Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong

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While under British administration (1842-1997), Hong Kong imported British laws wholesale without regard to the differences between England and Hong Kong. This article examines the sanctions aspect of the imported corporate and securities norms. One distinguishing feature of the corporate and securities regulatory framework is that its core has no legal force and therefore carries no legal sanctions.

While nonlegal sanctions may have been effective in England where there was a cohesive upper-class, this article contends that Hong Kong has none of the necessary conditions for successful implementation of nonlegal regulations. Moreover, nonlegal regulations are unnecessary because the merits of self-regulation — expertise, timeliness and industry participation — are severable from and attainable independently of nonlegal regulations. They are undesirable on at least three grounds: lack of effective sanctions, lack of compensation to victims and damage to the social fabric. It is proposed, therefore, that Hong Kong take stock of its nonlegal regulations and elevate their core to a legal status with a private right of action for breach.

It is also proposed that, due to ineffective private enforcement, the Securities and Futures Commission be given the power and duty to bring actions on behalf of investors for compensation for loss resulting from a breach of the new regulations. Finally, despite the abundance of criminal offences on the statute books, there are few prosecutions and these result in fairly low penalties. Such a system is unsatisfactory, not least because it smacks of favoured treatment of white-collar crime. This article argues that while the power of imprisonment must be held in reserve, there are dangers inherent in the application of criminal sanctions to corporate and securities offences and Hong Kong should explore alternative and more creative sanctions.

Sous l'administration britannique (1842-1997), Hong-Kong a adopté les lois britanniques en bloc sans considérer les différences existant entre l'Angleterre et Hong-Kong. Cet article examine les normes importées en droit des valeurs mobilières et s'attarde particulièrement au volet des sanctions. L'une des caractéristiques du système de règlements des valeurs mobilières est l'absence de force légale rattachable aux règlements au coeur du système.

Alors que les sanctions non-légales ont pu être efficaces en Angleterre grâce à une classe dirigeante cohésive, cet article tente de démontrer que Hong-Kong n'a pas les éléments nécessaires pour l'implantation de règlements sans force légale. Toutefois, ces derniers ne sont pas indispensables puisque les mérites de l'autoréglementation — expertise, célérité et participation de l'industrie — sont dissociables des règlements sans force légale. Au moins trois facteurs rendent ce type de règlements indésirables : l'absence de sanctions efficaces, le manque de compensation pour les victimes et les dommages causés au tissu social.

L'auteure propose que Hong-Kong fasse le point et transforme le coeur des règlements sans force légale en leur donnant un statut légal accompagné d'un droit d'action privé. L'auteure propose aussi que, vu l'inefficacité de l'application privée des règlements, l'on remette à la *Securities and Futures Commission* le pouvoir et le devoir d'agir au nom des investisseurs lésés par la violation des nouveaux règlements. Enfin, l'auteure démontre que malgré l'abondance de délits prévus par la loi, il y a peu de poursuites et que ces dernières aboutissent à des peines relativement clémentes. Un tel système est insatisfaisant et laisse tout au moins entrevoir un biais de traitement favorable des délits financiers. L'auteure conclut que bien que le pouvoir d'incarcération doit être tenu en réserve, l'application de sanctions criminelles dans le droit des valeurs mobilières comporte des risques. Hong-Kong devrait rechercher avec créativité des sanctions alternatives.

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Introduction

It is said and hardly disputed that effective corporate law is context-specific.[1] Despite the obvious differences, Hong Kong imported, lock, stock and barrel, English corporate and securities norms. This state of affairs is typical of Hong Kong's colonial past. One of the first laws passed by the local legislature established in 1843, one year after Hong Kong became a British colony, declared that English laws applied in the city.[2] Subsequent versions of the *Application of English Law Ordinance* provided that the common (decisional) law applies automatically in Hong Kong, subject to changes necessitated by local circumstances, but that statutory law only applies exceptionally.[3] While U.K. corporate and securities statutes have never been applicable in Hong Kong and while the legislature has been free to enact its own laws, it quite decorously, as befitting a colony, passed copycat statutes. For instance, the first *Companies Act* of the U.K. was enacted in 1862,[4] consolidating developments since 1844. Hong Kong followed with its first *Companies Ordinance* of 1865.[5] The *Companies Act 1908*[6] was followed by the *Companies Ordinance* 1911,[7] and so on. Many of such English imports have become fossilized in the host, devoid of relevance to the community and unrecognizable in their country of origin.

On July 1, 1997, the People's Republic of China ("P.R.C.") resumed the exercise of sovereignty over Hong Kong. Hong Kong is now a special administrative region of the P.R.C. (the Hong Kong Special Administrative Region, or H.K.S.A.R.). Its mini-constitution, the Basic Law,[8] provides that it shall have a high degree of autonomy[9] and that its previous capitalist system and way of life shall remain unchanged for fifty years.[10] Specifically, it is provided that "the laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation, and customary law shall be maintained except for any that contravene the Basic Law, and subject to any amendment by the legislature of the H.K.S.A.R."[11] As the tenor of the Basic Law is to preserve the existing legal system, there is no reason to believe that a future court will find that the present corporate commercial laws are in contravention of the Basic Law. It is therefore expected that the basic tenets of the corporate com-

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[1] See B. Black & R. Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 Harv. L. Rev. 1911 at 1914.

[2] See *Laws of Hong Kong, No. 6 of 1845*, 1845, s. 4.

[3] See *Application of English Law Ordinance*, 1966 (Cap. 88), s. 4.

[4] *Companies Act, 1862* (U.K.), 25 & 26 Vict., c. 89.

[5] *Companies Ordinance 1865*, No. 1 of 1865.

[6] *Companies (Consolidation) Act, 1908* (U.K.), 8 Edw. 7, c. 69. Unless otherwise indicated, "Companies Act" refers to the Companies Act of the U.K.

[7] *Companies Ordinance 1911*, No. 58 of 1911.

[8] Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, 3d Sess., 7th National People's Congress ("N.P.C."), 4 April 1990, reprinted in 29 I.L.M. 1519. Also available at http://www.cityu.edu.hk/Basic Law/b1.htm (17 June 1997).

[9] See *ibid.* art. 2.

[10] See *ibid.* art. 5.

[11] *Ibid.* art. 8.

mercial laws will not be affected by Hong Kong's new status.[12] However, there can be no objections to improving the law so long as its basic structure and spirit are unchanged — and improvement is sorely needed.

The economy of Hong Kong has undergone many reincarnations: from trading to light manufacturing to services. Today, the service industry contributes at least 83% of the gross domestic product of the people. Although financing, insurance, real estate and business services represent only 11.8% of those employed in the service sector, they contribute 26.1% of the G.D.P. generated by the service sector.[13] Thus, business services contribute relatively more than other sectors to the economy of Hong Kong. To be able to continue to deliver services at international standards, Hong Kong needs better soft infrastructure including better business laws. The end of colonial rule is an appropriate time for us to consider the fundamentals of our earlier English imports and to adapt them to be context specific. As mutants, such imports will have a chance to take root and to grow strong. Given the importance of the financial markets to Hong Kong, corporate[14] and securities laws obviously top the list of priorities.

For manageability, this article confines itself to the system of sanctions and will not address the merits of the rules regulating participants and their conduct in the securities[15] market. Part I briefly describes the regulatory framework to reveal three distinctive features. First, the core of corporate and securities "regulations" has no legal force and therefore carries no legal sanctions. Second, private enforcement of the corporate and securities regulations that do have legal force is so beset with difficulties as to be nonexistent. Third, there is an abundance of criminal offences on the statute books but with fairly low penalties and too few prosecutions.[16] This article contends that such a system

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[12] While the effect of the repeal of the Application of English Law Ordinance by the Standing Committee of the National People's Congress (decision adopted at its 24th sitting on 23 February 1997) awaits elucidation by the courts, most commentators believe the common law system in Hong Kong is not threatened ("What Future the Common Law?" *Hong Kong Lawyer* (July 1997) at 30). As Professor Ghai has argued, given the change of sovereignty, the establishment of the Court of Final Appeal in Hong Kong and the provisions of the Ordinance which apply English common law subject to local circumstances, it is open to the H.K.S.A.R. to depart from pre-July 1997 decisions of the Privy Council and the House of Lords. Future English decisions will be regarded as persuasive only and the H.K.S.A.R. will be able to draw on decisions from England and other common law jurisdictions to develop a uniquely Hong Kong common law (Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law* (Hong Kong: Hong Kong University Press, 1997) at 343-47). Since Hong Kong is meant to develop its own common law system on the fonndations of pre-July 1997 law, the formal repeal of the Ordinance should not affect the basic tenets of corporate commercial laws.

[13] B. Howlett, ed., *Hong Kong 1996* (Hong Kong: Government Printers, 1996).

[14] This article is only concerned with corporate law as applicable to public companies.

[15] Also for manageability, the term securities is used in the narrow sense: the futures market is excluded from this discussion.

[16] The enforcement record described in the text accompanying notes 156-68 should be seen in the context of the size of the securities market. As at December 31, 1995, there were 553 stocks listed on the Securities Exchange of Hong Kong with a capitalization of US$301 billion. This placed Hong Kong after New York, Tokyo, London, Toronto and Germany in terms of market capitalization (see Securities Exchange of Hong Kong, *Stock Exchange Fact Book 1995* at 78).

of sanctions is fundamentally flawed and requires root-and-branch reform. The absence of legal sanctions and ineffective private enforcement have always been justified on the ground of self-regulation. Part II explores the meaning of self-regulation and argues that it is not synonymous with nor dependant upon nonlegal regulation.[17] Part III considers the merits of private enforcement and its practicability in Hong Kong. Part IV considers the desirability of criminal sanctions and the inherent difficulties in their application. Notwithstanding the importance of the public enforcement of laws, this article does not propose to examine the powers of investigation and prosecution now contained in the *Companies Ordinance*[18] and the *Securities and Futures Commission Ordinance*.[19] I conclude with a summary of reform proposals.

I. The Regulatory Framework

As mentioned, Hong Kong's first companies legislation was enacted in 1865. The forerunner of Hong Kong's first stock exchange was established in 1891, but securities regulations were not introduced until 1974,[20] following the first major crash in 1973. By 1987, Hong Kong had three principal regulations governing the securities market: (i) a *Companies Ordinance*[21] which was a recognizable copy of the *Companies Act 1948*[22] with superimposed amendments incorporating developments in the U.K.; (ii) a *Securities Ordinance*[23] which required registration of stockbrokers and advisers;[24] and (iii) a *Protection of Investors Ordinance*[25] which proscribed fraudulent or reckless inducements to invest in securities or other property. Hong Kong had two exchanges: the Stock Exchange of Hong Kong Ltd. ("S.E.H.K.") and the Hong Kong Futures Exchange Ltd. ("H.K.F.E."). Supervising these were two part-time commissions, the Securities Commission and the Commodities Trading Commission, which had as their executive arm an underfunded Office of the Commissioner of Securities.[26] In fact, the Commissions degenerated into advisers for the Commissioner, except that

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[17] This term is used in this article to mean regulations without the force of law.

[18] *Companies Ordinance* (Cap. 32) [hereinafter C.O.].

[19] *Securities and Futures Commission Ordinance* (Cap. 24) [hereinafter S.F.C.O.].

[20] *Securities Ordinance*, No. 12 of 1974; *Protection of Investors Ordinance*, No. 13 of 1974.

[21] *Supra* note 18.

[22] *Companies Act 1948* (U.K.), 11 & 12 Geo. 6, c. 38.

[23] *Securities Ordinance* (Cap. 333) [hereinafter S.O.].

[24] As a review committee appointed by the Governor following the 1987 Crash noted, registrations were granted semi-automatically, on a 'nothing known against' basis: Securities Review Committee, Report on the Operations and Regulation of the Hong Kong Securities Industry (Hong Kong: Government Printers, 1988) [hereinafter Securities Review Report] at paras. 10.20-10.21.

[25] *Protection of Investors Ordinance* (Cap. 335). Modelled on ss. 13 and 14 of the *Prevention of Frand (Investments) Act, 1958* (U.K.), 6 & 7 Eliz. II, c. 45.

[26] In 1986-87 the Office of the Commissioner of Securities had a budget of HK$13.4 million: Securities Review Report, *supra* note 24 at para. 9.23.

in the 1987 Crash, their advice was not even sought.[27] The whole structure has been condemned for being *ad hoc*, with no one being firmly in the driving seat.[28]

The 1987 stock market crash exposed the weakness of the system and prompted its overhaul over the next two years. Today, the Securities and Futures Commission ("S.F.C.") stands at the apex of the regulatory framework. Under British rule, the directors of the S.F.C. were appointed by the Governor[29] who could give compulsory orders.[30] Its budget was approved by the Governor[31] and had to be presented to the Legislative Council.[32] Compared to its predecessor, these arrangements gave the S.F.C. a prominent status and assured substantial funding for it.

The S.F.C. is charged, *inter alia*, with the enforcement of corporate and securities laws,[33] the supervision and monitoring of the S.E.H.K., the H.K.F.E. and their clearing houses, the licensing and regulation of securities and futures dealers and advisers, the suppression of illegal, dishonourable and improper practices, and the protection of investors.[34]

The S.E.H.K. is a private company with a monopoly to operate the only stock market in Hong Kong.[35] Admission to membership on the S.E.H.K. is determined by its governing body, the Council, which is unaccountable for its decision.[36] The reforms forced upon the S.E.H.K. after the 1987 crash included the appointment of independent members to the Council[37] and the professionalization of its management. Its chief executive, whose appointment must be approved by the S.F.C.,[38] is an *ex officio* member of the Council.[39]

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[27] For an account of this period, see R. Fell, *Crisis and Change: The Maturing of Hong Kong's Financial Markets* (Hong Kong: Longman, 1992).

[28] See Securities Review Report, *supra* note 24 at paras. 9.1-9.28.

[29] See S.F.C.O., *supra* note 19, ss. 5 (1) and (8). As from 1 July 1997, any reference to the Governor of Hong Kong shall be construed as a reference to the Chief Executive of the H.K.S.A.R.: *Hong Kong Reunification Ordinance*, No 110 of 1997, s. 7.

[30] See *ibid.*, s. 11.

[31] See *ibid.*, s. 14(2).

[32] See *ibid.*, s. 14(3).

[33] These laws as specified in the S.F.C.O. are: parts of the *Companies Ordinance* (C.O.), *supra* note 18, the *Securities Ordinance*, *supra* note 23, the *Commodity Exchanges (Prohibition) Ordinance* (Cap. 82), the *Commodities Trading Ordinance* (Cap. 250), the *Protection of Investors Ordinance*, *supra* note 25, the *Stock Exchanges Unification Ordinance* (Cap. 361) [hereinafter S.E.U.O.], the *Securities (Clearing Houses) Ordinance* (Cap. 420), the *Securities (Disclosure of Interests) Ordinance* (Cap. 396) and the *Securities (Insider Dealing) Ordinance* (Cap. 395).

[34] See S.F.C.O., *supra* note 19, ss. 4(1)(b), (d), (e), (g), (h).

[35] See S.E.U.O., *supra* note 33, s. 27 (1); S.O., *supra* note 23, s. 20(1).

[36] See Memorandum and Articles of Association of The Stock Exchange of Hong Kong Limited (incorporated 7 July 1980), art. 13 [hereinafter S.E.H.K. Articles].

[37] *Ibid.*, art. 87A(a).

[38] See S.E.U.O., *supra* note 33, s. 10A.

[39] See S.E.H.K. Articles, *supra* note 36, art. 87A (a)(vii).

The S.E.H.K. has two principal functions. It controls the entrance of dealers into the market and regulates their conduct. It also sets the terms and conditions under which issuers can list and trade their securities on the exchange.

