider who has profited at the expense of the corporate position he holds should not be as accountable for his illicit gain on a declining market as he is on a rising market.[69] For an insider not to sell securities he holds, and thus avoid or lessen what he knows to be a sure loss, is more demanding on his integrity than the situation where he actively seeks to profit, but this is little reason to excuse him or reduce the burden of his responsibilities.

STATUTE OF LIMITATION

Although no limitation period is stated for criminal proceedings, as far as civil cases are concerned Section 140(8) provides that no action can be brought after the expiration of the period of two years following the dealing in securities to which the action relates, or the expiration of the period of twelve months following the discovery of the relevant facts by the person who suffered the loss or who seeks to recover the profit, whichever is the first to occur. Whilst these periods of limitation are reasonably short, it will be very difficult for a court in many instances to look back with any degree of precision perhaps three or four years so as to ascertain how the stock market would have behaved had the relevant information been publicly available. Whilst records and price lists will be of great utility, the best evidence for the court would be the opinions and educated guesses of participants in those very markets. However, despite these difficulties the present provisions relating to limitation no doubt represent the best compromise between a too short statute of limitation and the very great practical problems that could result from a too longer period.

VOID OR VOIDABLE?

A final, although most important point before we leave the question of civil liability under Section 140, is that subsection (12) provides that no securities transaction entered into in contravention of Section 140 will be void or voidable by reason of this fact alone. Whilst rescission can provide a most useful remedy for an innocent investor in an insider trading transaction, this provision, it is submitted, is both sensible and sound. Rescission can only properly be brought against a person in privity with the injured party, and as we have seen in most instances an insistence on finding contractual privity would be both useless and generally disadvantageous. If privity has been dispensed with as a requisite element in civil liability cases under Section 140(4)(a), it is at least arguable that it should not be resurrected by plaintiffs trying to establish a basis for rescission. It would seem illogical and somewhat contradictory if in one context privity had been dispensed with and market traders during the requisite period could recover damages, whilst at the same time other investors were asserting actual privity and claiming rescission. It is

[69] To sell out on a declining market is probably far more serious from the issuer's viewpoint. Insider transactions will invariably attract attention, and to a certain extent knowledge of their dealings is itself material 'market information'.

important to remember, however, that Section 140(12) only provides that the securities transaction shall not be invalidated by virtue of a violation of Section 140, and the general law with regard to avoidance for fraud, misrepresentation and illegality, except with regard to Section 140, would seem to apply.

Exceptions to Liability

The 'associated person' or insider is not however under subsection (11) of the provision prohibited from dealing, and thus subject to civil or criminal liability in a number of specific circumstances. These exceptions include, where his sole purpose is the acquisition of qualification shares required to be taken up because of his directorship; likewise, where an insider enters into dealings in good faith, performance of an underwriting agreement with respect to the securities the agreement relates to, he is exempted from the provisions of the prohibition, subject of course, in all cases to the statute not being used to perpetrate a fraud. Where an insider enters into dealings as agent for another person and has neither selected nor advised on the securities selected for the dealings, he is likewise not liable under the provisions relating to insider trading. This exemption would include a registered or exempted dealer or investment adviser, and also nominees or front men. Of course this provision is only directed to liability as principal, and the agent in certain cases may well be rendered liable as an aider or abettor or as a conspirator. The final exception deals with an insider who enters into dealings in good-faith in the exercise of his functions as a trustee of a pension fund established wholly or primarily for the benefit of employees of the corporation whose securities are involved in the dealings. This would seem to be a most peculiar exception, allowing insiders to enter into transactions on the basis of inside information, in the good faith performance of their duties as trustees, for the benefit of their beneficiaries. Obviously such a purpose was not intended by the legislature, especially when one considers that the beneficiaries will be employees of the issuer, themselves classified as insiders for the purposes of Section 140. The Deputy Permanent Secretary to the British Department of Trade, speaking of the analagous provision in Clause 14(e) of the 1973 Companies Bill, emphasised that whilst the exception was ambiguously drafted it was certainly not intended to create 'insider trading trusts'.[70] The Assistant Commissioner for Securities in Hong Kong considers that the 'good faith' requirement means that the trustees must not only consider their fiduciary duty to further the pecuniary interests of their beneficiaries but also their wider duties to the market, which dictate that it is wrong to utilise privileged information for any form of private gain. With the greatest respect there would seem to be much in the Assistant Commissioner's interpretation; certainly in America it has been repeatedly held that the Federal anti-insider trading provisions override the fiduciary duties of brokers to utilise privileged information to further the interests of their clients. Here the statutory duty under the Ordinance not to use inside information would predominate over the normal fiduciary responsibilities of trustees. Nevertheless, it is highly unfortunate that

