Civil sanctions will fail

A civil regime to penalise non-disclosure of information will not work. Hong Kong needs criminal sanctions

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"After carefully considering market comments, we propose adopting an evolutionary approach in developing a statutory disclosure regime, by focusing on inside information and civil sanctions."

In March this year, Hong Kong released a consultation paper on giving statutory backing to the disclosure of price-sensitive information. The government has proposed a civil regime to police breaches of this legislation but, despite leaving room for "evolution" to stronger sanctions, some market participants believe that civil sanctions are not enough, even in the short term. Instead, only criminal penalties can act as a deterrent to non-disclosure.

As David Webb, an activist for shareholder rights, says: "What's the point in producing a defective vehicle in the first place; why not produce a system that actually works?" Jamie Allen, secretary general at the Asian Corporate Governance Association agrees. "As usual, we're taking the incremental Hong Kong approach to solving a problem," he says. "Rather than coming up with the right solution, they are coming up with the politically acceptable solution."

But Webb and Allen are not just frustrated about the slow pace of change in Hong Kong or the lobbying of government by business interests. Both have serious doubts about the enforceability of a civil regime. The government wants to allow the Market Misconduct Tribunal (MMT) to use a range of civil sanctions – including regulatory fines – but this may contravene Hong Kong law.

In addition, the MMT is a small organisation with limited experience. Even if it can legally penalise companies and individuals with fines, will it have the clout to do so? The government may have to consider evolving to a criminal regime more quickly than it anticipates if it wants to be seen acting strongly against breaches of disclosure requirements.

The government stated in its consultation paper – and reiterated in a statement to IFLR last week – that "Since the Market Misconduct Tribunal has experience in dealing with cases concerning "inside information"... we propose extending the jurisdiction of the MMT to breaches of the statutory disclosure requirements."

However, although the MMT was set up in April 2003, the body was not referred its first case until June 2007. Since then, the tribunal has heard four cases (concerning QPL International Holdings, Sunny Global Holdings, Mobicon Group, and China Overseas Land and Investment). The MMT has a permanent secretariat and chairman – Mr Justice Lunn – but hearings are overseen by a panel of three comprising Lunn and two "ordinary members". Ordinary members are selected from a group of professionals appointed by Hong Kong's chief executive. As Allen comments: "The MMT hasn't been around for that long and hasn't done a huge amount. If the MMT is going to play a central role enforcing this then it does not bode well."

The Koon Wing Yee case

But of greater concern is whether the MMT can legally enforce all the civil sanctions outlined in the government's consultation paper. As Section 257 of the Securities and Futures Ordinance (SFO) outlines, the tribunal already has the power to impose some of these penalties – such as disqualifying a director for five years – but up until now it has not been empowered to fine companies or individuals. And, practically, it may not be allowed to going forward.

In the case of Koon Wing Yee vs Insider Dealing Tribunal, the Court of Final Appeal ruled in March 2008 that tribunals did not have the power to impose punitive fines, only orders to disgorge the amount of profit gained or loss avoided, and that the imposition of a fine by such a body would contrive the Bill of Rights

As a result, any attempt by the MMT to impose a fine under the new legislation would likely be subject to judicial review. This would inhibit the smooth running of enforcement, undermine the authority of the MMT, and as Webb says, "if you don't have any fines, or fining powers are ruled unconstitutional, then you're basically left with the same system of reprimands and censures that we already have".

However, in a statement to IFLR, the government said: "The proposed regulatory fine on breaches of PSI [Price-Sensitive Information] disclosure requirements would only apply to a limited class of persons". For example, it may be possible for the tribunal to order fines of licensed individuals through their licensing bodies. Justice Lunn, chair of the MMT, also suggests this may be a way that fines can be imposed: "It will be interesting to see how the government believes it can sail between Scylla and Charybdis on fining but I'm quite sure leading counsel will have been consulted on this point. It may be possible in the context of the fine being imposed by a body to which you belong."

But even if the MMT is able to overcome its lack of experience and find a way to fine, the limited sanctions available to it are unlikely to encourage timely disclosure of price-sensitive information. The government wants to cap fines at HK$8 million ($1 million), regardless of the severity of the perpetrator's non-disclosure. The consultation paper does provide that "persons suffering pecuniary loss as a result of others breaching the disclosure requirements could rely on the MMT findings to take civil actions to seek compensation." This could increase the overall penalty for an infringement, but Hong Kong does not have a strong history of litigation by individuals against companies. "I think investors will be underwhelmed by this legislation. It will be seen as incremental and weak and will not have as big an impact on the disclosure of price-sensitive information as criminal sanctions," says Allen.

Why not criminal?

Criminal sanctions were originally considered to deter non-disclosure. In November 2009, an internal document circulated around the exchange outlining plans to criminalise "intentional or reckless" non-disclosure under Part XIV of the SFO. Criminal sanctions were also considered in the previous two rounds of consultation on giving statutory backing to some or all of the listing rules. However, the government moved away from this regime, citing concerns about defining a breach of non-disclosure, international precedents, and "market comments".