In addition to the legislation already mentioned, the S.F.C., directly or through the S.E.H.K. or others, administers three principal pieces of regulation which have no legal force: the *Listing Rules*,[40] the Hong Kong *Code on Takeovers and Mergers*[41] and three collective investments codes.[42] The following sections highlight certain parts of the *Listing Rules* and the *Takeovers Code* and their enforcement through civil actions and criminal sanctions. Highlights are selected on the ground that they cover an important part of corporate and securities activity perceived to be in need of regulation not provided by law. It should be emphasized at the outset that this article does not attempt to analyze the merits of the contents of these regulations. For the purpose of this article they are assumed to be good; for if they were not, they should be removed even as nonlegal regulations. The central question of this article is why, if they are good, they are left in a nonlegal state.

A. *The* Listing Rules

The *Listing Rules* prescribe the conditions and resulting obligations for listing. The substantive content deals with issues not adequately addressed by corporate and securities laws. The *Listing Rules* themselves declare: "the rules seek to secure for holders of securities, other than controlling interests, certain assurances and equality of treatment which their legal position might not otherwise provide."[43] This section highlights three such assurances designed to protect the rights of shareholders from the inherent risks of non-disclosure, excessive executive remuneration and self-dealing. The effectiveness of enforcement of the *Listing Rules* by the S.F.C. and the S.E.H.K. will be examined using references to misconduct reported in the press.

1. Disclosure

True to the disclosure base of Anglo-American securities regulations,[44] the *Companies Ordinance* prescribes disclosure obligations on the initial flotation of a com-

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[40] S.E.H.K., *Rules Governing the Listing of Securities* [hereinafter *Listing Rules*].

[41] *The Codes on Takeovers and Mergers and Share Repurchases* (April 1996) [hereinafter *Takeovers Code*].

[42] These are the *Code on Unit Trusts and Mutual Funds* (February 1995), the *Code on Investment-linked Assurance and Pooled Retirement Funds* (April 1995) and the *Code on Immigration-linked Investment Funds* (February 1993). To keep this article manageable, the collective investments codes will not be examined.

[43] *Listing Rules*, *supra* note 40, rule 2.03.

[44] In the words of Justice Brandeis, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman" (L.D. Brandeis, *Other People's Money and How the Bankers Use It* (Fairfield, New Jersey: Augustus M. Kelley, 1932) at 92).

pany.[45] These provisions date from 1948 and are deficient. The *Companies Ordinance* has no provisions dealing with secondary distributions by substantial shareholders or with distributions to the public by a person of securities previously acquired under exemption.[46] Disclosure is not required when issuing securities to existing shareholders or in relation to shares that are uniform with those already listed on the S.E.H.K.[47] These omissions cannot be justified on the ground of company registration since continuous disclosure requirements are also inadequate.[48] The deficiencies in prospectus requirements have been rectified in the *Listing Rules*.[49]

Since 1934, it has been recognized in the U.S. that continuous disclosure by companies after flotation is as important as disclosure at the time of flotation. Except for the issue of an annual financial report, the *Companies Ordinance* does not prescribe any disclosures subsequent to flotation. This omission has also been rectified by the *Listing Rules*.[50]

2. Executive Remuneration

In Hong Kong, as elsewhere, there is frequent criticism of the princely sums paid to managers of public companies. The *Companies Ordinance* contains no provision regulating the formation of service or management contracts or the remuneration of managers. Even the statutory model articles allow directors to approve each other's remuneration as executives.[51] Restraint on executive remuneration takes the form of disclosure of the aggregate amount of directors' emoluments in the annual financial statements.[52] Since the introduction of a law for the disqualification of directors, there has been additional indirect legal restraint.[53] However, as excessive remuneration is only one of the many factors considered in the disqualification of directors, it is fair to say that disqualification is probably not an effective deterrent of excessive remuneration. If restraints are needed, they are not provided by law.

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[45] See C.O., *supra* note 18, ss. 37-45.

[46] Except for the limited anti-avoidance provision of s. 41, *ibid.*

[47] *Ibid.* ss. 38(5), 342(5)(a), (b).

[48] As regards the difference between and the relative merits of these types of registration, see M.B. Fox, "Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis" (1984) 70 Va. L. Rev. 1005; J.C. Coffee, Jr., "Re-engineering Corporate Disclosure: The Coming Debate Over Company Registration" (1995) 52 Wash. & Lee L. Rev. 1143.

[49] *Listing Rules*, *supra* note 40, rule 11.04 requires a prospectus for listing by way of offers for subscription, offers for sale, placings, introductions, rights issues, open offers, capitalisation issues and an exchange or substitution of securities but prescribes different content requirements for each.

[50] *Ibid.*, rule 2.03 (3).

[51] C.O., *supra* note 18, First Schedule, Table A, Reg. 86 (3), (4).

[52] *Ibid.*, s. 161.

[53] This was introduced in the U.K. in 1971 and made considerably more rigorous in 1986: *Company Directors Disqualification Act 1986* (U.K.) c. 46. These provisions were adopted in Hong Kong in 1984 and 1994 respectively. In Hong Kong, the current disqualification provisions were adopted in 1994 and are contained in Part IVA of the C.O., *ibid.*

A solution is attempted in the *Listing Rules* which mandate additional disclosure. Annual reports are required to include an analysis of the remuneration of directors and to classify the five individuals with the highest remuneration into brackets: (i) from 0 to HK$1,000,000[54] and (ii) thereafter into brackets of multiples of HK$500,000.[55]

3. Self-Dealing

It is common knowledge that Hong Kong public companies are far from the Berle and Means model.[56] Instead, they are controlled by individuals, often the founding family. According to one study in 1988, 54% of the stock-market capitalization of Hong Kong was controlled by the top ten families.[57] It is also common knowledge that there is extensive self-dealing between controlling shareholders and their companies.

The provisions in the *Companies Act*[58] regulating self-dealing between directors and their companies have been criticised as inadequate.[59] It is acknowledged that such self-dealings require supervision and regulation. In the case of self-dealing by controlling shareholders, there are no regulations at all. This means that minority shareholders can only look to the common law for relief.

As the controlling shareholder is not considered a fiduciary under Anglo — Hong-Kong common law, there is no basis for requiring substantive fairness in self-dealings. As far as procedural fairness is concerned, there is some law on the question of the controlling shareholder's right to vote, but the law is unclear. While some courts have taken the view that a controlling shareholder has absolute freedom in the

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[54] As of 23 July 1997, HK$1= CAN$ 0.1784: *The [Toronto] Globe and Mail* (23 July 1997) B21.

[55] *Listing Rules*, *supra* note 40, App. 7, para. 9 (1) (q) (i), (ii).

[56] See A.A. Berle & G.C. Means, *The Modern Corporation and Private Property*, rev. ed. (New York: Harcourt, Brace & World, 1968). Berle and Means showed the dispersion of stock ownership and the resulting control of American public companies by non-stockholding management.

[57] S.G. Redding, *The Spirit of Chinese Capitalism* (New York: De Gruyter, 1993) at 151-153. A recent survey by the Hong Kong Society of Accountants shows that almost 90% of listed companies have a major shareholder who by himself or with family members owns 25% or more of the share capital. The distribution of shareholding is as follows:

0 -	<10%	4%
10 -	<25%	8%
25 -	<35%	11%
35 -	<50%	24%
> 50%		53%

Source: Hong Kong Society of Accountants, *Second Report of the Corporate Governance Working Group 1997* at 12.

[58] *Supra* note 22.

[59] L.C.B. Gower, *Principles of Modern Company Law*, 5th ed. (London: Sweet & Maxwell, 1992) at 559-64, 576-78.

exercise of his voting rights,[60] others are of the view that there are restraints.[61] It is, however, difficult to divine distinctions between the cases. The Privy Council places a distinction between voting as a shareholder and voting as a member of a class of shareholders, without giving any rationale for it.[62] Another case differentiated ordinary resolutions and special resolutions.[63] Some despair of finding a principle for restraining the controlling shareholder's exercise of voting rights and others even write that principles are a bad thing.[64]

This defect is rectified in the *Listing Rules*, which stipulate special approval procedures for five types of important transactions.[65] For example, the connected transaction, primarily a transaction between a company and any of its subsidiaries and a connected person,[66] is conditional upon approval by shareholders[67] and must be disclosed to the S.E.H.K., to the public by a press release and to the shareholders by a circular.[68]

4. Status and Enforcement of the *Listing Rules*

The S.E.H.K.'s power to make rules includes enforcing the various agreements made on listing and designing the penalties or sanctions that may be imposed.[69] In pursuance of such powers, the S.E.H.K. has reserved the authority to cancel or to suspend the listing of any securities if the listed company fails, in a manner which the S.E.H.K. considers material, to comply with the *Listing Rules* or its listing agree-

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[60] See *e.g.*: *Northern Counties Securities Ltd* v. *Jackson & Steeple Ltd.*, [1974] 2 All E.R. 625, 1 W.L.R. 1133 at 1144, Walton J.: "When a shareholder is voting for or against a particular resolution he is voting as a person owing no fidicuary duty to the company and who is exercising his own right of property, to vote as he thinks fit".

[61] See *e.g.*: *Estmanco (Kilner House) Ltd.* v. *Greater London Council*, [1982] 1 All E.R. 437, 1 W.L.R. 2 at 11: "Plainly there must be some limit to the power of the majority to pass resolutions which they believe to be in the best interests of the company and yet remain immune from interference by the courts".

[62] See *British America Nickel Corporation* v. *M.J. O'Brien Ltd.*, [1927] A.C. 369 at 371, 1 D.L.R. 1121 (P.C.).

[63] See *Greenhalgh* v. *Arderne Cinemas Ltd.*, [1951] Ch. 286 at 291, [1950] 2 All E.R. 1120 (Eng. C.A.).

[64] "I think that one thing which emerges from the cases to which I have referred is that in such a case as the present, [the controlling shareholder] is not entitled to exercise her majority vote in whatever way she pleases. The difficulty is in finding a principle, and obviously expressions such as 'bona fide for the benefit of the company as a whole', 'fraud on a minority' and 'oppressive' do not assist in formulating a principle. I have come to the conclusion that it would be unwise to try to produce a principle, since the circumstances of each case are infinitely varied": *Clemens* v. *Clemens Bros Ltd.*, [1976] 2 All E.R. 268 at 282.

[65] *Listing Rules*, *supra* note 40 at c. 14.

[66] *Ibid.*, rule 14.23 (1) (a). A Connected Person includes a substantial shareholder, a person who is entitled to exercise or control the exercise of ten per cent or more of the voting power at any general meeting of the company or his associates (*ibid.*, rule 2.01.).

[67] Any connected person interested in the transaction should abstain from voting, *ibid.*, rules 14.26, 14.27.

[68] *Ibid.*, rule 14.29.

[69] See S.E.U.O., *supra* note 33, s. 34(1)(a), (v).

ment.[70] The S.F.C. also has a general power to direct a suspension of dealings in the public interest for the maintenance of an orderly market, for the protection of investors, or where there has been misleading information circulated by or on behalf of an issuer.[71] In addition, if the Listing Committee finds there has been a breach of the *Listing Rules*, it may impose sanctions ranging from a private reprimand to the denial of market facilities.[72] The potential offenders against whom sanctions may be applied are: (a) the listed company or any of its subsidiaries, (b) any director of a listed company or any of its subsidiaries, or any alternate of such directors, (c) any member of the senior management of a listed company or any of its subsidiaries, (d) any substantial shareholder of a listed company, (e) any professional adviser of a listed company or any of its subsidiaries, (f) any sponsor of a listed company or a new applicant, (g) any authorized representative of a listed company and (h) any supervisor of a company from the P.R.C.[73]

As an assessment of its record of enforcement, in its first two years of operation, the S.F.C. reported a total of five cancellations or withdrawals of listings,[74] with no subsequent cancellation reported. The annual reports of the revamped S.E.H.K. for the period from 1989 to 1996 disclose the following disciplinary proceedings against directors of listed companies: in 1993-94, three out of eight disciplinary proceedings resulted in public censure[75] and in 1994-95, twenty-three out of twenty-five received public censure.[76]

In the years concerned, three main forms of director misconduct and breaches of *Listing Rules* were reported in the press. First, in relation to the flotation of company shares, directors and their sponsors failed to ensure an open market. Such incidents were reported in the S.F.C.'s annual reports[77] and in the financial press:

> The new-listing business in Hong Kong between 1991 and 1993 was the Big Lie of the decade. It was a mechanism whereby some second-rate companies, aided and abetted by commission-driven merchant bankers, took money out of

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[70] *Listing Rules*, *supra* note 40, rule 6.01 (1).

[71] *Securities (Stock Exchange Listing) Rules* (Cap. 333), rule 9 (1989).

[72] The sanctions are: (a) private reprimand, (b) public criticism, (c) public censure, (d) reporting the offender's conduct to the appropriate regulatory authority (including professional bodies), (e) banning offenders from representing a specified party in relation to a stipulated matter coming before the Listing Division or before the Listing Committee for a stated period, (f) requiring remedial action including the appointment of an independent adviser to minority shareholders, (g) public statements that the retention of office by an offending director is prejudicial to the interests of investors, (h) suspension or cancellation of listing if the recreant director remains in office despite such criticism; (i) denial of market facilities for a specified period and prohibiting dealers and financial advisers from acting or continuing to act for the offending issuer, and (j) publicizing any action taken: *Listing Rules*, *supra* note 40, rule 2A.09.

[73] *Ibid.*, rule 2A.10.

[74] S.F.C., *Annual Report 1989* at 52, *Annual Report 1990/1991* at 48.

[75] S.E.H.K., *Annual Report 1994* at 25.

[76] S.E.H.K., *Annual Report 1995* at 45.

[77] S.F.C., *Annual Report 1993/1994* at 18; S.F.C., *Annual Report 1994/1995* at 17-19.

> the hands of retail investors in a process legitimised by the Hong Kong Stock Exchange's listing procedures.[78]

Action was recently taken in two cases where prospectuses proved unreliable. In one case, trading in the shares has been suspended pending the outcome of talks between the S.F.C. and the company.[79] In another case, the directors were publicly censured by the S.E.H.K.[80]

The second type of misconduct concerned directors' non-disclosure of their criminal past. In 1994 and 1995, six directors were exposed as having failed to disclose their criminal convictions prior to their own election as directors or upon listing their company. All have been reprimanded and all but one have resigned. Initially the authorities refrained from initiating proceedings under section 36 of the *Crimes Ordinance*[81] due to insufficient evidence of mens rea[82] and the failure of the declaration to

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[78] "Listing Shams Faced Scrutiny" *The [Hong Kong] Sunday Morning Post* (4 June 1995) M3.

[79] Pam & Frank International Holdings Ltd. (Pam & Frank) was listed in 1992. In 1993 anonymous allegations were made to the S.F.C. that false entries had been made in the accounts of Pam & Frank and that therefore its prospectus had been inaccurate: S.F.C., *Annual Report 1993/1994*, *supra* note 77 at 25-26. The Commercial Crime Bureau (C.C.B.) became involved in investigations of the company and its chairman. On February 3, 1994 newspapers reported that the directors of Pam & Frank and its chairman apologized for having issued inaccurate and misleading statements: *South China Morning Post* (3 February 1994). The shares which had been suspended when the allegations first surfaced were relisted on February 8, 1994. It plunged 23% in the first hours: *South China Morning Post* (9 February 1994). The C.C.B. investigations was completed by January 1996 when the C.C.B. came to the conclusion that there was insufficient evidence for prosecution. However, the S.F.C. was of the view that the allegations of falsification were accurate, *i.e.* a misleading prospectus had been issued. In the meantime the company experienced a decline in earnings and entered restructuring talks with its bankers. Trading was suspended again on August 14, 1996 pending a financial restructuring and the outcome of talks with the S.F.C. concerning the misleading prospectus: Pam & Frank International Holdings Ltd., Annual Report 1996 at 31.