[70] See Mr. P.A.R. Brown, *Conference on Insider Trading and Insider Disclosure,* London, April 1975. Indeed, Mr. Brown described this provision as due to 'ignorance, pure ignorance'.

the exception is so ambiguous, and no matter what interpretation is put upon the good faith requirement, it would seem necessary for the legislature to correct the grossly inadequate drafting of the present provision before the anti-insider trading provisions are implemented. It should also be noted that under this exception personal representatives, liquidators, receivers or trustees in bankruptcy are similarly excused.

Special Reporting Obligations

Whilst it has been emphasised on a number of occasions throughout this discussion that there are no regulatory requirements in the Colony requiring insiders to disclose their shareholdings and transactions, Part VII of the Securities Ordinance does require certain specified persons who by virtue of their positions are much more likely to have access to and possession of inside information to maintain a register of the securities in which they are interested, and of the particulars relating to their acquisition and disposal, in a manner and form provided for by the Commissioner.[71]

Interests in securities relevant for the purposes of this part of the Ordinance are broadly defined under Section 5. The basic principle is that 'a person has an interest in securities... if he has authority (whether formal or informal or express or implied) to dispose of, or to exercise control over the disposal of, those securities. It is immaterial that these powers are subject to, or capable of being subjected to restraint, or to joint control.[72] Where a corporation has authority to dispose of, or to exercise control over the disposal of, securities and it or its directors are accustomed to act or are under an obligation, whether formal or not, to act, in accordance with the instructions of someone else with regard to those securities; or a person, or an associate of a person, has a controlling interest in the corporation, that person will be deemed to have authority to dispose of, or to exercise control over the disposal or the relevant securities.[73] An 'associate' would include an issuer that is related to that person; a person in accordance with whose instructions that other person is accustomed to act, or who is under an obligation to act with regard to the securities in question; the person who acts in accordance with that other person's directions; a corporation that is, or whose directors are accustomed or obligated to act in accordance with another's instructions; and a corporation which gives such instructions, to another person, in relation to the securities concerned.[74] Thus, with regard to both 'interests in securities' and the term 'associate' the requisite test is the power to control, not necessarily absolutely, the acquisition and disposal of the security in question. This is again brought out in subsection (6), which provides that where a person has entered into a contract to purchase shares, or to have such transferred to him or his order, presently or in the future, or has the right to acquire securities under option, he is for the purposes of the Ordinance to

[71] Section 67.
[72] Section 5(2) and (3).
[73] Section 5(4).
[74] Section 5(5).

be regarded as having the control to dispose of the securities.[75] Mr. Smith, in his excellent article, criticises the test of 'power to dispose' on the ground that a number of taipans and investment companies in the Colony have informal powers over an enormous number of securities in which they have no beneficial interest at all.[76] Furthermore, the wording and sweep of such provisions as Section 5(4) is so wide, given the inter-related corporate community in the Colony, that it would seem likely that extraordinarily remote interests will nevertheless be covered. Indeed, literally interpreted and strictly enforced, the section would be practically unworkable.

The persons comprehended in these registration provisions are dealers, dealers' representatives, investment advisers and their representatives, and also, where the Governor in Council so orders, financial journalists.[77] The obligation to record securities under Section 67 extends to all listed securities and any other class of security laid down in regulations to be made.[78] Details of the securities in which a person to whom these provisions applies has an interest, and particulars of his interest in these securities, must be entered by that person in the register within fourteen days of his becoming aware of the acquisition. Where there is a change in his interest the person must similarly record it, with the relevant particulars, and this includes acquisitions and disposals.[79] A person who contravenes any provision of this section is guilty of an offence and to a fine of Hong Kong $5,000. Under Section 68 a person under a duty to so record his transactions must give the Commissioner notice in the form and containing the particulars prescribed in the regulations, including the place at which he will keep the register.[80] The Commissioner may require a person to whom this part of the Ordinance applies to produce for inspection the register, and the Commissioner may make copies and take extracts from it.[81] Under Section 71 the Commissioner can supply a copy of the register, or an extract from it, to the Attorney General, who may if he has reason to believe that an offence has been committed under the Securities Ordinance deliver the copy to any person whom

[75] Section 5(7) provides that a number of interests are to be disregarded. The only provision that need concern us is paragraph (a), which states that for the purposes of Section 67 (see *infra)* an interest in securities of a person whose ordinary business includes the lending of money, holding such as security for an ordinary business transaction, is to be disregarded.

