Consultation Paper on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance

The Law Society's Submissions

The Securities and Futures Commission (the "SFC") issued a consultation paper on "Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance" on 10 June 2022 ("Consultation Paper").

In response, the Law Society provides the following submissions on the questions posed. The same abbreviations and definitions appearing in the Consultation Paper are used in this paper.

Question 1: Do you agree with: (i) the proposal to amend section 213 of the SFO to expand the basis on which the SFC may apply to the CFI for remedial and other orders after having exercised any of its powers under section 194 or 196 of the SFO against a regulated person, and; (ii) the proposed consequential amendments to section 213(1), (2), (7) and (11)? Please explain your view.

Law Society's response:

1. In principle, and subject to what follows (in particular, paragraph 9), we have no objection to the SFC's proposal to amend section 213 of the SFO. We understand the SFC's role in acting in a protective capacity on behalf of investors and clients of regulated persons and we support it. Nevertheless, we believe it is also important to ensure that these broad powers to seek compensation and damages from regulated persons are subject to adequate scrutiny in the interests of the Hong Kong market and in the public interest.

2. Broadly, section 213(1) of the SFO enables the SFC to apply to the Court of First Instance ("**CFI**") for one or more of the orders specified in section 213(1) where a person has contravened any of the "relevant provisions" which include the SFO and its subsidiary legislation.

3. Before making an order under subsection (1), the CFI must satisfy itself, "so far as it can reasonably do so, that it is desirable that the order be made, and that the order will not unfairly prejudice any person".

4. The SFC now seeks a cause of action under section 213(1) to enable it to apply to the CFI for orders under section 213(2) after having exercised any of its powers under section 194 or 196 of the SFO against a regulated person so as to protect investors and clients of regulated persons more effectively.

5. However, we do not believe that this is as straightforward an amendment as is portrayed in the Consultation Paper. Under section 213 as it is currently drafted, the SFC may apply for final relief from the CFI in the form of remedial orders to address contraventions of the SFO, in particular contraventions of the market misconduct provisions contained in Part XIII and Part XIV of the SFO. In order to obtain such orders, case law suggests it is not enough for the SFC to be satisfied that a contravention has occurred and then for the Court to rely on the SFC's views in making substantive orders. The Court must be satisfied on the evidence that a contravention has occurred: see Kayden v Securities and Futures Commission [2011] 2 HKC 44.

6. In cases where the SFC has sought final orders under section 213(2) after a criminal conviction has been obtained against a person under Part XIV or a determination has been obtained from the Market Misconduct Tribunal ("**MMT**"), the Court's task is relatively straightforward. It may rely on the presumption contained in section 62(2) of the SFO and the terms in section 284 of the SFO respectively in order to establish that a contravention has occurred. In cases where there has neither been a prior conviction in the criminal courts nor a determination by the MMT, the SFC is obliged to prove its case on a balance of probabilities before the Court will make final remedial orders.

7. Under the proposed new section 213(1)(c), the situation will be rather different and we are concerned at the absence of information in the Consultation Paper concerning the evidential and procedural basis on which the SFC will proceed with applications under this new sub-section. Presumably, it will rely on its own disciplinary findings in making an application for final relief. The SFC decides its disciplinary cases based on its interpretation and application of its own codes of conduct, guidelines, FAQs and related guidance in relation to facts which have been established to its satisfaction by its own investigation. (We acknowledge that the SFC has put in place measures to provide a regulated person an opportunity to be heard in the disciplinary process, nevertheless, nearly twenty years after the SFO came into effect we query whether these measures continue to provide sufficient protection for the rights of regulated persons to due process and a fair hearing.) This is in marked contrast to the situation where the Court is able to rely on a prior criminal conviction or determination by the MMT i.e. it is relying on a decision by another Court or quasi-judicial body which is independent of the regulator making the application.

8. A regulated person has a right of appeal to the Securities & Futures Appeal Tribunal (and onwards to the Court of Appeal on a point of law) against a disciplinary decision made by the SFC. This is designed to provide an

independent overview of the SFC's decision making but it is used relatively infrequently by regulated persons.