[80] Iwai's International Holdings was listed in October 1995. In December it reported an unexpected collapse in profits for the period ending 30 September. Disclosures in the prospectus had been made on the basis of audited financial statements to the end of June: "Exchange Censures Iwai's for Negligence" *South China Morning Post* (15 July 1996) B1; "The Tough Questions are Being Asked, Way Too Late" *South China Morning Post* (8 January 1996) 28.

[81] *Crimes Ordinance* (Cap. 200), s. 36:

> Any person who knowingly and wilfully makes (otherwise than on oath) a statement false in a material particular, such statement being made —
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> (a) in a statutory declaration; or
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> (b) in an abstract, account, balance sheet, book, certificate, declaration, entry, estimate, inventory, notice, report, return or other document which he is authorized or required to make, attest or verify, by any enactment for the time being in force; or
>
> (c) in any oral declaration or oral answer which he is required to make by, under or in pursuance of any enactment for the time being in force,
>
> shall be guilty of an offence and shall be liable on conviction upon indictment to imprisonment for 2 years and to a fine.

[82] "Censured directors let off the hook" *South China Morning Post* (10 November 1995).

qualify within the ambit of the section.[83] The public pressure was, however, too great and a prosecution was launched against one of the six directors, a solicitor who had failed to declare his conviction on nine charges of corruption in 1960. The prosecution failed on the ground feared: the declaration was not a statutory declaration because it was not made orally with the required formalities.[84] Although the S.E.H.K. has since revised its forms, it has no means of controlling the administration of declarations. The only way to ensure that declarations filed by directors are actionable is to give statutory authority to the requirement, a course of action that the S.F.C. was said to have been considering although no action has yet been taken.[85]

The third misconduct, which came to light in 1995, concerns questionable and undisclosed loans by companies to their directors. Shortly after its listing in 1994, Cheerful Holdings Ltd. began to make a series of loans to Mr. Chee Jing Yin, its chairman, and continued lending until May 1995. These loans on average amounted to approximately 74% to 180% of the company's net tangible assets. Mr. Chee failed to secure proper disclosure and approval of these loans as required by the *Listing Rules* and was publicly censured by the S.E.H.K. in June 1995.[86] Similarly, Lion Asia Ltd. made two loans representing 8% and 24% respectively of its net tangible assets to connected persons in 1994. Three directors of the company were publicly censured.[87] Dr. Frank Sze-Bang Chao, a director of Wah Kwong Shipping Holdings Ltd., went one step further. He borrowed HK$38 million from the company over a period of three to four years without the knowledge of the board of directors. The loans came to light during the audit of the company's financial statements for the year ending March 31, 1995. Dr. Chao was publicly censured.[88] Fortunately for the shareholders, all loans have been repaid with interest. In summary, although the *Listing Rules* have addressed lacunae in the existing law, the lack of effective means of enforcement by the S.F.C. and the S.E.H.K. has deprived the *Listing Rules* of their force.

B. *The* Takeovers Code

1. The Law

Serious abuses associated with takeovers, such as insider trading and market manipulation, are proscribed by law.[89] There are, however, no statutes regulating takeovers *per se*. At common law, directors have no duty to communicate the terms of a

[83] "S.F.C. to Plug Loophole in Directors' Declarations" *South China Morning Post* (29 December 1995) 3.

[84] *R.* v. *Robert Eli Low*, (27 November 1996), Magistracy Appeal No. 1180 of 1996 Hong Kong Supreme Court.

[85] *Supra* note 83.

[86] S.E.H.K., Public Censure Announcement (23 June 1995) in *South China Morning Post* (26 June 1995).

[87] *Ibid.*

[88] S.E.H.K., Public Censure Announcement (8 August 1995) in *South China Morning Post* (9 August 1995).

[89] *Securities (Insider Dealing) Ordinance*, *supra* note 33, s. 9; S.O., *supra* note 23, ss. 135-37.

bid to shareholders[90] nor to consider whether the bid would be in their best interest.[91] Since a bidder has no relationship with the shareholders of the target, he owes no duty of disclosure. This principle was confirmed in the U.S. where a shareholder was unsuccessful in restraining a bid on the grounds that the bidder failed to disclose its existing shareholdings, its plans for the target, its financing, its knowledge and market prices.[92] In a takeover involving securities exchanges, one might have thought that the bidder should at least comply with the prospectus requirements concerning itself and the securities it proposes to issue in exchange. An English court rejected that argument.[93]

2. The Nature and Ambit of the *Takeovers Code*

Even more than the *Listing Rules*, the *Takeovers Code* is a copy of British regulations. The origin of the *Takeovers Code* can be traced to the Securities Advisory Council, established in 1973 to consider and to propose securities legislation. The Council, and the Securities Commission which succeeded it in 1974, decided to follow the approach of the *City Code on Take-overs and Mergers*[94] ("*City Code*"). A version of the *City Code* was published in 1975 and major revisions were made in 1992. In that year, the S.F.C., in consultation with the Takeovers and Mergers Panel ("Panel"), issued the *Takeovers Code* which has been extensively redrafted to bring it in line with the *City Code*.

The *Takeovers Code* is drafted in the form of principles and rules. Some rules are examples of the application of principles and others are rules of procedure to ensure their implementation. The administrators may modify or relax the application of a rule in exceptional circumstances, for example, when they believe that its strict application would operate harshly.[95]

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[90] See *Enterra Corporation* v. *SGS Associates*, 600 F. Supp. 678 (E.D. Pa. 1985).

[91] See *Dawson International plc* v. *Coats Paton plc* (1988), [1989] B.C.L.C. 233.

[92] See *Jacobsen Manufacturing Company* v. *Sterling Precision Corporation*, 282 F. Supp. 598 (E.D. Wis. 1968).

[93] See *Governments Stock and Other Securities Investment Co.* v. *Christopher*, [1956] 1 All E.R. 490, 1 W.L.R. 237. The reasons given were, firstly, that the bidder was not required to issue a prospectus because the document he issued was headed "Forms of Acceptance and Transfers" whereas the statute only required prospectuses to accompany "forms of application for shares". This part of the reasoning is still applicable today. Secondly, the document issued by the bidder was not a prospectus and therefore was not required to be in the statutory form. The definition of a prospectus then read: "a prospectus offering to the public for subscription or purchase of any shares". The court held that subscription involved the notion of payment in cash which was not required in the impugned transaction. The current definition of prospectus refers to subscriptions "for cash or other consideration". Therefore, this part of the reasoning is no longer applicable. However, if the bidder offers shares which are to be in all respects uniform with shares previously issued and listed on the S.E.H.K., an exemption from most of the prospectus regulations is available: C.O., *supra* note 18, s. 38(5)(b).

[94] Panel on Takeovers and Mergers, *City Code on Take-overs and Mergers* (1975).

[95] *Takeovers Code*, *supra* note 41, Introduction, para. 2.1.

3. Substantive Contents

There are seven principal requirements of the *Takeovers Code*.[96] Bidders and their financial advisers must take care not to launch a bid which they are unable to execute. During the bid, all persons concerned should make full and prompt disclosure to prevent a false market. Except as permitted by the *Takeovers Code*, neither bidders nor targets should favour some shareholders with information. Shareholders of the target should be given sufficient information, advice and time to reach an informed decision on an offer. Furthermore, all shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly. If control of a company changes, is acquired or is consolidated, a general offer should be made to all other shareholders. The board of directors of the target has a duty to advise them.

4. Enforcement and Sanctions

The sanctions that may be imposed by the Panel, similar to those of the *Listing Rules*, range from private reprimands to a denial of market facilities.[97] As the *Listing Rules* require compliance with the *Takeovers Code*,[98] a breach of the code also constitutes a breach of the *Listing Rules*.

In its *Annual Report 1993/1994*, the S.F.C. noted the following beneficial effects of the *Takeovers Code*: "We have enquired into numerous takeover situations, resulting in bids being made for the benefit of minority shareholders in a number of cases and the prices of the bids being increased in others."[99]

5. Case Study

In November 1988, William K.M. Cheng acquired 34.5% of Shun Ho Resources Holdings Ltd. ("Shun Ho"). He was, in fact, acting in concert with others and had acquired beneficial interests of more than 35% and therefore should have made a general offer. In June 1991, another transaction triggered an investigation by the S.F.C. which led to the discovery of the 1988 transgression. In 1993, the Panel held hearings and ordered Mr. Cheng to compensate beneficial owners of shares on the date of breach. Mr. Cheng applied for judicial review of the Panel's decision. In October

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[96] *Ibid.* at General Principles 1-6, Rule 2.1.

[97] The sanctions are: (a) a private reprimand, (b) issuance of a public statement which involves criticism, (c) public censure, (d) reporting the offender's conduct to the S.F.C. or another regulatory authority (for example, the S.E.H.K., the Commissioner of Banking or any professional body) or to an overseas regulatory authority, (e) requiring dealers and advisers, for a stated period, not to act or continue to act in any or a stated capacity for any person who has failed to comply, or has indicated that he does not intend to comply, with either Code or a ruling, (f) banning advisers from appearing before the Executive or Panel for a stated period, and/or (g) such other action to be taken or not taken, as it thinks fit: *Ibid.*, Introduction 12.1 (an 'order' to make compensation has been made under the last head: *Re Cheng Kai Man William* (1995) 16 S.F.C. Bulletin 11.

[98] *Listing Rules*, *supra* note 40 at App. 7, para. 3 (2).

[99] S.F.C., *Annual Report 1993/1994*, *supra* note 77 at 5; see also, S.F.C., *Annual Report 1995/1996*, para. 2.32.

1995, the Privy Council ruled in favour of the S.F.C.[100] Mr. Cheng then accepted the Panel's decision, apologized for having contested it, acknowledged the S.F.C.'s order requiring compensation but stated that he had no cash resources. Accordingly, the Panel ordered that Mr. Cheng be denied access to the facilities of the securities markets until he had satisfied claims for compensation or for a limited period of five years.

Three days after the publication of the S.F.C. order, Shun Ho published an announcement in the newspapers clarifying the order, that the order did not affect Shun Ho, Shun Ho Construction (Holdings) Ltd. or any other company in the Shun Ho group. The Shun Ho directors opined that the S.F.C. order should not affect the business nor the financial position of the group.[101] The clarification was indeed correct. Shun Ho, the listed company, was not itself in breach of the *Takeovers Code*, which it had agreed to observe on listing. Mr. Cheng, as director of Shun Ho, had to sign a director's undertaking to comply with the code but that undertaking only required him to abide by the code in the exercise of his powers and duties as a director of Shun Ho. What was outstanding was his personal obligation as bidder, which was not covered by the undertaking. Although the omission is not a loophole, it puts in relief the futility of the sanction and the powerlessness of the S.F.C. It is right that the *Takeovers Code* does not seek to impose any obligation on the target itself or to deny it any market facility because any such sanction would injure the minority shareholders as well. However, as the bidder's corporate entities are not affected, the force of the sanction is considerably weakened and he has little incentive to pay voluntarily.

In December 1996, a newspaper reported that Mr. Cheng had increased his holdings indirectly in the Shun Ho group and continued:

> We attempted to do some totals for Mr. Cheng. The market value of his increased holdings in the three Shun Ho stocks has reached HK$53.75 million. The amount of compensation which Mr. Cheng has owed to minority shareholders since last year is only HK$49 million. If Mr. Cheng *et al.* sell their increased holdings at today's prices, Mr. Cheng still has close to HK$5 million in change after repaying the minority shareholders. Put another way, if Chairman Cheng had not increased his holdings and had used the amount so invested, namely HK$28 million, to repay minority shareholders, they at least would have received 60% of their due.[102]

What the report made clear is that whether or not Mr. Cheng had other resources, he had large holdings in Shun Ho which could have been liquidated or used to raise funds if only there had been a way to compel him so to do. The *Takeovers Code*, like the *Listing Rules*, addresses cracks in the legal framework, but has little force because of the lack of effective means of enforcement.

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[100] *Panel on Takeovers & Mergers & ANOR* v. *Cheng Kai Man William*, [1995] 3 H.K.C. 517 (P.C.).

[101] Company announcement, *South China Morning Post* (4 December 1995).

[102] *Hong Kong Economic Times* (3 December 1996) 56 [author's own translation].

C. Enforcement by Civil Action

Enforcement of corporate and securities norms by civil action in Hong Kong is inhibited by substantive and procedural roadblocks. The substantive difficulty is establishing a cause of action based on an implied right of action for breach of statute or on a right of action for breach of nonlegal regulation. The procedural obstacle is satisfying the requirements for derivative and class actions.

1. Causes of Action

The courts have created duties of care and of loyalty owed by directors, executives, trustees and investment advisers. Causes of action are also expressly created by statute: civil liability is prescribed for fraudulent trading,[103] misstatements in prospectuses[104] or other inducements to invest,[105] and unlawful distributions.[106] Ostensibly, the public investor has a cause of action for breach of a common-law duty or a statutory provision enacted for his benefit, but practical and procedural obstacles remain.

In many more cases, however, acts are proscribed or prescribed without any mention of civil consequences. The question then arises whether there could be an implied private cause of action for breach of statute. There is no consensus among the courts on a methodology to imply such a right.[107] Some courts state they give effect to the intention of the legislature,[108] some admit they only give effect to their own intention,[109] while others change their minds over the years.[110] The absence af any guiding principles was best expressed by Lord Denning: "you might as well toss a coin to decide".[111]

As the methodology for implying rights of actions is nebulous, applying this doctrine to corporate and securities regulations is bewildering. The courts have held that breaches of certain regulations are actionable. For instance, issuance of shares at a discount is prohibited; injunctions have been granted and directors and allottees have been held accountable.[112] Issuance of shares for consideration in kind is subject to regulations; allottees and transferees who know, or have reason to know, that their shares have not been regularly allotted are liable to repay the value of the shares.[113]

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[103] C.O., *supra* note 18, s. 275(1).

[104] *Ibid.*, s. 40.

[105] *Protection of Investors Ordinance*, *supra* note 25, s. 8.

[106] C.O., *supra* note 18, s. 79M(1).

[107] *Solomons* v. *R. Gertzenstein Ltd.*, [1954] 2 Q.B. 243 at 253, 2 All E.R. 625 (Eng. C.A.); *Maceachern* v. *Pukekohe Borough*, [1965] N.Z.L.R. 330 at 332.

[108] *Cutler* v. *Wandsworth Stadium Ltd.*, [1949] A.C. 398 at 407-17.

[109] *O'Connor* v. *S.P. Bray Limited*, [1936-37] 56 C.L.R. 464 at 478, Dixon J. (Aust. H.C.).

[110] *E.g.* Kitto J. in *Australian Iron and Steel Limited* v. *Ryan*, [1956-57] 97 C.L.R. 89 at 98 (Aust. H.C.) and *Sovar* v. *Henry Lane Pty. Limited*, [1966-67] 116 C.L.R. 397 at 405 (Aust. H.C.).

[111] *Ex parte Island Records Ltd.*, [1978] 1 Ch. 122 at 135, 3 All E.R. 824 (Eng. C.A.).

[112] *Mosely* v. *Koffyfontein Mines Limited*, [1904] 2 Ch. 108 (Eng. C.A.); *Hirsche* v. *Sims*, [1894] A.C. 654 (P.C.); *Welton* v. *Saffery*, [1897] A.C. 299 (H.L.).

[113] *Re London Celluloid Company*, [1888] 39 Ch. D. 190 (Eng. C.A.); *Re African Gold Concessions and Development Company Markham and Darter's Case*, [1899] 1 Ch. 414.