[76] Law Lectures for Practitioners, *Hong Kong Law Journal* 1974, page 38 *et seq.*

[77] Section 66. Financial journalists are defined in subsection (2) so as to include a person who in the course of his business or employment contributes advice concerning securities for publication in a newspaper, magazine, journal or other periodical publication. It should be noted that the Governor in Council, after consultation with the Commission, is given reasonably wide powers to make regulations under the Ordinance (see Section 146).

[78] Section 66(1)(b).

[79] Section 67(2), (3) and (4).

[80] Section 67. There is a defence in Section 69, regarding the offences under Sections 67 and 68, in so far as a person is not liable 'if he proves that the contravention was due to his not being aware of a fact or occurrence, the existence of which was necessary to constitute the offence.' However, there is a rebuttable presumption that a principal did have knowledge of things a servant or agent had knowledge of, relating to the securities concerned, provided the servant or agent had duties or was acting in relation to the principal's interest in the relevant securities.

[81] Section 70.

he thinks fit, for the purpose of an investigation or prosecution of the offence. However, there is nothing authorising inspection of these registers by the public, or allowing the Commissioner to disclose the content of such to private litigants. Thus, whilst these registration provisions are of some regulatory value it is most unfortunate that the public will not generally be allowed to have access to the information contained in the registers — which could be highly relevant from the point of view of detection of insider abuse.

Some Other Points

When the Securities Ordinance was first published in Bill form, the various offences relating to insider trading were not confined to dealings within the Colony as such. Because of the degree of foreign business conducted in Hong Kong and the fact that the majority of larger securities houses were either based abroad or had foreign connections, and particularly as the United Kingdom had no compatible legislation, it was thought both politically and commercially prudent to restrict the ambit of the anti-insider trading provisions to where the dealing had been carried out in the Colony.[82] Given the practical limitations of jurisdiction and the characteristics of the local business community, this was probably the wisest thing to do. Nevertheless, it is important to recognise that this provides a serious means of evasion and will inevitably involve the courts in difficult questions as to where the dealings were in fact carried out and what degree of 'indirect dealings' in the Colony is sufficient to provide jurisdiction.

It is certainly true that in recent years there have been a number of major international securities frauds, where no single country has been able adequately to police the offenders within the terms of its own jurisdiction. As we have already seen the use of nominees and foreign bank accounts has greatly handicapped the various national regulatory agencies. Whilst there has been evidence of increased co-operation among national police forces and regulatory bodies, it would be wrong to under-estimate the present enforcement problems.[83] Perhaps a short term answer to some of these problems would be the development of Regional Securities Commissions; there have been strong suggestions to this effect within the European Economic Community, although the practical and political implications would require much consideration.

[82] The American courts have on a number of occasions considered that the various regulatory provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 have extra-territorial effect and application. The body of law that has been developed on this question is not however necessarily logical or certain, and the American experience would hardly augur well for the Colonial courts.

[83] One of the most serious problems is that a number of countries have strong commercial interests connected with their banking secrecy laws. To allow penetration of numbered accounts would in many cases involve a withdrawal of money from that country to a safer haven. Furthermore, there is a wide divergency of feeling on whether insider trading is properly to be regarded as criminal or not. For instance, insider abuse is very rarely considered as criminal in the United States' and countries operating a banking system with strict secrecy laws as a general rule will only allow disclosure of information about accounts where the inquiry is in relation to a criminal investigation. Moreover, a number of smaller countries have actively sought to attract corporations by maintaining a very rudimentary and lax corporation law; this again works in favour of international 'swindlers'.