9. In the interests of justice, we submit that the SFO should be amended to provide the CFI with clear and unambiguous power to scrutinise the merits of SFC's disciplinary findings when deciding whether to make an order in favour of the SFC under section 213(2). As presently drafted, section 213(4) would not expressly permit the CFI to do this in order to satisfy itself that the findings on which the SFC relies are fair and justify the relief sought. To improve the fairness and transparency of the process by which section 213 orders are made, we submit the SFC should consult the public on a suitable amendment to section 213(4) along the lines we have indicated.

10. A related point is what should be the appropriate form for the SFC's application to the CFI for a section 213(1)(c) order? To date, the SFC's usual practice has been to seek determination of a contravention of one of the "relevant provisions" by filing an Originating Summons accompanied by affidavit/affirmation evidence. However, this has proved to be far from ideal in section 213 applications where serious wrongdoing is alleged and the underlying facts and legal issues are complex and are disputed. In a number of cases, the CFI has been critical of this approach by the SFC: See, for example, Commission v Tiger Asia Management LLC and others [2011] 6 HKC 149 (CFI) and Commission v Hontex International Holdings Co. Ltd. (unreported, HCMP 630/2010, 2 August 2011).

11. In our view, the SFC should be required to issue a Writ of Summons in cases where it intends to rely on its disciplinary findings to seek compensation and similar orders which may have a significant impact on the regulated person. This is also essential because the SFC's Codes etc. do not have the force of law and are not drafted with the precision of subsidiary legislation. This being the case, it is only fair that the SFC be required to articulate and particularise the basis in law for the relief sought. A properly pleaded case would also provide the regulated person with a fair opportunity to address the SFC's case. This will be all the more necessary when some cases likely involve complex questions of causation, issues such as contributory negligence and quantum. Finally, it would greatly assist the CFI in terms of efficient case management and the administration of justice to adopt the usual pre-trial procedures of pleadings, discovery, the exchange of statements by witnesses of fact and expert witnesses, case management conferences and a trial of all the issues.

Question 2: Do you have any comments on the proposed consequential amendments to section 213(3A) in respect of OFCs[1]? Please explain your view.

[1] Open-ended fund companies

Law Society's response:

Please see our answer to Question 1.

Question 3: Do you agree with the proposal to amend the exemption set out in section 103(3)(k) and the consequential amendments to section 103(3)(j)? Please explain your view.

Law Society's response:

1. For the reasons given below, we do not agree with the proposal to amend the exemption set out in section 103(3)(k) (the "**Exemption**") and the consequential amendments to section 103(3)(j). In our view, as currently formulated, the Exemption provides sufficient protection for the investing public and therefore the proposal to narrow the terms of the Exemption is not justified in the circumstances.

2. As a preliminary point, we regard the SFC's summary of the CFA's interpretation of section 103(3)(k) in paragraphs 24&25 as cursory and incomplete. In delivering the Judgment of the CFA in Commission v Pacific Sun Advisors Limited and another ("**Pacific Sun**"), FACC 11 of 2014, Mr Justice Fok PJ provided a cogent interpretation of the Exemption and how, properly construed, it meets the statutory purpose of protecting retail investors adequately against exposure to unsuitable investment products. It is unfortunate that a summary of his Lordship's analysis was not included in the Consultation Paper. The public would have benefited from having the opportunity to consider the CFA's underlying reasoning for its decision in Pacific Sun when being asked to comment on the merits of amending the Exemption.

3. In our view, the CFA interpreted the Exemption in accordance with the legislative intention expressed in the SFO. While the SFC may have wanted the Exemption to reflect a different policy intention, the CFA determined that as matter of statutory interpretation the provision is incapable of bearing the meaning the SFC seeks to attribute to it. Therefore, we believe that it is incorrect for paragraph 17 of the Consultation Paper to state that the CFA has given a wider construction to the Exemption than was intended by the underlying policy. The impression created by paragraph 17 is that the CFA has somehow made a "wrong" decision in Pacific Sun and this must be corrected to reflect the SFC's policy. On the contrary, we consider the CFA's judgment encapsulates a nuanced understanding of how the Exemption achieves the regulatory objective of protecting the interests of the investing public while allowing relevant products to be advertised without disproportionate restrictions being imposed.