While corporate distributions are regulated by the *Companies Ordinance*, it merely provides for the liability of a recipient of unlawful distributions to repay.[114] On the other hand, despite the absence of provisions regarding directors' liability, the courts have held them liable without providing an explanation.[115] A common feature of the cases is the absence of discussion of a rationale for an implied right of action. Also common to the cases is the characterization of the wrong as *ultra vires*.[116]

There is one reported English decision dealing explicitly with private actions for the breach of corporate and securities regulations. In *Conway* v. *Petronius Clothing Co.*,[117] a director sued his co-directors and sought an order for production of corporate books. The 1948 *Companies Act*[118] stipulated that records were open to inspection by directors and provided a fine for non-compliance. Slade J. rejected an implied right of action for breach of statutory obligations:

> The sanction of criminal proceedings, however, may tend to show that the statutory obligation is imposed for the public benefit and that the breach of it is intended to be a public wrong, not a private wrong giving rise to an action at the suit of an individual injured.[119]

However, since the court had a residual discretion to entertain the action, it granted relief because the right of a director to inspect corporate records is a common-law right recognized, not conferred, by statute.[120]

The above authorities suggest that unless an independent common-law right is found, a breach of a statutory obligation does not imply a private cause of action. This conclusion also finds support in two Canadian decisions dealing directly with the issue of private rights of action in securities.[121]

As for rights of action for nonlegal regulations, they offer little recourse to shareholders. There is no common-law right of action against the S.E.H.K. for failure to implement or for negligently implementing its *Listing Rules*,[122] and this immunity has been confirmed by statute.[123] As regards causes of action against the offender for vio-

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[114] C.O., *supra* note 18, s. 79M(1).

[115] *Re Alexandra Palace Company*, [1882] 21 Ch. D. 149; *Re Sharpe*, [1892] 1 Ch. 154 (Eng. C.A.).

[116] The abolition of the *ultra vires* doctrine (Hong Kong, *Companies (Amendment) Ordinance No. 3 of 1997*, s. 6) would place these decisions in doubt unless some other ground for action is explicated.

[117] [1978] 1 All E.R. 185, 1 W.L.R. 72 [cited to W.L.R.].

[118] *Supra* note 22, s. 147.

[119] *Supra* note 117 at 86.

[120] See *ibid.* at 90.

[121] See *Exco Corporation* v. *Nova Scotia Savings & Loan Co.* (1987), 35 B.L.R. 149, 78 N.S.R. (2d) 91; *Ames* v. *Investo-Plan Ltd.*, [1973] 35 D.L.R. (3d) 613, 5 W.W.R. 451 (B.C.C.A.).

[122] See *Richardson Greenshields of Canada (Pacific) Ltd.* v. *Keung Chak-kin*, [1989] 2 H.K.L.R. 103 (H.C.) (no right of action against Hong Kong Futures Exchange); *Yuen Kun Yeu* v. *Hong Kong (A.G.)*, [1988] 1 A.C. 175, [1987] 2 All E.R. 705 (P.C.) (no action against the Commissioner of deposit-taking companies); *Li Ngan-shui Brumen* v. *Hearder*, [1995] 2 H.K.L.R. 248 (C.A.) (no action against a trustee in bankruptcy); *Melton Medes Ltd* v. *Securities and Investments Board*, [1995] Ch. 137, 3 All E.R. 880 (no action against The Securities and Investment Board).

[123] S.E.U.O., *supra* note 33, s. 27A (3); S.F.C.O., *supra* note 19, s. 56 (1).

lation of the *Listing Rules*, since the *Listing Rules* constitute contracts among various parties other than the public investor, the doctrine of privity of contract would preclude a public investor from bringing an action.[124] Listed companies agree in their listing agreements to observe the *Takeovers Code*.[125] The shareholders are not parties to this contract and cannot enforce it. Bidders which are not listed companies do not assume obligations to observe the *Takeovers Code*, although it purports to apply to them.[126] Shareholders of the target are even further removed from the bidder and do not even have a remote basis for action.

In summary, a right of action exists for breach of a common-law duty, or where expressly provided by statute. However, no right of action may be inferred for breach of statute or of nonlegal regulation.

2. Derivative Actions

The rule in *Foss* v. *Harbottle*[127] states that the proper plaintiff, in respect of a wrong alleged to be done to a company or an association of persons, is *prima facie* the company. Ultimately a simple majority of shareholders has the right to determine whether to take action in the company's name. Consequently, if the simple majority is the wrongdoer or is otherwise associated with or sympathetic to him, the minority has no recourse. This state of affairs is intolerable even under English law, which established exceptions to the *Foss* v. *Harbottle* rule. These exceptions allow the minority to sue on behalf of itself and all the shareholders, excluding the defendant. This is the derivative action, the fruits of which belong to the company. These exceptions are, however, narrowly and confusingly interpreted by the courts. Professor Gower argues that this results from the court's hostility towards the derivative action:

> One gets the impression that the Bench as a whole likes the *Foss* v. *Harbottle* rule so much and derivative actions so little that it is reluctant to recognise any exceptions to the rule when the plaintiff seeks derivative relief [as opposed to personal relief against infringement of personal rights].[128]

There is no better evidence of this hostility than the decision of the English Court of Appeal in *Prudential Assurance Co.* v. *Newman Industries Ltd. (No 2)*.[129] In the *Newman* case, two directors were sued by minority shareholders alleging that they conspired to use the funds of their company ("N. Ltd.") to aid another company ("T. Ltd.") of which they were also directors. This was done without the knowledge or authority of the board of N. Ltd. The two defendants then made misrepresentations to the board of N. Ltd. to induce it to take over T. Ltd. A misleading circular was sent to

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[124] See *Tweddle* v. *Atkinson* (1861), 121 E.R. 762, 1 B. & S. 762; *Beswick* v. *Beswick*, [1968] A.C. 58, [1967] 2 All E.R. 1197 (H.L.).

[125] See *Listing Rules*, *supra* note 40, App. 7, para. 3 (2).

[126] *Takeovers Code*, *supra* note 41 at Introduction, para. 4.1.

[127] (1843), 67 E.R. 189, 2 Hare 461.

[128] L.C.B. Gower, *supra* note 59 at 660.

[129] [1982] 1 Ch. 204, 1 All E.R. 354 (Eng. C.A.) [hereinafter *Newman* cited to Ch.].

the shareholders of N. Ltd. who approved the transaction. The plaintiff who led the opposition held 3.2% of the ordinary shares of N. Ltd.

Counsel for the defendant company stated that the independent board of directors did not want the action to be allowed to proceed. However, no proof was given of the independence of the board, nor were they put to any test. The trial judge refused to try as a preliminary issue the capacity of the plaintiff to sue derivatively.[130] He then made serious findings of conspiracy and fraudulent conduct.[131] The Court of Appeal reversed the findings on five of six misconducts and reduced the losses from £450,000 to £45,000.[132]

The Court was scathing in its criticism of the trial judge and the plaintiff. The defendants, including the director who had remained in office, were encouraged to contest their liability for costs, on the ground that they were not as culpable as the plaintiff painted them to be.[133] Considering the difficulties the plaintiff faced in conducting the action without information except such as was publicly available — difficulties clearly understood by the court[134] — and considering the respectability of the plaintiff, the *Newman* decision sent the clearest possible signal to minority shareholders: go away.

3. Class Actions

A private cause of action, express or implied, in favour of members of the investing public is ineffective unless investors can join forces and pool resources in a class action. Although class actions are now associated with American litigiousness, it has a respectable English origin[135] and is provided for in the *Supreme Court Rules*.[136]

However, the law of class actions is underdeveloped in England and in Hong Kong. This is both the cause and effect of the paucity of class actions. The rules so far developed are unduly restrictive. Despite some sympathetic views,[137] investors in a securities fraud case are unlikely to be able to sue as a class.[138] There are few controls over the selection of the representative of the class or over the carriage of the case. For example, it is not necessary to obtain a certificate of class status before commencing the action. Anyone may initiate a class action by issuing the writ in a representa-

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[130] See *Prudential Assurance Co.* v. *Newman Industries Ltd.*, [1980] 2 W.L.R. 339, [1979] 3 All E.R. 507 at 510.

[131] *Prudential Assurance Co.* v. *Newman Industries Ltd. (No.2)*, [1980] 2 All E.R. 841 at 855.

[132] See *Newman*, *supra* note 129.

[133] See *ibid.* at 235-36.

[134] See *ibid.* at 225.

[135] *Cockburn* v. *Thompson*, [1809] 16 Ves. Jun. 1005.

[136] *Supreme Court Rules*, Rule 12, Order 15 [H.K.]. As of 1 July 1997, any reference to the Supreme Court of Hong Kong shall be construed as a reference to the High Court of the H.K.S.A.R., *surpa* note 29, s. 6.

[137] *Supra* note 129; *E.M.I. Records Ltd.* v. *Riley*, [1981] 1 W.L.R. 923, 2 All E.R. 838.

[138] *Makrt & Co.* v. *Knight Steamship Co.*, [1900] 2 K.B. 1021 (Eng. C.A.); *Electrical, Electronic, Telecommunication and Plumbing Union* v. *Times Newspapers Ltd.*, [1980] 1 Q.B. 585, 1 All E.R. 1097.

tive capacity, although the court may not allow the action to proceed if the class is improperly constituted[139] or if the initiator cannot be trusted to provide proper representation of the class.[140] The representative cannot be dislodged by dissenting members of the class, who may participate only as defendants.[141] The representative has complete carriage of the action, and may discontinue the action or settle at will. Discontinuance of the action does not prejudice other members of the class from initiating their own action.[142] On the other hand, settlement or dismissal of the action is binding on all members.[143] Estey J. of the Supreme Court of Canada commented on the Canadian version of the same English model: "the skeletal nature of Rule [12] suffers from a host of procedural deficiencies that ... can be addressed only by wholesale reform of the law of class actions in Ontario."[144] These procedural difficulties are insurmountable for the small investor. Civil actions may not be easily instigated as the causes of action are restricted to breach of common-law duties and of express statutory rights. Furthermore, the courts have been reluctant to allow derivative actions. The English model of class actions and role of the class representative create insurmountable hurdles.

D. Enforcement by Criminal Sanctions

General criminal law is sometimes employed to punish corporate or securities offenders. For example, a director or shareholder who misuses corporate assets for personal benefit can be charged with theft.[145] A person who provides false information on his application for an investment representative licence can be prosecuted for obtaining a pecuniary advantage by deception.[146] Persons who issue a false prospectus can be charged with conspiracy to cheat and defraud.[147] In turn, those who spread false rumours can be charged with conspiracy to affect the price of government funds.[148]

1. Offences under Corporate and Securities Laws

A myriad of offences is created under the corporate and securities laws of Hong Kong. The *Companies Ordinance*[149] lists offences and their punishment, including 121 punishable by fines alone and forty-six leading to imprisonment. The fines range

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[139] See *Burt* v. *British Nation Life Assurance Association*, [1862] 4 De G. & J. 162; *Wolff* v. *Van Boolen* (1906), 94 L.T. 502.

[140] See *Re The Services Club Estates Syndicate Ltd.*, [1930] 1 Ch. 78.

[141] See *Fraser* v. *Cooper, Hall & Co.*, [1882] 21 Ch. D. 718.

[142] See *Abraham* v. *Prosoccer Ltd* (1980), 31 O.R. (2d) 475, 119 D.L.R. (3d) 167.

[143] See *Watson* v. *Cave (No. 1)*, [1881] 17 Ch. D. 19 (Eng. C.A.); *Re Calgary and Medicine Hat Land Company*, [1908] 2 Ch. 652 (Eng. C.A.).

[144] *Naken* v. *General Motors of Canada Ltd.*, [1983] 1 S.C.R. 72, 144 D.L.R. (3d) 385 at 400.

[145] See *Christakis Philippou* (1989), 89 Cr. App. R. 290 (Eng. C.A.); *McHugh* (1989), 88 Cr. App. R. 385.

[146] See S.F.C., *Annual Report 1995/1996*, *supra* note 99 at 44-45 (re Tang Wing Leung).

[147] See *R.* v. *Aspinall*, [1876-77] 2 Q.B.D. 48 (Eng. C.A.).

[148] See *R.* v. *De Berenger* (1814), 3 M. & S. 67. In that case, the rumour was of Napoleon's death.

[149] *Supra* note 18, Sch. 12.

from HK$25,000 to HK$100,000 and imprisonment from six months to two years. The *Securities and Futures Commission Ordinance*[150] creates twelve offences, eleven of which are punishable by a fine of HK$1,000,000 and imprisonment for two years on conviction by indictment or a fine of HK$100,000 and imprisonment for six months on summary conviction. The *Securities Ordinance*[151] creates at least forty-two offences, most of which are punishable only by fines ranging from HK$2,000 to HK$500,000. Fourteen offences are punishable by fine and imprisonment, ranging from HK$2,000 and three months in jail to HK$50,000 and two years. The *Securities (Disclosure of Interests) Ordinance*[152] creates at least sixteen offences with punishment ranging from a fine of only HK$2,000 to a fine of HK$100,000 and imprisonment for two years. The *Securities (Insider Dealing) Ordinance*[153] creates four offences punishable by fine and imprisonment ranging from HK$100,000 and six months in jail to HK$1,000,000 and two years. The *Protection of Investors Ordinance*[154] creates five offences with punishment ranging from a fine of only HK$10,000 to HK$1,000,000 and seven years in jail. The *Commodities Trading Ordinance*[155] creates at least twenty-seven offences with punishment ranging from a fine of HK$5,000 to a fine of HK$1,000,000 and imprisonment for seven years.

2. Enforcement Record

Despite a provision encouraging bounty hunters,[156] there are few criminal prosecutions. The S.F.C.'s *Annual Report 1995/1996*[157] discloses the following enforcement actions. Ten defendants were convicted under twenty-three summonses for breach of the *Leverage Foreign Exchange Trading Ordinance*,[158] the *Securities Ordinance*[159] and the *Commodities Trading Ordinance*[160] and fined an average of HK$11,630.43 per summons.[161] Seven defendants were convicted under twenty-two summonses for breach of the *Protection of Investors Ordinance*[162] and fined an average of HK$10,181.81 per summons.[163] Seventy-six defendants were convicted under 234

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[150] *Supra* note 19, ss. 21-59.

[151] *Supra* note 23, ss. 20-146.

[152] *Supra* note 33, ss. 15-42.

[153] *Ibid.*, ss. 18-30.

[154] *Supra* note 25, ss. 3-7.

[155] *Supra* note 33, ss. 23-113.

[156] C.O., *supra* note 18, s. 352.

[157] *Supra* note 99 at 41-45.

[158] (Cap. 451).

[159] *Supra* note 23.

[160] *Supra* note 33.

[161] The offences were mostly employing unlicensed employees (see *Annual Report 1995/1996*, *supra* note 99).

[162] *Supra* note 25.

[163] The offences were selling unauthorized investment arrangements (see *Annual Report 1995/1996*, *supra* note 99 at 42).

summonses for short-selling and fined an average of HK$2,561.96 per summons.[164] In addition, in 1993 a person who manipulated the market for shares of a company at a profit of HK$22,715,000 was sentenced to four months' imprisonment, suspended for twelve months and ordered to pay costs of HK$476,858 to the S.F.C. It was the first prosecution in Hong Kong of a person for market manipulation.[165] This was followed by another case in 1994 in which the accused manipulated the market by making wash sales that constituted up to fourteen percent of the total market turnover in the shares of the company. He pleaded guilty and was sentenced to six months' imprisonment, suspended for twelve months and ordered to pay to the S.F.C. costs of HK$100,000.[166] In 1995, one person was sentenced to imprisonment for six months for providing false information on an application for an investment representative licence[167] and another was sentenced to imprisonment for three months, suspended for two years, fined HK$5,000 and ordered to pay costs of HK$27,000 to the S.F.C. His crime was providing false information in regard to the paid-up capital of his company in order to retain a licence as an investment adviser.[168]

E. Summary

The regulations highlighted from the *Listing Rules* and the *Takeovers Code* are not matters of detail or novelty: they are the very core of corporate and securities norms in Hong Kong. They are elaborate and, particularly in the case of the *Listing Rules*, legalistically drafted. The regulations are administered by or under the supervision of quasi-governmental bodies possessing delegated regulatory authority. As the regulations are not law and their infringement is not a breach of law, two consequences follow. First, as argued above, since a breach is not actionable, a person injured has no legal claim to compensation. Second, as will be argued in Part II, the available sanctions are ineffective. Also, despite the abundance of laws, the application of criminal sanctions is sporadic and lenient. Such a system is fundamentally flawed and requires root-and-branch reform.