Another interesting question in the context of insider trading, and particularly short-term speculation, is that of taxation. In Hong Kong the position is particularly interesting, as in the absence of a capital gains tax the Inland Revenue Authority have sought to rely upon Section 14 of the Inland Revenue Ordinance, which imposes a profits tax 'on every person carrying on a trade, profession or business, in the Colony in respect of his assessable profits arising in or derived from the Colony for that year from such trade, profession or business'. Naturally the applicability of this provision turns on what degree of securities dealings are needed to constitute a 'trade or adventure in the nature of a trade'.[84] Although the law on this topic is uncertain and awaiting further clarification, for our present purposes it is sufficient to mention that a possible liability for tax is present in the case of securities dealings, and this may well be sufficient disincentive to engage in regular short-term trading of the sort that is often associated with insider abuse.[85]

In concluding this section on insider trading as such, it is perhaps worth mentioning the strict rules regarding disclosure of confidential information by the Commissioner and his staff. Section 19 of the Ordinance provides that, except in performing his duties under this Ordinance, every person appointed under or employed in carrying out the Ordinance 'shall preserve and aid in preserving secrecy with regard to all matters coming to his knowledge in the performance of his duties under this Ordinance and shall not communicate any such matter to any person nor suffer or permit any person to have access to any records in his possession, custody or control'. Under subsection (4) a member of the Commission and a person employed in the administration of the Ordinance shall not directly or indirectly effect or cause to be effected on his own account or for the benefit of any other person any transaction in securities which he knows to be, or to be of a class which is subject to investigation or proceedings under this Ordinance, or under the Commissioner's consideration, or in respect of which a prospectus or any takeover document is to his knowledge being considered by the Registrar of Companies.[86] Where any member of the Commission, or any person employed in the administration of the Ordinance is in the course of his duties required to consider any matter relating to securities or to a corporation in which he has any interest, securities in the same class as those in which he has an interest or a person with whom he is or has been employed or associated or of whom he is or has been a client, or who was a client of a person with whom he is or was employed or associated, he shall immediately inform the Commission or the Com-

[84] Section 2 of the Ordinance. See generally the article by P.G. Willoughby: 'The taxation of profits acquired from dealing in securities', volume 4, *Hong Kong Law Journal,* page 52. There is also the equally important question of whether cases in securities dealings can be used to obtain tax relief under Sections 15A and 19 of the Ordinance. It would seem they could. Thus, as Professor Willoughby points out if the Revenue does seek to enforce liabilities under the profit tax the net result could well be a loss to the amount of revenue recoverable in securities transactions overall, as since the crash more people have lost than have gained.

[85] Indeed, it would seem that the announcement of the Inland Revenue's intention to seek and impose tax liability under Section 14 in the case of securities transactions had a marked impact on the securities markets just before the collapse; *Financial Times,* London, 4th February 1974.

[86] First Report, Protection of Investors, paragraph 9.6.

missioner. Under subsection (7) any person who without lawful authority or reasonable excuse contravenes these provisions is liable to a fine of $10,000 and six months' imprisonment. These penalties have been criticised on the basis that they are significantly less severe than the penalties imposed under Section 140(10). It has thus been argued that the Ordinance is too indulgent to the officials administering it. With the greatest respect, it would seem that these contentions are fallacious. In many cases an official receiving inside information will be within the scope of Section 140, in most instances as a tippee, and thus subject to the normal provisions. Furthermore, although there will no doubt be a number of circumstances where Section 140 does not apply, in addition to the penalties imposed under Section 19(7) there are strict disciplinary proceedures under the normal Civil Service rules, and the present author has been assured by a very senior official that any indiscretion would result in immediate dismissal. Moreover, there is a procedure under which the officers must disclose their holdings and seek prior approval for transactions as is normally the case in this type of regulatory body. In addition, Section 122(3) and (4) makes it an offence punishable by a fine of $2,000 for the Commissioner to make a record or disclose to another person any information that he acquires by reason of the making of an inspection under that section relating to books and records of registered people, except for the purposes of the Ordinance or a criminal prosecution.