In paragraph 2.26 of its consultation paper, the government expresses concerns that price-sensitive information is a subjective concept and should not therefore be policed by a criminal regime. This is a concern that corporates also voice. One person close to an organisation of listed companies says: "Listed companies in general feel that civil sanctions are more appropriate as what is price sensitive is at the discretion of directors' judgement." If non-disclosure would prompt criminal sanctions, the market could be flooded with information as companies and their directors seek to ensure that no information that could be price-sensitive remains undisclosed.

However, in defining what information should be disclosed, the government proposes borrowing the concept of "relevant information" currently used to prosecute insider dealing, and renaming it "inside information". Insider dealing is dealt with under a dual criminal and civil regime. As David Webb says: "Anyone who says that's too grey a concept for a criminal law has forgotten that it's exactly that definition which is used in the insider-dealing law."

The government also repeatedly turns to select international precedents – namely the EU and UK – to justify a civil regime. Both are also mentioned in the government's statement to IFLR, and followed immediately by the words: "In light of all these, we propose that a range of civil sanctions... be imposed." The UK's legislation on disclosure of price sensitive information comprises the Disclosure and Transparency Rules (DTR Rules), which came into effect in July 2005. These rules implement an EC directive on the matter and a civil regime which is enforced by the Financial Services Authority (FSA) under the Financial Services and Markets Act (FSMA).

However, unlike Hong Kong's proposals, the UK FSA can impose unlimited fines. And the UK's corporate governance and shareholder culture are rather different to Hong Kong. Unlike the UK, many Hong Kong-listed companies have one large shareholder or have a large proportion of shares owned by one family. The UK's diverse shareholder base provides an incentive to disclose that does not exist in Hong Kong as UK companies need to keep their shareholders informed to maintain a good relationship.

Jamie Allen believes the government is "cherry-picking" which international experience it uses as a precedent. Australia, for example, has a criminal regime. Under the Corporations Act, the country operates a three-tier system against infringements of its continuous disclosure requirements. At an administrative level, the Australian Securities and Investments Commission (Asic) is first able to issue infringement notices to companies, issuing a non-binding fine for slightly belated disclosure or other minor breaches. Companies can either accept and pay the fine, or apply to Asic to have it withdrawn. The regulator can follow up with more serious charges if a company chooses to ignore such a notice. More serious breaches can be dealt with under the civil penalty regime. Companies can be fined up to A$1 million ($903,750) per breach, while individuals are liable for A$200,000.

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Jamie Allen, Asian Corporate Governance Association

The breach has to be proven "on the balance of probabilities". For very serious breaches of continuous disclosure or allegations of insider dealing, a case can be brought under the criminal regime. The case must be proved "beyond all reasonable doubt" and individuals can face up to five years in jail. In practice, criminal sanctions have been used to prosecute insider dealing rather than non-disclosure, but the Director of Public Prosecutions has the discretion to recommend criminal or civil sanctions for non-disclosure.

Influential feedback

So why has Hong Kong opted for a civil regime (and supported its stance with selective international precedents) if "inside information" is a well understood concept in criminal law? The government's consultation paper hints at another potential reason for its rejection of criminal sanctions: market comments. Throughout the paper, the government mentions feedback from previous consultations and suggests that it has done further soft consultation before publishing this paper: "In developing the proposed disclosure obligation, we have engaged market participants to have a better grasp of the key areas to which we should pay attention".

K.S. Lo, for example, chairman of Great Eagle and of the Chamber of Hong Kong Listed Companies, confirmed that "the Chamber has expressed our views to the Government" on price-sensitive information in the organisation's Winter 2009 newsletter. However, Jamie Allen says that the Asian Corporate Governance Association was not spoken to, nor (to his knowledge) were members. Hong Kong's tycoons are rumoured to have lobbied the government on price-sensitive information. As Allen says: "I understand that the government watered down its proposals under strong pressure from the tycoons. The government is simply not prepared to take them on."

Attempts by the listing committee to introduce another transparency-boosting reform, extending the blackout period, failed in February 2009 after several tycoons expressed their opposition in an open letter published in local newspapers. Webb believes the decision not to introduce criminal sanctions "fits the trend which has been clear since the blackout saga that the government will only do things that the tycoons will accept and will drag its feet and prevaricate on everything else".

Hong Kong's political system makes it likely that certain business interests will continue to exert a lot of influence over the pace of reform. The chief executive is elected by the Election Committee (and then approved by Beijing) which comprises 800 members from professional industries, including 664 from different sectors of the economy. Meanwhile, the Securities and Futures Commission's directors are appointed by the government, as are the board of the stock exchange, limiting disagreement with official policy. The Legislative Council (LegCo) will debate statutory backing before it becomes law and it could encourage a rethink on the type of sanctions; the Financial Affairs Panel held an initial discussion on the proposed legislation on May 3. However, while better legislation could result, this might delay implementation.

But if Hong Kong does not create a more transparent investing environment – by having criminal sanctions for non-disclosure, for example – it could ultimately damage its reputation as a financial centre.

As David Webb says: "The future of Hong Kong's capital markets depends on having a competitive advantage. If there are checks and balances to deter bad behaviour, companies get better share prices because investors will pay more as they expect to lose less from abuse. The latest proposals once again show the power of the tycoons in our political system, holding back the reforms that would increase our competitive advantage as a financial market."