II. Nonlegal "Regulations"

The nonlegal status of the core of corporate and securities regulations has been justified on the ground of self-regulation. Self-regulation is an article of faith of securities practitioners in Hong Kong. In most financial markets there is hostility towards outside regulation; this is particularly true in Hong Kong where outside regulation was only recently introduced into a well-established market. In order to secure

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[164] Fines ranged from HK$500 to HK$30,000 and amounted to HK$599,500 (see *ibid.* at 44-45). This was an unusual year. Fifty-five of the prosecutions arose out of short-selling in the securities of two issuers. The corresponding figures for 1994-95 were seven persons convicted and fined an aggregate of HK$88,000 (see *Annual Report 1994/1995*, *supra* note 77 at 22).

[165] See *Annual Report 1993/1994*, *supra* note 77 at 22.

[166] See *Annual Report 1994/1995*, *supra* note 77 at 21-23.

[167] See *Annual Report 1995/1996*, *supra* note 99 at 44-45.

[168] See *ibid.* at 41.

industry support for regulation, self-regulation is written into the law.[169] This Part examines the meaning and merit of self-regulation and nonlegal regulations, and their proper role in the regulatory framework.

There is no doubt that nonlegal sanctions are applied with great effect in commercial relationships even where legal regulation and legal sanctions are available. Professor Charny identified three types of nonlegal sanctions. The first type is the simplest; it is the sacrifice of a relationship-specific prospective advantage.[170] In the corporate and securities field, this means forfeiting the culprit's licence to practise or to raise funds in the market — an empty threat. Other types of sanctions are the sacrifice of psychic and social goods, and the loss of reputation among market practitioners.[171] Whether old-style self-regulation is suitable to Hong Kong depends on whether these sanctions can be applied with effect.

A. Old English-Style Self-Regulation

Although the term self-regulation is bandied about, it is very difficult to define it as idealized and practised in pre-"Big Bang" England.[172] The Bank of England has described self-regulation in these terms:

> the realization by a group of individuals or institutions that regulation of their activities is desirable in the common interest, and their acceptance that rules for the performance of functions and of duties should be established and enforced ... In some cases the enforcement of such standards is entrusted to a committee of a profession or of practitioners in a market. Frequently, however, the enforcement of the regulations may be entrusted to an authority outside the group, which is or becomes customarily recognized and obeyed and which may also become the initiator of new regulations ... In both cases the system can be described as self-regulation, the first intrinsically so, the second by common consent.[173]

This description embraces two central themes: the rules are self-generated and are enforced by and with the consent of the regulated. The idealized version of self-regulation then predicates self-regulation on nonlegal regulation. This is the sense in which the term "old English-style" (or "old-style") self-regulation is used in this arti-

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[169] The S.F.C.'s functions include the function "to promote and develop self-regulation by market bodies in the securities and futures industries" (S.F.C.O., *supra* note 19, s. 4(1)(k)).

[170] D. Charny, "Nonlegal Sanctions in Commercial Relationships" (1990) 104 Harv. L. Rev. 373 at 392.

[171] See Charny, *supra* note 170 at 393-94.

[172] "Big Bang" refers to the changes introduced to the rules and procedures of the London Stock Exchange and generally connotes the simultaneous introduction of regulation and deregulation to the financial industries in England in the late 1980s. For an account, see N.S. Poser, *International Securities Regulation* (Boston: Little, Brown, 1991).

[173] U.K., Committee to Review the Functioning of Financial Institutions, "Report" Cmnd 7937 in *Sessional Papers* (1979-80) vol. 74, 89 (Chairman: H. Wilson), quoted in J.J. Fishman, "Enforcement of Securities Laws Violations in the United Kingdom" (1991) 9 Int'l Tax & Bus. Law. 131 at 194.

cle. Its suitability to present day England has been called into question.[174] Can it be effectively applied in Hong Kong?

Students of old-style self-regulation have identified the conditions of its success in England. First, the financial-services community was small and members knew each other well. Second, the community was a homogeneous group. Third, one's reputation among peers was vital, carrying greater weight than potential penalties.[175] These have been elaborated by Michael Clarke:

> The greater the mutual knowledge of members of City institutions, the more extensive their shared backgrounds, and more importantly the greater store they set by membership of an exclusive institution, both because of its social rewards and because of its financial and career opportunities, the greater the possibility of effective internal self-regulation and maintenance of mutual internal trust.[176]

These observations by lawyers and securities-market practitioners have support from social scientists who study pressures to conform.[177]

Do these conditions exist in Hong Kong? Hong Kong is as far from the homogeneous community in which old-style self-regulation flourished as could be imagined. One look at the origin of mutual funds and securities intermediaries should confirm this beyond a doubt. Of the funds authorized to be marketed in Hong Kong, only 6% in number and 4.7% in value are organized from within that market. The bulk is organized in Jersey, Luxembourg, Ireland, Guernsey, the United Kingdom, other European countries, Bermuda, the Bahamas, the British Virgin Islands, the Cayman Islands.[178] Of the 505 corporate-securities dealers and dealing partnerships registered in Hong Kong, 214 are controlled from over twenty different countries.[179]

Old-style self-regulation has been described as "based upon the belief that most individuals and firms strive to uphold the norms of business practice. These standards are set by the leading firms — the establishment. Enforcement problems are expected to be directed at those firms on the fringe".[180] In other words, a condition for success-

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[174] See *e.g.* B.A.K. Rider, "Self-Regulation: The British Approach to Policing Conduct in the Securities Business, with particular Reference to the Role of the City Panel on Take-overs and Mergers in the Regulation of Insider Trading" (1978) 1 J. Comp. Corp. L. and Sec. Reg. 319; M. Clarke, *Regulating the City* (London: Open University Press, 1986); for milder criticism, see G.K. Morse, "Companies Securities Regulation" (1991) J. Bus. L. 65.

[175] See Poser, *supra* note 172 at 85; Fishman, *supra* note 173 at 195.

[176] Clarke, *supra* note 174 at 3.

[177] "[M]uch of the pressure to conformity undoubtedly comes from the smaller groups within a society to which individuals belong. These pressures exist as group standards of the face-to-face group and are only sometimes formalized and made very explicit" at 4. "The more cohesive the group, the more effectively it can influence its members" at 100: L. Festinger, S. Schachter & K. Back, *Social Pressures in Informal Groups* (Stanford: Stanford University Press, 1950). See also M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1971).

[178] See S.F.C., *Annual Report 1995/1996*, *supra* note 99 at 35, Table 2.

[179] See *ibid.* at 20, 22.

[180] Fishman, *supra* note 173 at 198-99.

ful self-regulation is the presence of an irreproachable leadership. This does not exist, not in Hong Kong, not anywhere. It is the core that is rotten. A flip through the list of those implicated in the financial scandals of the recent past shows a "who's who" of financial services. Even venerable regulatory bodies have not escaped unscathed: the ability of the Bank of England to order rescues has diminished.[181] The depths to which leadership has sunk is illustrated by the Maxwell affair.

In the 1970s, Robert Maxwell became a household name in England as a result of a takeover bid for his company Pergamon Press Ltd., while he became notorious in legal circles for resisting inspectors appointed under the *Companies Act*.[182] In 1991, his theft of corporate assets and employee pension funds was exposed posthumously. *The Economist* editorialized:

> The surprise about the Maxwell story is not that his shaky empire could have lasted, and carried on expanding, for so long. A man as forceful as Maxwell, and with such a magnetic attraction for money, could always find new helpers to replace those scared off by what they saw or sensed. The surprise is that at the end his helpers included top people, in top firms, with top reputations. The fact that he had been known for 20 years to be a rogue at best, a crook at worst, might have been expected to enforce a sort of reputational arbitrage: trading down to the more obscure and manipulable corners of capitalism. Yet it did not. Reputations counted for less, it seems, than the business Maxwell offered.[183]

Hong Kong was not surprised, for there was a similar story at home in the 1980s. An unknown by the name of Tan, adjudged bankrupt in Singapore, arrived in Hong Kong in 1972. In 1977, he formed a group of companies under the name "Carrian". Within six years, the Carrian Group was insolvent with liabilities estimated at HK$6 billion. All the leading banks in Hong Kong were involved; they had been competing against one another to get part of this business. As the former commissioner of banking said, "Tan had left a clear trail, but a blind eye was turned in case the projected gain disappeared".[184] The Carrian bubble was burst, not by professionals anxious about their reputations, but by a falling out among Tan and his associates.

As Hong Kong has a large and diverse financial market, unlike the archetype of the old-style self-regulation, reputational restraints are attenuated. Certainly, where there is no network with which one identifies and whose good opinion one values on a personal and social basis, to that extent reputational restraints do not exist in Hong Kong either. However, reputational restraints on a depersonalized and materialistic level could, in theory, exist. Indeed, this is a tenet of the neo-classical economists who

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[181] See the account of the rescue of Johnson Matthey in Clarke, *supra* note 161 at 45-49 and of the failure to rescue Barings in "The Collapse of Barings: A Fallen Star" *The Economist* (4 March 1995) 19 at 20.

[182] See R.R. Pennington, "Investigations Under the Companies Acts and the Pergamon Affair" (1974) 118 Sol. J. 507; B.J. Davies, "An Affair of the City: A Case Study in the Regulation of Takeovers and Mergers" (1973) 36 Mod. L. Rev. 457.

[183] "Maxwell Meltdown" *The Economist* (7 December 1991) 15 at 16.

[184] Quoted in Fell, *supra* note 27 at 91.

argue that punishment by the market of misdeeds is sufficient restraint.[185] It is contended here that even at the market level, reputational restraints are not effective in Hong Kong. Those who subscribe to the effectiveness of reputational restraints overlook at least four flaws in the system: reputation is a double-edged sword which can deliver us from sin or lead us into temptation; it is of less value in a colonial outpost; it is in the hands of its agents; and "reputation losses" do not necessarily lead to financial losses.

The first flaw in the effectiveness of reputational restraints is that regard for one's reputation may work both ways. In a world where participants are measured by performance, the desire to get into or to remain in the major leagues may lead to shady transactions. In such circumstances, the first excess baggage to be jettisoned would be nonlegal norms. The rewards of a reputation for making deals being immediate and certain, and the rewards of a reputation for maintaining high ethical standards being remote and uncertain, it is not difficult to guess which would be preferred. The Blue Arrow affair is a vivid illustration of how preoccupation for a reputation as a major-league player led to contravention of the law. As reported by *The Economist*:

> On the evening of September 28th 1987, National Westminster's bid to become a real force in investment banking began to falter ... County [an investment banking subsidiary of National Westminster] had hoped that this rights issue, at the time London's largest ever, would propel it into the big league of merchant banking. But the news that evening was grim. Blue Arrow shareholders had taken up their rights to only 38% of the shares on offer. ... They hatched a scheme to sell the remaining shares by placing them with investing institutions, and ... to mislead the market into thinking that the rights issue had been more popular than it had.[186]

Of course, one thing led to another; to maintain the lie, the parties involved breached a statutory requirement to disclose their shareholdings.

A second flaw is that even institutions with a high regard for business standards appear to slacken their internal controls in colonial outposts. Practices not tolerated at home appear to be acceptable abroad. When caught, the local community can be blamed, preserving the reputation of the home institution.[187] An example is the failure of reputable institutions to observe even the minimalist requirement of registering

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[185] See *e.g.* H.G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110; M.C. Jensen & W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 J. Fin. Anal. 305; E.F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. Pol. Econ. 288; F.H. Easterbrook, "Two Agency-Cost Explanations of Dividends" (1984) 74 Amer. Econ. Rev. 650; D.R. Fischel & M. Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 Cornell L. Rev. 261; H.N. Butler, "The Contractual Theory of the Corporation" (1989) 11:4 Geo. Mason U. L. Rev. 99 at 101.

[186] "The Blue Arrow Affair: The Buck Stops Where?" *The Economist* (7 March 1992) 23.

[187] "The whole lifestyle in Hong Kong is to do the deal, perform well and then let the back office catch up": Paul Bateman, chairman of Robert Fleming Asset Management, speaking from London on the occasion of being fined for rat trading (quoted in "Breachers to Make Future Checks More Scrupulous" *The [Hong Kong] Sunday Morning Post* (1 September 1996) M2).

employees.[188] One wonders whether these lapses would have occurred if these reputable institutions had had as much respect for colonial regulations as for American ones. The Barings case offers another example. In January 1992, Barings submitted an application to have Nick Leeson recognised as a registered representative. What followed was most interesting. The Report of the Board of Banking Supervision of the Bank of England on the collapse of Barrings noted drily:

> The SFA Securities and Futures Authority raised questions concerning an undisclosed outstanding County Court judgement against Leeson in respect of an unpaid debt. Later in March 1992, after he had expressed his desire to work in Singapore, Leeson was asked by Killian if he would go to BFS to run the back office. Killian said: "Nick's [Leeson] name was put forward to the Management Committee in London and he was approved to go out and do that [run the back offiee]". The application to the SFA was subsequently withdrawn by Barings in September 1992.[189]

Leeson's voluntary transfer to Singapore meant that no action needed to be taken about his failure to make proper disclosure. One can only speculate whether Barings would have or could have retained Leeson's service had lie not volunteered to go overseas.[190]

The third weakness in reputational restraints is that the players whose reputations are at stake are juridical rather than natural persons. This has two consequences. The institution can save its own reputation by making scapegoats of the individual human agents. This is typically the reaction of an institution that claims to be the victim rather than the sinner. To the extent that the institution's reputation survives, incentives to exercise internal control are weakened. Furthermore, whatever regard an institution may have for its reputation, it may be jeopardised by its agents. Agents do not

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[188] On January 26, 1995 the S.F.C. reprimanded Smith Barney (Hong Kong) Ltd. for having allowed a number of its staff to deal in securities and/or commodities trading without the necessary registrations, having carried on business as a commodities dealer while a director accredited to it was unregistered and having dealt in securities for two months without a registered dealing director as required (see (1995) 11 S.F.C. Bulletin 3). On May 19, 1995, Merrill Lynch (Asia Pacific) Ltd. was reprimanded for allowing four employees to perform some of the functions of a dealer without being registered as its representative under the *Securities Ordinance* (see (1995) 13 S.F.C. Bulletin 9). On June 1, 1995, Morgan Stanley Asia Ltd. was reprimanded for similar conduct (see (1995) 13 S.F.C. Bulletin 15). And on February 28, 1997, Salomon Brothers Hong Kong Ltd. was reprimanded partly for not registering staff promptly (see (1997) 23 S.F.C. Bulletin 15).

[189] Report of the Board of Banking Supervision Inquiry into the circumstances of the collapse of Barings (London: H.M.S.O., 1995) at para. 2.57.