THE HONG KONG CODE ON TAKE-OVERS AND MERGERS

The colonial authorities have been increasingly made aware in recent years of the problems that can arise in the context of take-over and merger transactions. The Companies Law Revision Committee in its First Report examined the practice of corporate take-overs in Hong Kong, and although at that time merger and acquisition operations were nowhere near as common as they have been in the last couple of years, the Report expressed concern on the patent possibilities for abuse that such operations presented.[86] One of the most serious abuses was that of the 'smash and grab raid', often engineered from abroad, which was carried out with the sole aim of stripping from the acquired corporation valuable assets, which because of the deficient disclosure system in the Colony had not been properly appreciated by the market. An aspect of these 'asset stripping' operations was invariably the use of inside information. Moreover, even where the operation was not necessarily abusive in itself, usually because of the poor disclosure requirements there would be ample opportunity for heavy insider trading and manipulation. Yet another problem was controllers making secret deals with prospective purchasers to sell out their holdings at a greatly inflated price, leaving minority shareholders stranded in a market that would be artificially depressed.

The Companies Law Revision Committee considered that the question of take-over and merger regulation in the Colony should be dealt with along the same lines as were recommended by the Jenkins Committee for Britain.[87] The Report recommended the drawing up of take-over and merger rules basically modelled on the British Licensed Dealers (Conduct of Business) Rules 1960, with certain modifications. The Committee recognised that without sophisticated legislation, which

[87] Report of the Company Law Committee (Cmnd. 1749) paragraphs 265-294.

they considered would be inappropriate in Hong Kong, the various abuses could not be prevented completely. Nevertheless they expressed the hope that although the City Code on Take-overs and Mergers in the United Kingdom was not strictly binding in the Colony everyone, if for no other reason than the preservation of their own good name, would comply with its spirit. Indeed, 'the onus would certainly be on anyone departing materially from the Code to justify this to the public'[88] Unfortunately this proved to be largely wishful thinking on the part of the Committee, as the abuses continued to proliferate. Mr. Peter Chan, the Chairman of the Kowloon Stock Exchange, among other local businessmen and financiers spoke out strongly against the lack of Government regulation, particularly in the case of dubious take-over bids and acquisitions from companies incorporated and operating outside the Colony.[89]

In the result the Hong Kong Securities Commission after a period of research and consultation published a Code on Take-overs and Mergers, which seeks to prevent the type of abuses that have presented such a bad image in recent years.[90] Whilst the Code is to a large extent modelled on the London Code, it is worth while briefly examining those of its provisions which bear particularly on the question of insider trading and manipulation. Of course it is important to remember that it only extends to transactions in furtherance of a take-over or merger[91] and that its 'object is to provide guidelines for companies and their advisers who contemplate or become involved in takeovers and mergers' and not to lay down legal principles.[92]

The Code is administered by a Committee on Takeovers and Mergers, with the aid of a secretary, who will be an officer of the Hong Kong Securities Commission. The Committee itself consists of three members of the Commission, a representative from the Federation of Stock Exchanges, and two other members representing financial institutions in the Colony. The Committee's chairman, who is to have the daily responsibility with the secretary of administering the Code, must be also a member of the Securities Commission. Although it is not contemplated that all acquisitions and mergers in Hong Kong will be cleared in advance with the Committee, it would seem that whenever there is any doubt as to the possible application or interpretation of a provision under the Code it would be prudent to consult the chairman. Where the chairman's answer is not accepted reference can be made to the Committee itself.

88 First Report, Protection of Investors, paragraph 9.23.
89 Volumes 1 and 2, *Hong Kong Law Journal,* page 258.
90 *South China Morning Post,* 17th January 1975; *The Times (London),* 19th August 1975.
91 For the purposes of the Code a takeover occurs when a company or an individual or group of individuals acting together acquires the control of another company by means of a specific offer addressed to the general body of shareholders of that company; and if for example a company or person gains control by buying shares on a stock exchange in the ordinary course of business this is not a takeover for the purposes of the Code. A merger is an ill-defined term and is sometimes used for a take over. It usually refers to an arrangement by which the assets of two companies are acquired by another company, often newly-formed, whose shareholders are those of the two original companies. In either case an offer is made to the general body of shareholders of the offeree company. Introduction to the Code, page 1.
92 Introduction to the Code, page 1.