4. The Pacific Sun case was heard by the CFA in March 2015--- more than seven years ago. We are not aware of any significant incidents in the

intervening years where investors have suffered harm which can be attributed to advertisements issued under the Exemption. As a result, we believe it is incumbent on the SFC to go beyond making abstract statements about the need to safeguard investors and articulate why the proposed amendment is needed in 2022. Is there tangible evidence available to the SFC that suggests that the Exemption as interpreted by the CFA is insufficient to protect investors? If so, we suggest this be shared with the public as part of the consultation process. If not, we query why the Exemption need be amended at all given the terms of the CFA judgment summarized below.

5. Pacific Sun was charged under section 103(1), SFO which makes it an offence to issue advertisements, invitations or documents relating to investments subject to various exemptions under section 103(3). This happened as a result of the circulation by Pacific Sun of an email to potential investors to promote the launch of a fund in November 2011. Documents relating to the fund were also published around the same time on Pacific Sun's website. The release of the email and the fund documents had not been approved or authorized by the SFC. Subsequently, SFC commenced criminal proceedings against Pacific Sun and its chief executive officer alleging contraventions of section 103(1). When the case reached the CFA in March 2015, the following issues were considered:

   (a) whether for the Exemption to apply, it must be seen from the advertisement or invitation itself that it is, by its terms, confined to professional investors only to the exclusion of other member of the investing public; and

   (b) whether the carrying out of a screening process to ensure that all investors investing in (here) the fund are professional investors is irrelevant to the application of the Exemption.

6. The SFC's case was that, for the Exemption to apply, the advertisement must make it clear that the advertised product is intended only for professional investors. Senior counsel for the SFC submitted that the advertisement has to state expressly that the investment product is or is intended to be sold only to professional investors. He submitted that any other construction would defeat the statutory purpose and would be inimical to the protection of the investing public intended by the statutory scheme.

7. Pacific Sun argued that the Exemption applies, if as a matter of fact, the investment product is or is intended to be sold only to professional investors. Their counsel submitted that the burden will be on the person issuing or possessing the advertisement to prove this fact, for example by proving that there is a screening process to exclude persons who are not professional investors.

8. The CFA rejected the SFC's construction of the Exemption and accepted Pacific Sun's argument that the Exemption applies even if the intention to

dispose of the interests in the fund to professional investors only is not stated in the advertisement or invitation. First, the Court said that for the Exemption to come into play, the advertisement, invitation or document in question must be made "in respect of" one of the relevant products. Applying the natural and ordinary meaning of this phrase, the Court found that the Exemption simply applies to the issue of an advertisement etc. having some connection or relation to the investment products disposed of only to professional investors. Second, there is no express requirement under the Exemption that an express statement be made to the effect that the fund or other relevant product is intended to be disposed of only to professional investors. In the CFA's view, if it was intended that an advertisement must contain such an express statement in order for the Exemption to apply, the legislature would have expressly stated this and the particular form of words to be used. Third, the Exemption goes to the substance of the investment and it is therefore necessary for the person claiming its benefit to demonstrate that the relevant investment is in fact intended solely for professional investors. It is the demonstration of this fact that shows a retail investor is protected from exposure to an unsuitable investment product.