[190] A study of selection criteria for expatriates noted that while European multinational corporations tended to send their best people, the situation was different in the U.S., "where it [was] not uncommon for the company to send abroad people who [were] a bit of a nuisance or embarrassment to the company" (R.L. Tung, *The New Expatriates: Managing Human Resources Abroad* (Cambridge, Mass.: Ballinger Publishiug Co., 1980) at 169). Another study of expatriates in the electronics industry in Hong Kong showed that the primary reason for appointing expatriates was technical competence, followed by corporate communications and sales and marketing. Ethics or trust did not appear on the list (see A.M. Findlay *et al.*, "The International Migration Circuit: A Study of Expatriates in Hong Kong's Electronics Industry" Applied Population Research Unit Discussion Paper 94/2 (University of Glasgow, 1994) at 18).

necessarily act to maximize profits for the firm.[191] Here again, if the agent is focused on personal reputation, it may be reputation as a performer that is important. More important, at the individual level, the end-run mentality displaces whatever restraints reputation may have. It is accepted that self-enforcing agreements are not feasible if the actors know that the transaction will be their last, since they have nothing to lose by violating its terms. Therefore, in planning a self-enforcement regime, the end of a sequence of transactions would ideally be uncertain.[192] While it is possible for an enterprise to have an indefinite end, the role of individual agents is finite. In the financial services field, where the gains are so enormous, individuals could quite feasibly make an end-run even as rookies.

The recent scandal at Jardine's is an illustration. Jardine Fleming's chief investment officer, Armstrong, allegedly acting by himself, had engaged in rat trading. On executing orders for two funds, he had waited to see the results of the trades. If profitable, he would book them to his own or a preferential account and allocate another, less profitable, trade to the original funds. The volume of these diverted trades generated a hidden commission of HK$26.3 million.[193] The misdeeds were apparently discovered by management in December 1993, but were not reported to the Investment Management Regulatory Organisation (I.M.R.O.) until August 1995.[194] Armstrong and Jardine Fleming's former chief executive have since been barred from the industry for life. The U.K. (I.M.R.O.) and the S.F.C. imposed on Jardine Fleming fines of HK$8.4 million and ordered it to compensate investors to the tune of HK$150 million.[195] Armstrong was said to have contributed "up to US$3 million from his own profits" towards the compensation.[196] No criminal action has been taken although he was said to have left Hong Kong with assets of more than HK$150 million. In June 1997, reporters located him living in a Surrey country house worth HK$40 million.[197]

What deterrent effect would these sanctions against Armstrong have? His profits from the transactions were undisclosed, if known. His voluntary repayment only deprived him of part of his hidden commissions. It did not touch his trading profits nor his bonuses earned in previous years. In absolute terms, US$3 million is not a trivial sum, but to an investor of Armstrong's standing, it is all too affordable.

A final flaw in the effectiveness of reputational restraints is that reputation losses do not necessarily lead to financial losses. The late Professor Sutherland, writing on white-collar crime in general in 1949, stated:

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[191] See J.C. Coffee, Jr., "Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions" (1980) 17 Am. Crim. L. Rev. 419 at 459-61.

[192] See L.G. Telser, "A Theory of Self-enforcing Agreements" (1980) 53 J. of Business 27.

[193] See "Rat-trader Made Easy Killing on Clients Money" *South China Morning Post* (30 August 1996) B1.

[194] See "J.F. Staff Benefitted From Scam" *The [Hong Kong] Sunday Morning Post* (1 September 1996) M1.

[195] See "J.F. Penalty Rocks Funds Industry" *The South China Morning Post* (30 August 1996) B1.

[196] *Ibid.*

[197] "Armstrong Lives in Surrey Splendour" *South China Morning Post* (10 June 1997) B1.

> The businessman who violates the laws which are designed to regulate business does not customarily lose status among his business associates. Although a few members of the industry may think less of him, others admire him.[198]

Recent history proves that Sutherland's assertion was not too cynical. Ivan Boesky is back,[199] as Yoshihisa Tabuchi, the president of Nomura who had had to resign for illegally compensating favoured customers for investment losses.[200] Tabuchi has been forced to resign again, this time in connection with Nomura's use of client money to pay off gangsters.[201] The Jardine's scandal broke just before an annual election of the executive committee of the Investment Funds Association, but Jardine's retained its seat on the blue-ribbon committee charged with oversight of the investment funds industry.[202]

In summary, Hong Kong has none of the conditions necessary for successful implementation of old-style self-regulation.[203] First, the financial community is too large and heterogeneous. Consequently, the only available influential forces are reputational restraints within the market. These, however, are crippled by four flaws: one's reputation is a double-edged sword; business standards are slackened in colonial outposts; the parties are juridical persons, not natural persons; and reputational losses do not necessarily lead to financial losses.

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[198] E.H. Sutherland, *White Collar Crime* (New York: Dryden Press, 1949) at 219.

[199] See "More Reversals of Fortune" *The Economist* (3 August 1991) at 74.

[200] See "On With the Show" *The Economist* (26 June 1993) at 78.

[201] See "Tea-time raid" *The Economist* (29 March 1997) at 93; "Japan's Scandals" *The Economist* (7 June 1997) at 88.

[202] See "Jardine's Holds Committee Role" *The South China Morning Post* (5 September 1996) B1.

[203] This is hardly original. In 1971, the Companies Law Revision Committee reached the same conclusion regarding regulations for takeovers:

> There are, of course, in Hong Kong, besides the stock exchanges several bodies concerned with various aspects of commerce and finance, but these do not have the same close inter-relationships and continuous contacts as in the City of London, and there is certainly no counterpart to the amorphous but extremely powerful concentration of financial and business interests popularly known as "the City". Nor is there a counterpart to the Governor of the Bank of England, who is the acknowledged, if not titular, head of the City, and can exercise enormous direct and indirect influence upon those engaged in its activities. Consequently, there does not exist in Hong Kong the essential substratum on which a Code similar to the City Code could be based, and there is no alternative to some form of statutory control (Report of the Companies Law Revision Committee on the protection of investors (Hong Kong: Government Printers, 1971) at para. 9.11).

The quarter-century since 1971 has seen even greater diversification and urbanization in Hong Kong, rendering old-style self-regulation even less practicable.

B. Self-Regulation and Its Merits

The debate over securities regulations has confused self-regulation with non-statutory (*i.e.*, without legal force) regulation.[204] "There is the tendency to assume that only self-regulatory rules can be administered by self-regulatory bodies and only statutory rules by statutory bodies."[205] Such assumptions are misleading. No less a body than the Wilson Committee has asserted, "Non-statutory regulation is not synonymous with self-regulation".[206] As Hong Kong persists in this confusion, this section examines the merits of self-regulation and whether, to secure these merits, it is necessary to maintain regulations in a nonlegal state.

It is often said that the merits of self-regulation are the expertise of market practitioners and their ability to react quickly:

> Persons on the scene and familiar with the intricacies of securities and markets from daily and full-time pursuit of the business can more readily perceive and comprehend some types of problems, and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the event, and often must defer decision and action until thorough investigation or study has been completed.[207]

There is no doubt these observations are valid, but they can be taken only so far. First, expertise and nimbleness are not confined to self-regulatory organizations. The concept of the regulatory commission has proven to be successful precisely because of these qualities.[208] Experience worldwide also shows that the securities regulator has been able to attract outstanding practitioners from the private sector, resulting in considerable expertise within regulatory agencies. Nor should it be suggested that a self-regulatory organization like the S.E.H.K. would implement a proposal without thorough investigation or study.[209] Second, because of increasing complexity, self-regulation is no longer done directly by market practitioners. Instead, self-regulation only means regulation by a professional body of bureaucrats employed by market practitioners. These bureaucrats may formerly have been in private practice, but once employed, they engage in full-time regulation. In profile, they are not very different from employees of the regulatory commission.[210]

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[204] See J.A.C. Suter, *The Regulation of Insider Dealing in Britain* (London: Butterworths, 1989) at 372.

[205] T. Hadden, "Fraud in the City: Enforcing the Rules" (1980) 1 Co. Law 9.

[206] Committee to Review the Functioning of Financial Institutions, *supra* note 173 at para. 1108.

[207] Securities and Exchange Commission, *Special Study of Securities Markets* (Washington: U.S. Government Printing, 1963) at 694; see also Committee to Review the Functioning of Financial Institutions, *ibid.* at para. 1103.

[208] See J.L. Howard, "Securities Regulation: Structure and Process" in *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services Canada, 1979), vol. 3 at 1615.

[209] And, it has been pointed out, the recent history in England showed that "non-statutory supervisors [were] themselves not immune from failures to keep abreast of changing situations" (Committee to Review the Functioning of Financial Institutions, *supra* note 173 at para. 1105).

[210] For example, the new chief executive of the S.E.H.K., Alec Tsui Yiu Wah, had done a stint at the S.F.C. for five years and held the rank of assistant director (licensing) before leaving the S.F.C. in

It is also sometimes said that self-regulation is cheaper and less of a drain on the public purse. Professor Jennings has argued otherwise.[211] The evidence from the U.S. is that the Securities and Exchange Commission ("S.E.C.") returns more to the U.S. Treasury through its fees and fines than it receives in appropriations.[212] In Hong Kong, in the year 1995-96, the S.F.C. declined appropriations from general revenues and managed to show a small surplus.[213] Further, its operating expenses were significantly lower than those of the S.E.H.K.[214] Costs are not a significant factor in the Hong Kong debate on the merits of self-regulation.

Another important aspect of self-regulation, it is argued, is that it is more acceptable to the industry: "Opportunity to participate in the regulatory process makes it much more palatable".[215] However, Hong Kong's experience shows that industry participation in the regulatory process is not limited to nonlegal regulations. All major corporate and securities laws are now developed in consultation with practitioners[216] before submission to the legislature. In adjudication, however, a distinction may be drawn between nonlegal and legal regulations. Breaches of *Listing Rules* are adjudicated by the S.E.H.K., whereas breaches of law are generally adjudicated by the courts. Again, this point cannot be pushed too far. On the one hand, the S.E.H.K. is under the supervision of the S.F.C. and the parties do not hesitate to appeal to the courts. Therefore, the state is not eliminated from the private adjudication of the S.E.H.K. On the other hand, as the enforcement of insider-trading regulations shows, the industry can participate in the enforcement of legal regulations.[217]

The merits of self-regulation are therefore not dependent on nonlegal regulations and could and should be preserved in the system.

1993. He joined the S.E.H.K. in January 1994 and was made chief executive effective February 1997. See also Poser, *supra* note 172 at 114.

[211] See R.D. Jennings, "Self-regulation in the Securities Industry: The Role of the Securities and Exchange Commission" (1964) 29 Law & Contemp. Probs. 663 at 677.

[212] See Securities Exchange Commission, *1986 Annual Report* (Washington: U.S. Government Printing, 1987) in Fishman, *supra* note 173 at 204.

[213] See *Annual Report 1995/1996*, *supra* note 99 at 67, 70.

[214] In the year 1995-96, the S.F.C. and the S.E.H.K. had operating expenses of HK$245,864,000 and HK$426,000,000 respectively. See *ibid.* at 67, and S.E.H.K. *Annual Report 1995*, *supra* note 76 at 63.

[215] Jennings, *supra* note 211 at 678.

[216] Through the Standing Committee on Company Law Reform established in 1984 on the recommendation of the Second Report of the Companies Law Revision Committee (Hong Kong: Government Printers, 1973) at para. 1.204.

[217] Alleged insider trading is investigated by an Insider Dealing Tribunal consisting of a chairman who must be a judge appointed by the Governor and two other members who must not be public officers and who are appointed by the Financial Secretary (*Securities (Insider Dealing) Ordinance*, *supra* note 33, s. 15). The Tribunal has power to impose penalties, including a fine of up to three times the profits made, on a finding of insider trading (*Securities (Insider Dealing) Ordinance*, *ibid.*, s. 23).

C. Merits of Nonlegal Regulations

Once the link between nonlegal regulations and self-regulation is severed, it is possible and necessary to examine the merits of nonlegal regulations. Most important, it is said, nonlegal regulations can be drafted in the form of general principles, thus aspiring to develop the best market practice rather than a minimum standard, all the while avoiding rigidity. Robert Alexander recognized this advantage in the 1987 Annual Report of the Panel on Take-overs and Mergers.[218] He elaborated on the role of the *Takeovers Code* panel:

> It can base its rules on concepts of best practice, which reflect evolving standards and can be developed as new situations give rise to novel issues. This flexibility also enables the Panel to stress the importance of compliance with the general principles of the Code and not merely with specific rules. If we had a legislative system, the rules would either have to be less strict, so giving less protection to shareholders, or they would be wide-ranging as at present but without the ability to mitigate their potential harshness in appropriate cases. Moreover, a statutory system could lead to some practitioners seeking to design ways around the strict rules in preference to complying with the principles. Such an approach would not promote good business practices. It is, moreover, only if there is flexibility that the Panel is able in some individual cases to apply the Code in a way which is consistent with the principles of fairness which underlie the Code.[219]

The above argument, of letter versus spirit of the law, has been rejected by the Wilson Committee.[220] Indeed, Alexander's statement seems apposite as an indictment of the draftsmanship and construction of statutes. There is no reason why statutes cannot be drafted as principles and construed purposively to achieve fairness. As for the evolution of standards to meet new demands, this is the function of an expert market-oriented body discussed in the previous section and not a function of the legal status of the regulations. The argument that nonlegal regulations can prescribe best practice is sound and is considered further below.

D. Disadvantages of Nonlegal Regulations

Securities practitioners in Hong Kong, whether they be company executives, dealers, bankers, lawyers or accountants, complain of the supervision of the S.E.H.K. Not only do the *Listing Rules* require pre-authorization of company announcements,

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[218] 1987 Annual Report of the Panel on Take-overs and Mergers. He also recognized two other advantages examined in the previous section: expertise of market practitioners and their ability to react quickly.

[219] Chairman's Statement, *ibid.* at 3-4.

[220] We do not ourselves subscribe to the view put to us by some witnesses that statutory regulation necessarily encourages those concerned to pay greater attention to the letter of the law rather than to its spirit. Those of us who visited the U.S. were frequently assured that, despite the greater reliance on statute in the regulation of securities markets in that country, those concerned felt themselves to be under no less of an obligation to abide by the spirit of particular rules than their counterparts in this country (Committee to Review the Functioning of Financial Institutions, *supra* note 173 at para. 1107).

the S.E.H.K. has teams of workers whose job it is to scrutinize newspapers and to call upon listed companies for an explanation of the fluctuations in the price of their shares. Although there are often calls for self-certification[221] — let the practitioner do and be damned — the problem is that supervision is the only effective way to administer a nonlegal code. Without the force of law behind the *Listing Rules*, practitioners can "do and *not* be damned".

The first weakness of nonlegal regulation is the lack of any effective sanctions. There are long lists of sanctions for breaches of the *Listing Rules* and the *Takeovers Code*. For example, there is the power to cancel or suspend the listing of shares. As these measures reduce the marketability of shares, controlling shareholders would be affected. However, as they are in control of the company, they can extract benefits even while the shares are unmarketable, whereas minority shareholders are locked in with no means of forcing corporate distributions. Since minority shareholders would be injured to a greater extent, sanctions such as suspensions and cancellations of listings are not frequently applied by the authorities and their threat is not real.