In paragraph 11 of the General Principles the Code provides that it is necessary that in all cases the spirit of the Code should be followed, even though an express ruling on the particular point in question may not be present. In the context of more specific obligations the General Principles require that a change of control should be disclosed to the shareholders as soon as is practicable,[93] and that directors of both companies have a fundamental obligation to place the interests of their respective shareholders over their own personal interests[94] and that after the communication of a *bona fide* offer, or where the offeree's board have reason to believe that such is imminent, there is an obligation not to do anything that would frustrate such, as for example disposing of the target company's assets or placing a new issue of shares in friendly hands.[95] Moreover, it is expressly stated that 'rights of control must be exercised in good faith and the abuse of shareholders' rights is wholly unacceptable,'[96] and all shareholders of the same class in an offeree company should receive the same treatment.[97] Under paragraph 15 of the General Principles it is stated that 'all parties to a takeover or merger transaction must endeavour to prevent the creation of a false market in the shares of an offerer or offeree company.'

Turning to the substantive rules in the Code, it is made clear that the initial approach in a takeover or merger must be to the target company's board, and that 'the vital importance of absolute secrecy before an announcement must be emphasised'.[98] Under paragraph 24 it is made absolutely clear that there is an obligation on both the offeree and also the offerer company to disclose the offer or approach by a press release as soon as is practicable. Ideally this should be a joint release. Even where the offer or initial approach is tentative or uncertain, the Code makes it equally clear that 'as soon as the two companies are agreed on the basic terms of an offer and are reasonably confident of a successful outcome to the negotiations' an announcement must be made.[99] Of particular interest is paragraph 26, which provides 'that in any situation which might lead to an offer being made, whether welcome or not, a close watch should be kept on the share market. In the event of an undue movement in share prices an immediate announcement should be made, accompanied by such comment as may be appropriate.'

The rules substantially improve the quantum and quality of information that investors are to receive in the case of a takeover or merger; 'shareholders must be given all the facts necessary for

93 General Principles, paragraph 12.

94 General Principles, paragraph 13. It is also expressly provided that in the case of a bid the directors should in the interests of shareholders avail themselves of outside advice; and this is particularly desirable where the target corporation is already a subsidiary company: paragraph 16.

95 General Principles, paragraph 1. Obviously a *bona fide* contract already entered into to dispose of certain assets or issue shares is unobjectionable.

96 General Principles, paragraph 17, and also paragraph 30.

97 General Principles, paragraph 18. Any differentiation must be justified to the satisfaction of the Committee. See also paragraph 1, on partial bids.

98 Paragraph 23.

99 Paragraph 25.

them to be able to make a reasonable judgement of an offer'.[1] 'The obligation of the offerer in these respects towards the shareholders of the offeree company is no less than its obligations towards its own shareholders'.[2] The principle that all shareholders are entitled to equal treatment, by their directors, the controllers and the offerer company, is reaffirmed in paragraph 30 and in particular paragraph 31. This last paragraph states that 'from the time that a takeover is seriously contemplated neither the offerer company nor any of their advisers shall furnish information to some shareholders, in their capacity as shareholders, which is not available to all shareholders.' The content of the offer document and the statement of the offeree company are strictly regulated by Schedules I and II of the Takeover Code, and copies of all documents circulated to shareholders must be sent in duplicate to the Chairman of the Committee at the time of or preferably previously to circulation.[3]

The requirements of the offer document under Schedule I are interesting in the amount of disclosure that they demand: the identity of the offerer, the number of securities held in the offeree by the offerer and its directors, beneficially, including details of any acquisitions of such shares within the previous six months, as well as information on the terms of the offer and the closing market price of the security in question.[4] Moreover, details of any benefits which will be given to any director of the offeree or its subsidiary companies as compensation for loss of office must be disclosed, as well as any agreement between the offerer and any of the offeree company's directors which is conditional on the outcome of the bid. Apart from searching disclosure requirements relating to the capital structure, class rights and operations of the offerer, the offer document must state 'whether to the knowledge of the directors there has been any material change in the financial position of the offerer company since the date of the latest available accounts'.[5]

The statement to be given by the offeree company under the terms of Schedule II requires the directors of the target corporation to make a recommendation as to whether the bid should be accepted or not, and whether the directors or anyone dealing on their behalf intend to accept the bid with regard to their own securities.[6] Where the directors recommend the offer to the shareholders, the aggregate of their beneficial holdings must be disclosed, together with in all cases the number of shares held in the offerer by the offeree company and each director of the offeree company, with details of any of these shareholdings which have been purchased within six months before the date of the offer document, although seemingly not sales, and the holdings of any person dealing on the director's behalves.[7] Furthermore, as in the offer document itself details must be disclosed of any