9. In reaching its decision, the CFA specifically rejected the SFC's argument that it was only by construing the Exemption in the manner it contended for that effect could be given to the legislative purpose of protecting the public from exposure to the prescribed types of unauthorized advertisements. The CFA pointed out an "obvious flaw" in the SFC's argument that if the investment products are not in fact sold or intended to be sold to the general public and instead are sold or intended to be sold to professional investors, there is no necessity to protect the general public since they are not exposed to any material risk. The SFC's leading counsel sought to side-step this point by referring to the advertisements in this case and pointed to the fact that the size of the minimum investment in the fund was well within the threshold of a retail investor and therefore those investors might think the fund was intended for sale to them. We note with emphasis to paragraph 42 of the Judgment, Mr Justice Fok said:

"The thrust of the Commission's (SFC's) argument in this respect would appear to be that, because the advertisements did not expressly state that the Fund was or was intended to be disposed of only to professional investors, retail investors might have their interest piqued and, relying on the minimum investment amount, might wrongly think the Fund was intended for them. But, if that were so, a retail investor would soon be disabused of this misapprehension upon his expressing an interest in the Fund to the appellants. Once telephone or other inquiries informed a retail investor that the Fund was not intended for disposal to him, there would be no interest of the retail investor for the statutory regime to protect, save possibly from a waste of the time necessary to discover that the Fund was only for professional investors. There is nothing to suggest the legislative purpose of section 103(3)(k) is to protect retail investors from wasting their time or, alternatively, against having their investment appetites whetted."

10. Finally, the CFA rejected the SFC's contention that the purpose of the Exemption would be frustrated by adopting Pacific Sun's construction of the Exemption. At paragraph 47 of the Judgment, Mr Justice Fok PJ had this to say:

"On the contrary, to accept the Commission's ("SFC's") construction of the exemption would require the Court "to attribute to a statutory provision a meaning which the language of the statute, understood in the light of its context and the statutory purpose, is incapable of bearing". The statutory purpose of investor protection is achieved on the appellants' construction since the burden remains on the issuer of the advertisement to demonstrate that the investment product is or is intended for disposal only to professional investors.

11. Despite the clarity of the CFA's decision, the SFC says that potential problems may arise in enforcing this provision to protect retail investors. We question this analysis and would ask the SFC to articulate what harm has come to or may come to retail investors by the issue of advertisements for products which will in fact only be sold to professional investors. We do not believe that it is part of the SFC's regulatory objectives to protect investors from merely seeing advertisements when those relying on this Exemption are under an obligation to demonstrate that in fact they intend only to sell or have actually sold the relevant only to professional investors.

12. All regulated firms that have a condition on their license that they can deal with professional investors or are offering investment products which are not authorized by the SFC are obliged to ensure that only those who qualify as professional investors are actually permitted to purchase such products and that such products are suitable for each such professional investor. In our submission, this requirement, in conjunction with the terms of the Exemption, provides ample protection for retail investors. Further or alternatively, the SFC's amendments appear disproportionate in answer to what appears to be a theoretical harm which may not be capable of quantification in any meaningful way.

13. Furthermore, imposing a requirement on licensees that advertisements may only be issued to investors who have already been identified as professional investors through KYC and suitability procedures would cause unnecessary disruption to the dynamic process of marketing funds.

14. Based on the cogent judgment of the CFA discussed above and in the absence of evidence that the Exemption fails to provide adequate investor protection, we submit that the amendments proposed by the SFC are simply unnecessary. In the seven years since the CFA's decision, the Exemption has operated without significant difficulty as far as we are aware. If the SFC is committed to amending the Exemption, we submit it needs to provide a more compelling case for change which identifies actual practical problems that investors have

encountered with the operation of the Exemption. Otherwise, the current proposed amendments appear disproportionate and undesirable.

Question 4: Do you agree with the proposal to expand the scope of insider dealing provisions of the SFO to cover insider dealing perpetrated in Hong Kong with respect to overseas-listed securities or their derivatives? Please explain your view.

Law Society's response:

We agree with the proposal, for reasons that should be self-evident – namely, to protect investors, the integrity of markets and/or the wider public interest.

Question 5: Do you agree with the proposal to expand the scope of insider dealing provisions of the SFO to cover insider dealing perpetrated outside of Hong Kong, if it involves any Hong Kong-listed securities or their derivatives? Please explain your view.

Law Society's response:

We agree with the proposal, for reasons that should be self-evident – namely, to protect investors, the integrity of markets and/or the wider public interest.

The Law Society of Hong Kong
16 August 2022