Other sanctions, ranging from criticism to denial of market facilities, are premised on the assumption that the availability of the market is important to the potential rule-breaker. This assumption is patently false in a number of situations. For instance, rule 6.06 of the *Listing Rules* requires a listed company to obtain the approval of shareholders to delist and to provide minority shareholders with a cash or other reasonable alternative. Otherwise, the S.E.H.K. does not permit the company to delist voluntarily. If a company violates this rule by delisting without providing a cash alternative to minority shareholders, the ultimate punishment that the S.E.H.K. can mete out is to deny to the rule-breaker the market facilities and to delist the company, thereby fulfilling the rule-breaker's initial goals. There are several other rules in this category which neither punish nor deter.[222]

The second demerit of nonlegal regulation is the lack of compensation to victims. It is outrageous that a statutory body such as the S.F.C. can solemnly declare that minority shareholders have the right to be bought out on a change of control and order a bidder to pay, but only publicly reprimand him for not executing the order, letting the matter end there.[223] If the S.F.C. is correct in formulating such a rule of conduct, the investor should have a legal right to be paid according to the rule. As the Court of Appeal of California stated:

> It may be asserted that the proposed [broker-dealer] guidelines are merely ethical standards and should not be a predicate for civil liability. Good ethics should not be ignored by the law. It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions.[224]

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[221] G. Hewett, "It's time to show some faith in HK blue chips" *South China Morning Post* (13 August 1996) M12.

[222] See *Listing Rules*, *supra* note 40, rules 6.05, 6.06; *Takeovers Code*, *supra* note 41, rules 2.2, 2.10.

[223] See the takeovers incident discussed in the text above, accompanying notes 100-02.

[224] *Twomey* v. *Mitchum, Jones & Templeton Inc.*, 69 Cal. Rptr. 222 at 244 (Ct. App. 1968).

The third demerit is damage to the social fabric. What is at stake is the credibility of the state's enforcement powers: what may be lost is respect not only for the regulation in question but for laws in general. Further, the result of the mix of legal and nonlegal regulations is unjust. Contrast directors who fail to acknowledge their criminal past[225] with Joseph Tang Wing-leung who obtained a licence as an investment representative by omitting from his *curriculum vitae* two convictions of theft and false accounting. He was convicted and sentenced to six months' imprisonment for obtaining a pecuniary advantage by deception and for forging documents.[226] Directors of listed companies are let off with a mere public reprimand for essentially the same wrong. This disparity has not escaped notice and could create resentment harmful to society if permitted to persist.[227]

E. Proper Role of Nonlegal Regulations

It is not suggested that all nonlegal regulations be eliminated or be given legal force. The best justification advanced for nonlegal regulations is that they prescribe the very highest of standards. Justice Douglas, formerly of the U.S. Supreme Court, described their role when he was chairman of the S.E.C.:

> Self-regulation ... can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach. For these reasons such self-regulation is by far the preferable course from all viewpoints.[228]

There are three roles, then, for nonlegal regulations: dealing with subsidiary matters of detail, addressing novel and developing issues and, above all, dealing with matters of ethics — prescribing rules of best practice. However, matters do not remain novel forever and best practice should evolve. Standards rise and markets improve only when the novel becomes the mundane and best practice becomes normal practice. Accordingly, there should be a continuous legalization of nonlegal regulations. As the Wilson Committee stated:

> it is probably the case that it is possible to enforce higher ethical standards through non-statutory regulation ... But it does not necessarily follow that the division which exists at any particular moment between the minimum standards imposed by law and the best practices enforced non-statutorily should be regarded as immutable. Indeed, in general we would expect the law to be sub-

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[225] See the text above, accompanying notes 81-83.

[226] See S.F.C., *Annual Report 1995/1996*, *supra* note 99 at 44-45.

[227] See G. Hewitt, "Exchange must make directors follow the rules" *South China Morning Post* (11 December 1996) B20.

[228] Address, quoted in Jennings, *supra* note 211 at 678.

> ject to a more or less continuous process of updating to bring it into line with standards initially set non-statutorily.[229]

An example of an effective deployment of nonlegal regulations is found in Ontario. Ontario securities regulations comprise the Ontario Securities Act,[230] the Ontario Securities Regulations,[231] policy statements, notices, blanket rulings, blanket orders and principles of regulation.[232] The Act and the Regulations are statutory while the remaining instruments are nonlegal. The Act has 152 articles drafted in general principles. For example, the content requirement for a prospectus is stated in nine words: "full, true and plain disclosure of all material facts".[233] This is a statement of principle and spirit difficult to get around. Detailed content requirements which are stipulated in the regulations give certainty without injuring the principle. Being subsidiary legislation, they can be formulated and amended speedily by experts, but they have legal force. Matters of detail, such as engineering reports in a prospectus, and matters in a continuing state of flux, such as generally accepted accounting principles, are covered by policy statements[234] — nonlegal regulations. Legal bite is coupled with flexibility.

The defect in the Hong Kong system is that the very core of corporate and securities regulations are minimum standards that are nonlegal and without effective sanction. The first step forward is to examine and to grade all existing nonlegal regulations. The *Listing Rules*, the *Takeovers Code* and other nonlegal regulations should be analyzed and broken down into basic principles, implementing procedures and exhortations to higher standards. Basic principles such as obligations to disclose and advise, to make a bid, and to avoid conflicts of interest should be enacted as law. More detailed provisions for the implementation of the core principles should be raised to the status of subsidiary legislation, while the remainder may remain as nonlegal regulations subject to change as needed.

F. Enforcement of Nonlegal Regulations

Even if the above reforms are adopted, there will remain some nonlegal regulations. The principal sanction that could be applied to enforce them is public condemnation. It is surprising, therefore, that the S.E.H.K. goes to such lengths to protect the anonymity of those censured. Their names appear only in the press release of censure; thereafter, they only appear as statistics. If shame is our weapon, there ought to be a register of shame. One minor reform that could be implemented without any structural changes to the system of sanctions is to publish the names of censured persons and their misconduct in *The Securities Journal* and the annual reports of the S.E.H.K.

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[229] Committee to Review the Functioning of Financial Institutions, *supra* note 173 at para. 1106.

[230] *Securities Act*, R.S.O. 1990, c. S.5.

[231] *Securities Act Regulations*, R.R.O. 1990, Reg. 1015.

[232] See McCarthy Tétrault, *Annotated Ontario Securities Legislation*, 17th ed. (North York: CCH Canadian, 1995).

[233] *Supra* note 230, s. 56.

[234] See Ontario Securities Commission Policy No. 5-1; GAAP National Policy No. 27.

III. Utility of Civil Actions

A. Anglo — Hong-Kong View of Private Civil Actions

As mentioned in Part I, Anglo — Hong-Kong law views private enforcement with hostility. The English Court of Appeal stated:

> We were invited to give judicial approval to the public spirit of the plaintiffs who, it was said, are pioneering a method of controlling companies in the public interest without involving regulation by a statutory body. In our view the voluntary regulation of companies is a matter for the City. The compulsory regulation of companies is a matter for Parliament.[235]

Although there is reluctance in enforcing civil actions, these do have merit. It is no doubt true that the per share recovery of most derivative actions and class actions is small. But this is not the only measure of the desirability of such actions. In contrast with the English courts, U.S. courts see another function to private actions, be they derivative or class actions. This function is to deter, rather than to compensate. The U.S. Supreme Court has stated:

> This action born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least the grossest forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.[236]

The *Newman* case stated that Parliament and the City suffice; Parliament can enact laws, the City can enact codes, but who is to enforce them? Parliament is not an enforcement agency, while the City has limited powers of enforcement and limited sanctions at its disposal. The ineffectiveness of Parliament and the City has been demonstrated above and alternative enforcement deserves consideration.

Commentators, following *Cohen*,[237] argue that the derivative action and the class action should have deterrence as the organizing principle.[238] The theory runs that a person motivated by personal gain is more zealous in seeking out the wrongdoer. This increased risk of detection produces a greater deterrent effect. This reasoning has been questioned by some commentators who doubt the social utility of private enforcement.[239] Professor Coffee, who studied the issue in depth in the 1980s, agrees that the private enforcer is a free-rider who only commences an action after the public agen-

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[235] *Newman, supra* note 129 at 224.

[236] *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541 at 548 (1948) [hereinafter *Cohen*].

[237] *Ibid.*

[238] See J.C. Coffee, Jr. & D.E. Schwartz, "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform" (1981) 81 Colum. L. Rev. 261 at 302; see also G.W. Dent, Jr., "The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Action?" (1980) 75 Nw. U. L. Rev. 96.

[239] See *e.g.* L.A. Bebchuk, "Suing Solely to Extract a Settlement Offer" (1988) 17 J. Legal Stud. 437; R. Kraakman, H. Park & S. Shavell, "When Are Shareholder Suits in Shareholder Interests?" (1994) 82 Geo. L.J. 1733; J. Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions" (1991) 43 Stan. L. Rev. 497.

cies have done their investigation. To the extent that the risk of detection does not increase, the deterrent effect has been over-rated. This does not mean, however, that the private enforcer makes no contributions. The action adds to the penalty exacted for the wrong and this increased penalty has some deterrent effect. Coffee concludes that, overall, there is merit in the private enforcement.[240]

Another reason why civil actions may have even greater deterrent effect is that the relevant burden of proof is lighter, making it easier to secure a conviction. Criminologists argue that the certainty of a sanction has greater deterrent value than its severity.[241] The enforcement of laws proscribing market manipulation is a case in point. There have been only two successful prosecutions in Hong Kong,[242] although practitioners are convinced that many more instances have occurred and remain unpunished. One reason for the paucity of prosecutions is the high burden of proof required. The prevalence of the offence is due not only to the low risk of conviction but also to the derisory sanctions applied even if there is a conviction. In both successful prosecutions, the accused were given suspended sentences. Given that these crimes are crimes calculated for enormous profits, laws that could readily strip the offender of his ill-gotten gains would have a much greater impact than unserved prison terms.

Professor Kennedy draws attention to another benefit of civil actions: development in the law.[243] Kennedy, like Coffee, concedes that private plaintiffs are free-riders, using the factual bases provided by public investigations. But their numbers contribute to the deterrent effect.[244] More important, the civil actions allow the courts to develop new legal theory and doctrine. If there is one U.S. export that is universally accepted, it is insider-trading regulations, the development of which is largely due to the litigiousness of Americans.

Accordingly, it is recommended not only that the core of corporate and securities regulations be given legal force, but also that an express right of action be given to investors injured by any breach.

B. The Enforcer

A right of civil action itself would not be sufficient to realize the deterrent value of civil actions, since the likelihood of investors taking action is low. In the U.S., rules governing class actions and derivative actions are more plaintiff-friendly than those

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[240] See J.C. Coffee, Jr., "Rescuing the Private Attorney-General: Why the Model of the Lawyer as Bounty Hunter is Not Working"(1983) 42 Mod. L. Rev. 215 at 224-27. This is supported by some empirical studies: M. Bradley & C.A. Schipani, "The Relevance of the Duty of Care Standard in Corporate Governance" (1989) 75 Iowa L. Rev. 1 at 74; H.N. Seyhun, "The Effectiveness of the Insider-trading Sanctions" (1992) 35 J. L. & Econ. 149 at 176.

[241] See Coffee, *supra* note 191 at 423.

[242] See the text above, accompanying notes 165-66.

[243] See J.E. Kennedy, "Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: an Empirical Study" (1977) 14 Hous. L. Rev. 769 at 784.

[244] Following the investigation by the S.E.C. of the *Texas Gulf Sulphur* insider trading, there were outstanding, on 31 October 1969, 63 private actions on the same wrong pending in the District Court for the Southern District of New York (see Kennedy, *ibid.* at 785).

existing in Hong Kong. The question, then, arises: should Hong Kong liberalize its rules on class actions and derivative actions? Not yet since Hong Kong does not have the contingency-fee system, the factor which contributes to the flourishing of class and derivative actions in the U.S. The attorney general issued a Consultation Paper on Legal Services[245] recommending the adoption of contingency fees on a restrictive basis which received some support.[246] Nevertheless, given the notoriety of contingency fees and the pervasive English influence in Hong Kong, their adoption is not likely in the near future. Without a contingency-fee system, liberalizing class-action and derivative-action rules is meaningless.

This leaves only one alternative in the interim: for the S.F.C., vested with the power and duty to protect investors, to bring actions on their behalf for compensation. This would not be alien to the spirit of Anglo — Hong-Kong law. At common law, the attorney general has absolute discretion to bring action on behalf of citizens.[247] In the U.K., the Securities and Investments Board[248] has exercised powers to recover profits or damages from persons unlawfully carrying on an investment business and to distribute the funds so recovered among injured investors.[249] Indeed, scattered among the various ordinances of Hong Kong are a number of provisions empowering different officers to bring actions in court. For instance, the financial secretary has power to bring derivative actions following an investigation if public interest so warrants.[250] The S.F.C. has power to apply for a restrictive order,[251] and to apply to the court for relief if the affairs of a listed company have been conducted in a manner unfairly prejudicial to the interests of its members.[252]

The existing statutory powers were granted piecemeal and are too haphazard to be useful. First, the financial secretary is too far removed from the market and lacks the technical support to effectively exercise the power to bring derivative actions. Vesting the power in the financial secretary jeopardises the action with costs and delays. Second, since the power is vested in a public officer and the ultimate arbiter is the court, there is no reason why the power could not be exercised before the completion of investigations. The timing of the action should be left to the discretion of the enforcer, public opinion and their repercussions being sufficient to restrain premature actions. Third, the powers granted to the S.F.C. are too restrictive. Again, considering that the ultimate arbiter is the court and that a high failure rate would reflect adversely on the S.F.C., expanding the available actions that could be brought by the S.F.C.

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[245] Consultation Paper on Legal Services (Hong Kong: Attorney General's Chambers, 1995).

[246] See G. Yu, "The Case for Contingent Fees in Hong Kong", Law Working Paper Series, Paper No. 15 (Hong Kong: The University of Hong Kong, 1997).

[247] See *London County Council* v. *Attorney-General*, [1902] A.C. 165 (H.L.).

[248] See Financial Services Act 1986 (Delegation) Order 1987, S.I. 1987/942; *Financial Services Act* (U.K.), 1986, c. 60, s. 6.

[249] See *Securities and Investments Board* v. *Pantell S.A.*, [1990] 1 Ch. 426; *Securities and Investments Board* v. *Lloyd-Wright*, [1994] 1 B.C.L.C. 147.

[250] See C.O., *supra* note 18, s. 147(3).

[251] See S.O., *supra* note 23, s. 144.

[252] See S.F.C.O., *supra* note 19, s. 37A.

would not be likely to lead to abuse. Indeed, such a move would be welcomed by the investing community.[253]

IV. Criminal Sanctions

In the sphere of public enforcement, a difficult policy decision is the extent to which criminal sanctions should be applied to secure compliance with corporate and securities laws. A criminal sanction is a punishment to which stigma is attached meted out by the state after a violation of a public norm has been proved beyond reasonable doubt in a trial in which every step has been taken to protect the rights of the accused.[254] The application of criminal sanctions in Hong Kong is in need of reform

A. Arguments in Favour of Criminal Sanctions

Whatever the proper definition of white-collar crime may be,[255] a violation of corporate and securities regulations is the quintessential white-collar crime. Sutherland pointed out that not only does white-collar crime cause greater financial loss, but it is more harmful to the social fabric.[256] Notwithstanding their seriousness, white-collar criminals receive favoured treatment at the hands of the law.[257] The summary of enforcement of securities regulations set out above indicates that of the few offenders successfully prosecuted, only one person has served a prison term. He was an investment representative, a lowly employee. Owners of investment advisory firms and market manipulators received suspended prison terms and directors of listed companies received mere reprimands. Hong Kong is not unique. Studies elsewhere have shown that administrative sanctions are applied in preference to criminal sanctions.[258] Even within an organization, employers are less likely than their employee-managers to be charged under the criminal code. They are more likely to be charged with securities-act violations that carry less stigma and lower sentence exposure.[259]

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[253] See S. Fluendy, "Fighting Fund Needed? Help Biased Minorities" *South China Morning Post* (17 June 1996) B16.

[254] See K. Mann, "Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law" (1992) 101 Yale L.J. 1795 at 1813, Table 1.