[1] Paragraph 30, this information must not only be 'fairly and accurately presented' but also provided in time for the shareholders to give the matter proper deliberation. On the information that an offence company should make available to offerors and *bona fide* potential offerers see paragraph 29.
[2] Paragraph 30.
[3] Paragraph 36.
[4] Paragraph 50.
[5] Paragraph 51.
[6] Paragraph 52(1) and (2).
[7] Paragraph 52(3) and (4).

compensation for loss of office or contracts with the directors conditional upon the result of the bid, and also details of material contracts entered into by the offerer in which a director of the offeree has a material interest, and details of any service contracts that the offeree company's directors have with the offeree and its subsidiaries which have more than twelve months to run.

Of great interest from the point of view of insider trading regulation, is paragraph 43, which provides that

> No dealings of any kind in the shares of the offeree company by any person or company, not being the offerer or persons acting on behalf of the offerer, who is privy to the preliminary takeover or merger discussions may take place between the time when there is reason to suppose an approach of an offer is seriously contemplated and the announcement of the approach or offer or the termination of the discussions.

The importance of these provisions in the context of this present examination of the anti-insider trading provisions in Hong Kong should not be underestimated. The Code does not, however, make it clear what is to be done if an issuer or insider or a professional engaged in the securities industry chooses to ignore the 'guidelines'. This would seem to be a serious deficiency: certainly the City Code on Takeovers and Mergers in Britain received rather dubious support until the Panel declared that violations would be visited with public disclosure, censure both private and public, the sending of reports to the various professional bodies and official authorities, and the possibility of stock exchange suspensions or delistings. Nevertheless, there is a close association between the Committee charged with the administration of the Hong Kong Code and the Securities Commission. In addition, the Code was officially promulgated, and the Secretary to the Committee is a senior official from the Commissioner's Office. It would thus appear that although the Takeover and Merger Committee does not possess regulatory powers as such, the whole structure is closely associated with the regulatory mechanism of the Commission and the Commissioner's Office.[8]

CONCLUSIONS

It is perhaps both premature and unfair to attempt to draw any conclusions as to the viability, and for that matter suitability, of the various anti-insider trading provisions that we have been examining. Certainly the Colonial Government deserves commendation for its admirable stand against this particular type of abuse, particularly when one considers the undoubted prevalence of insider trading in the Colony. It is on the other hand unfortunate that the Hong Kong authorities have decided to postpone the implementation of the basic insider trading provisions until the United Kingdom Government enacts and starts to administer similar laws.

[8] The Committee is empowered under paragraph 9 to amend and extend the Code, as well as to issue releases and interpretations. It is understood that the Assistant Commissioner is not opposed to the idea of the drawing up of 'guidelines for insiders' on a semi-official basis. This approach has recently been adopted by the French Commission, although rejected by the American Securities Exchange Commission as impractical.

It has been one of the primary aims of the present author to show that it is both misconceived, and in some instances naive, to analyse anti-insider trading laws in the abstract. Close attention should be given to the financial infrastructure and business community in which it is supposed the relevant legal norms apply or will be applied. This is particularly important when one is discussing an environment such as that of Hong Kong. Although the Colony in recent years has become one of the major financial centres of the world, the corporate life of the Colony has until a couple of years ago operated under archaic corporation laws and an extremely deficient disclosure system. To this can be added the phenomenal growth of the securities industry and the wild securities speculation which characterised the meteoric rise of the securities markets. Moreover, to fully appreciate the value or estimated impact of the anti-insider trading laws it is very important to examine the regulatory bodies concerned in the administration thereof, and their various powers. It is only in the context of these wider considerations that any meaningful appreciation of the system can be obtained.

Having looked at as many of these aspects as it is practical here to do it is the present author's view that without some important amendments the present provisions are deficient, and could cause considerable embarrassment and uncertainty to those to whom they are intended to apply, and to the Government and the Commission. Furthermore, it is also felt that the present provisions, even if improved before implementation, are unlikely to be of any major impact without a bold and energetic approach by the officers of the Commission. It is to be hoped that they will be given the means and opportunity to do just this.

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