[255] Sutherland defined it as "a crime committed by a person of respectability and high social status in the course of his occupation": *supra* note 198 at 9.

[256] "This financial loss from white collar crime, great as it is, is less important than the damage to social relations. White collar crimes violate trust and therefore create distrust; this lowers social morale and produces social disorganization. [...] Ordinary crimes, on the other hand, produce little effect on social institutions or social organization": *ibid.* at 13.

[257] See J. Hagan, I.H. Nagel & C. Albonetti, "The Differential Sentencing of White-Collar Offenders in Ten Federal District Courts" (1980) 45 Am. Soc. Rev. 802 at 818.

[258] See E.H. Sutherland, "Is 'White Collar Crime' Crime?" (1945) 10 Am. Soc. Rev. 132.

[259] J. Hagan & P. Parker, "White-Collar Crime and Punishment: The Class Structure and Legal Sanctioning of Seeurities Violations" (1985) 50 American Sociological Review 302 at 312; see also S.P. Shapiro, "The Road Not Taken: The Elusive Path to Criminal Prosecution for White-collar Offenders" (1985) 19 Law & Soc. Rev. 179.

Clearly, continued indulgence or perceived indulgence of white-collar crime and criminals is dangerous. The argument in favour of criminal sanctions for corporate and securities offences is not so much efficient deterrence as social justice. Indeed, efficiency concerns may be subordinated. Some criminal sanctions must be imposed regardless of efficiency costs; the only question is the extent and method.

B. Dangers in the Application of Criminal Sanctions

1. Trivializing the Criminal Law

The principal feature of the criminal paradigm is morality. The purpose of criminal law is to punish a moral wrong by, *inter alia*, stigmatizing it in order to dissuade misbehaviour. The anomaly of applying criminal sanctions to enforce economic regulatory laws is the wrong targeted. Conduct forbidden by economic regulatory laws is not considered immoral either before or after the imposition of criminal sanctions.[260] Because the conduct is not considered immoral, the prescribed sanctions are seldom imposed. This inability or unwillingness to enforce the law tends to weaken its moral authority: "if a law declares a practice to be criminal, and cannot apply its policy with consistency, its moral effect is necessarily weakened".[261] And the debilitating effect of under-enforced economic regulatory criminal law does not stop at those laws; it rebounds on all criminal laws. This is the objection of well-known criminal-law scholars to the criminalization of economic misconduct.[262] Others, however, believe that criminal sanctions could usefully be applied to some economic conduct and that the analysis must be particularized within this context.[263]

The list of offences in the statute books set against their enforcement record evidences over-criminalization. It is time to take stock and prune the list so as to avoid trivializing the law.

2. Imprisoning the Wrong Person

The application of criminal sanctions to corporate and securities offences is particularly challenging because these are often organizational wrongs. Difficulties in law may have been resolved, but difficulties in fact remain.

The initial hurdle lies with the mens rea requirement for offences. *Prima facie*, there is no vicarious liability for crimes.[264] However, if a statute creates an absolute- or

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[260] See H.V. Ball & L.M. Friedman, "The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View" (1965) 17 Stan. L. Rev. 197 at 213.

[261] Freund, *Legislative Regulation* (1932) at 253, quoted in S.H. Kadish, "Some Observations on the use of Criminal Sanctions in Enforcing Economic Regulations" (1963) 30 U. Chi. L. Rev. 423 at 437.

[262] See H.M. Hart, Jr., "The Aims of the Criminal Law" (1958) 23 Law & Contemp. Probs. 401; H.L. Packer, *The Limits of the Criminal Sanction* (Stanford: Stanford University Press, 1968) at 354-66; S.H. Kadish, *ibid.*

[263] *Supra* note 260 at 223.

[264] See *Chisholm* v. *Doulton* (1889), 22 Q.B.D. 736 at 741 (C.A.).

strict-liability offence and the executive of a company commits the offence in the course of his employment, his company is liable.[265] Where mens rea is required for the offence, a new theory must be adopted: the organic theory, developed to meet this need. According to this theory, certain human agents are considered organs of the company: their thoughts are its thoughts, their motives are its motives.[266] Who qualifies as an alter ego of the company "depends on the nature of the matter under consideration, the relative position of the officer or agent and the other relevant facts and circumstances of the case".[267] This organic theory places corporations on the same plane as individual actors, thereby resolving one legal difficulty.

Punishing the company, however, may not achieve the same deterrent effect as punishing the individual criminal. The crime, in fact, has been committed by the executives, although they might have done so for the benefit of the company. Therefore, some statutes render human agents liable for the crimes of corporations where they might have escaped liability under general agency principles. The *Securities and Futures Commission Ordinance*,[268] *Securities Ordinance*,[269] *Securities (Insider Dealing) Ordinance*,[270] *Securities (Disclosure of Interests) Ordinance*,[271] *Protection of Investors Ordinance*[272] and *Companies Ordinance*[273] all have provisions rendering officers in default liable for corporate offences. Another legal difficulty has been removed.

By the organic theory and statutory provisions, responsible executives can be punished for crimes committed on behalf of companies. There remains a stubborn difficulty which makes application of the most effective of criminal sanctions — imprisonment — fraught with risks: finding the culprit. Experts in organizations indicate that such laws are not enough to net the culprit.[274] The immediate actors are often lower echelon officials or employees who are mere tools of their supervisors.[275] While it is unfair to punish them or to punish only them, it may be impossible to punish their superiors. They may have exhorted subordinates to abide by the law while requiring

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[265] See *Mousell Brothers Ltd.* v. *London and North-Western Railway Company*, [1917] 2 K.B. 836.

[266] See *Lennard's Carrying Company* v. *Asiatic Petroleum Company*, [1915] A.C. 705 at 713, [1914-15] All E.R. Rep. 280 (H.L.).

[267] *H.L. Bolton (Engineering) Co.* v. *T.J. Graham & Sons*, [1957] 1 Q.B. 159 at 173 (Eng. C.A.).

[268] S.F.C.O., *supra* note 19, s. 57 (1).

[269] S.O., *supra* note 23, s. 147.

[270] *Supra* note 33, s. 34(1).

[271] *Ibid.*, s. 48.

[272] *Supra* note 25, s. 7(1).

[273] C.O., *supra* note 18, s. 351(2).

[274] See C.D. Stone, *Where the Law Ends: The Social Control of Corporate Behavior* (New York: Harper & Row, 1975) at c. 6 & 7; S.N. Brenner & E.A. Molander, "Is the Ethics of Business Changing?" (1977) 55:1 Harv. Bus. Rev. 57 at 62; J. Sonnenfeld & P.R. Lawrence, "Why do companies succumb to price fixing?" (1978) 56:4 Harv. Bus. Rev. 145 at 149-50; S.H. Kadish, *supra* note 261; J.C. Coffee, Jr., "'No Soul to Damn: No Body to Kick': An Unscandalized Inquiry into the Problem of Corporate Punishment" (1981) 79 Mich. L. Rev. 386 at 393-400. See also fictional accounts of the life of a middle manager: E. Shorris, *The Oppressed Middle: Politics of Middle Management* (Garden City, N.Y.: Anchor Press, 1981).

[275] See Kadish, *ibid.* at 430-31.

them to achieve certain impossible targets. They thus stay clean if the lower-level employee is caught. A famous study on the ethics of business contains this finding:

> Our results suggest two explanations for this failure [to apply ethics in business]. First, despite its long-run value, ethical conduct apparently is not necessarily rewarded. Within the business organization, 50% of our respondents feel that one's superiors often do not want to know how results are obtained, as long as one achieves the desired outcome.[276]

This difficulty in finding the offender makes the application of criminal sanctions dangerous. Therefore, while the power to imprison must be held in reserve, there ought to be alternative sanctions available.

3. Fining the Wrong Person

The obvious alternative is to fine the offender, and a number of arguments support this approach. To the extent that corporate and securities laws are amoral, the use of monetary sanctions avoids trivializing the criminal law.[277] Moreover, there is no risk of putting the wrong person in jail. The Chicago school believes that punishing the white-collar criminal by monetary penalties is also more efficient. Professor Becker presents a cost-benefit analysis of combatting crime, asserting that an optimal system of criminal justice reduces these costs to a minimum. Fines conserve resources, compensate society and punish offenders. The implication is that if an offender can pay the fine he should be punished solely by fine; if he cannot pay, then another punishment must be available.[278]

Many objections have been raised against substituting fines for imprisonment. Becker himself raised and answered one moral objection: fines are immoral because they allow the purchase of a right to commit an offence. He answered this objection by suggesting that prison terms can be regarded in the same light. The only difference between a fine and imprisonment is the unit of account.[279] This may be the scholar's view, and even the "correct" view, but it is not the public's view. To allow the rich to buy themselves freedom but to incarcerate the poor arouses a sense of injustice and imposes a "demoralization cost" that has been left out of the Chicago formula.[280]

A much debated objection is the low deterrent value of fines. Professor Coffee points out that stipulated fines are very low in absolute terms. At the time of his writing, the common trade-off was US$1,000 for one year of imprisonment, whereas the average earning power for one year exceeded US$10,000.[281] Fines are also derisory in Hong Kong where, for example, a fine of HK$25,000 is imposed for issuing a non-conforming prospectus,[282] and a fine of HK$25,000 is imposed on directors who fail to

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[276] Brenner & Molander, *supra* note 274 at 62.

[277] See Mann, *supra* note 254.

[278] See G.S. Becker, "Crime and Punishment: An Economic Approach" (1968) 76 J. Pol. Econ. 169.

[279] See *ibid.* at 195.

[280] See Coffee, *supra* note 191 at 446-49.

[281] See *ibid.* at 434.

[282] C.O., *supra* note 18, s. 38(1B).

disclose a material interest in the company's contract.[283] It is clear that such fines are not equivalent to imprisonment in deterrence value. Two questions arise: can a monetary equivalent to imprisonment be found and should fines be raised to this level? Professor Posner (as he then was) argues that there is a monetary equivalent to imprisonment though it may be difficult to calculate.[284] Coffee disagrees. Part of his argument is intuitive. The principal costs of imprisonment to the offender are humiliation and stigma. How does one calculate a monetary equivalent? Putting the imponderable aside, assume the offender is a rational economic animal. The first problem he faces is the uncertainty of benefits. If he engages in insider trading for his own account, his expected gains are affected by the uncertainties of the market. This he may be able to calculate. However, if he engages in a crime on behalf of the company, by for instance authorizing the issuance of a non-conforming prospectus, the immediate gains accrue to the company. The benefit to him of this crime is preservation of his position and promotional prospects within the organization. This is a very uncertain and intangible benefit. Nevertheless, assuming the benefits can be ascertained, can he and the criminal justice system calculate the costs so that the crime would not pay? Simply put, if the benefit is expected to be $100,000, costs of $100,000 should deter. The stipulated fine itself, however, would have to be significantly higher than $100,000 because the cost of a penalty is its severity discounted by the risk of apprehension. The fine cannot be determined in relation to a known and fixed benefit unless the risk of apprehension is known. Coffee points out that there is no reliable means for determining this risk.[285] The rational offender has insufficient data to come to a decision.

Even if the offender and the system overcome all difficulties with quantification, two factors still detract from the deterrent value of fines. First, a large enough fine may not be affordable; to threaten someone who has a net-worth of $1,000,000 with a fine of $10,000,000 is meaningless. Second, where the fine is affordable, it is often not collectable because of the ease with which the offender can hide his assets. Again, the threat is meaningless.[286]

Apart from the question of deterrence, Coffee points out that the Chicago school overlooks the costs of fines, both to society and to the offender. While prison costs are obvious and calculable, the enforcement costs of fines have been ignored. Actual experience shows a high default rate in the payment of fines.[287] Moreover, the costs of fines are not borne by the offender.

Another problem with fines is their flow-through effect. A company that breaches its obligation to supply information to shareholders commits an offence punishable by a fine of HK$25,000 and a daily default fine of HK$200.[288] Who ultimately bears the

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[283] C.O., *ibid.*, s. 162(3).

[284] See R.A. Posner, "Optimal Sentences for White-Collar Criminals" (1980) 17 Am. Crim. L. Rev. 409.

[285] See Coffee, *supra* note 191 at 442.

[286] See *ibid.* at 436-39.

[287] See *ibid.* at 440-41.

[288] See C.O., *supra* note 18, s. 129G (2), (3).

burden of this fine? The shareholder. So the system penalizes shareholders for a breach of a statute designed for their protection. This may seem absurd to the uninitiated and may be the reason for the derisory amounts prescribed and actually levied. A powerful reply supporting this model is that if shareholders are hurt, they will establish systems to ensure that the human agents of the corporation do not offend in future. To achieve this, the fines would have to be raised considerably. However, when fines are raised, other stakeholders suffer. Consumers are on the forefront. If the severity of fines threatens the solvency of the company, creditors and employees suffer for the fault of someone else. This is neither fair nor efficient.

C. Alternative Sanctions

Coffee proposes two sanctions, neither of which involve imprisonment or payment of cash, which may address the particular problems of sanctioning the corporate offender. One proposal is to direct adverse publicity towards the responsible individual. As an illustration, he cites the result of investigative reports following the U.S. foreign-payments scandal.[289] The most imaginative is the equity fine. Coffee proposes that a convicted corporation be required to authorize and issue shares to the state's criminal-victim compensation fund. The number of shares demanded would have an expected market value equal to the cash fine necessary to deter illegal activity. Because there is no payment of cash, the threat of a large fine to the survival of the corporation is minimized and the spillover of corporate penalties to workers and consumers is reduced. The sanction effectively falls on the shareholders. Thus, shareholders would discount legally risky firms and this would in turn cause managers to behave accordingly.[290] In Hong Kong, an equity fine is particularly apt because the dilution of control and equity has an immediate impact on the controlling shareholder who, unlike the dispersed shareholders of Anglo-American companies, is in a position to correct the situation. In fact, where the controlling shareholder is the perpetrator, the equity fine is a punishment that perfectly fits the crime.

Conclusion

This article has argued that the system of sanctions in Hong Kong, which relies on nonlegal sanctions for breaches of corporate and securities norms, is fundamentally flawed. While there has been sporadic recognition of this problem,[291] there has never been any systematic study of it nor any political will to pursue the matter. It is

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[289] See Coffee, *supra* note 274 at 424-33.

[290] See *ibid.* at 413-24.

[291] On the occasion of an aborted takeover, the S.F.C. stated: "Consideration may need to be given as to whether there should be a statutory remedy for those who incur losses by purchasing shares on the strength of an announcement of an unconditional offer" (*Annual Report 1995/1996*, *supra* note 92 at 33). On the question of disclosure, the S.F.C. stated: "CFD is currently preparing a consultation paper which proposes the introductiou of minimun statutory obligations for listed companies aimed at ensuring that documents issued by listed companies to investors or their shareholders must meet minimum disclosure standards and are not misleading or inaccurate" (S.F.C., *Annual Report 1991/1992* at 45).

necessary to review the entire system and to separate out core principles, implementing procedures and exhortation to higher standards. Only the last category should remain nonlegal; the first two should be enacted as principal and subsidiary legislation, respectively. In addition, express rights of action should be provided in statute, as the courts are unable or unwilling to imply such rights. Rights of action are necessary to secure compensation for the injured investor and also to deter. Before rules of derivative and class actions are liberalized and a contingency-fee system is introduced, enforcement by the S.F.C. is the only viable alternative. It requires that the S.F.C. be vested with the power and duty to take civil actions to enforce corporate and securities laws. Finally, the list of criminal offences in Hong Kong is long, but the record of enforcement is poor. This trivializes the law and damages the social fabric. Consideration should be given to pruning the list and to devising more effective sanctions. If none of the above is palatable to the authorities, the system of nonlegal sanctions itself could be made more meaningful by instituting a public register of shame.