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IN THIS ISSUE:

Securities- the 'grey market' - trades binding legally ?

Securities- margin call- how is it calculated ?

Legal fees- the enormous charge out rates of some firms

Computer Software problems- have you any rights ?

China and the WTO- how to distribute into China ?

Money laundering- do you have any responsibility ?

Trusts/Wills- the differences

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(Notes in red indicate important facts, points and principles)
(Notes in blue are our summary comments)

1. Securities Law

(A) Sales of Shares in the 'grey market'

Any person having the remotest interest in the Hong Kong share market will have heard of the 'grey market' and will know it is an off market trade carried on privately after market hours and both in and outside Hong Kong territory. Its use before listing of an IPO is most common. There is a long delay between the opening of subscriptions on an IPO and the commencement of trading of the shares on the Exchange during which time market participants might wish to increase or reduce their exposure. The trade is agreed but payment would only be made and delivery of the shares would only take place once the shares have been listed on the Exchange. Typically, settlement would take place two days after the listing of the shares. If, for any reason, the listing does not occur, there would be no transaction.

Is a trade in the "grey market" enforceable ? What if a buyer refuses to pay for the shares purchased ? And what of a trader who trades in this market who is not licensed as a securities dealer in Hong Kong ?

The Court of Appeal case of APC Securities Ltd ('APC') V Tullet and Tokyo International Ltd ('TT') provides an instructive example of the situation mentioned and provides a useful summary of the relevant law in Hong Kong.

As to the facts, a dealer ('R') at APC entered into a trade with TT on the grey market to purchase 1,000,000 China Telecom shares at HK$18.05. R was trading illegally on his own account but the trades were made in the name of APC with R using a fictitious name as a client at APC. The price of she shares dropped appreciably after purchase and R was unable or refused to pay personally, saying that the purchase was on behalf of a client. APC directors, knowing nothing of the trade, refused to honour the debt of some HK$18.00 Million on the basis that R had no authority as the agent of APC to undertake the trade, that TT was not registered as a dealer, and that the trades were creating another market in breach of the exclusive role of the Exchange to run a stock market. TT sold the shares at a loss of some $7000,000.00 and sued APC for this loss.

The Court of Appeal held that APC were liable for the loss on the basis that:

(a) Having clothed R with the necessary authority as a dealer, APC was liable for the acts of its agent albeit R had acted illegally and fraudulently. The situation may have been different if there had been evidence that R had been specifically forbidden from dealing in the grey market, but that was not so. Nor was the fact that R traded on his own account relevant as he had put the trade in the name of APC and they were liable for it.

(b) The evidence showed that TT dealt with its counterparties on a one-to-one basis.,The counterparties' relationship was with TT and no one else. TT may have sought to match its trades. Nevertheless, it did so on a principal-to-principal basis. In other words to commit an offence under section 20 of the Securities Ordinance, which prohibits the establishment of a secondary stock market, it would have to be proved that TT were acting as dealers and intermediaries and creating a market in their office. As they owned the shares and were selling as beneficial owners, no false market was created.

(c) TT were not in breach (although it was not registered) of section 48 of the Securities Ordinance in that in terms of section 3 (the definition of dealing in securities) they were acting as principals and were dealing with APC as registered dealers, which is permitted (the " dealer exemption') whereas had they been acting as agents for a commission then the dealing with APC would have been illegal.

Summary: The case shows that there is a considerable difference in law between a party buying and selling on the 'grey market" as a principal as opposed to an agent attempting to make a market and sell securities as a dealer for a commission. The lesson is clear that the public would be unwise to deal with a party buying or selling securities unless it is known that the party is a registered dealer acting for a licensed firm, or the party concerned can prove that he or it is the beneficial owner of the securities at the time of sale.

(B) **<u>How is a Margin Call calculated by a Bank</u>** ?

A recent case decided by the Court of Final Appeal in March 2002 dealt with how a margin call is calculated and is worth noting, as it shows that the method of calculating the margin is not always straightforward. And the valuation concept itself, that is a loss of value in the security, may be difficult to understand. So difficult in fact that the Court of Final Appeal found that the Court of Appeal below had completely misunderstood the valuation principle involved, and thought that value of the currency in which a party was speculating was the key to deciding whether a margin call was justified, rather than the value of the speculative currency in terms of the loan currency.

The trader M entered into a Master Agreement ('Agreement') with the Bank to cover currency trading activities. The terms of the Agreement contained the following clauses:

" 3.1 Immediately upon the Customer entering into a Contract, the Customer shall, unless the Bank otherwise agrees, pay to the Bank an Initial Cash Margin in an amount equivalent to five per cent. (5%) ... of the face value of the Contract ..."

3.2 The Bank may at any time and from time to time...request the Customer to pay Additional Cash Margin or Margins for any outstanding Contract ... in such amounts so that the percentage that the relevant Margin bears to the then current value of the relevant Contract is not less than the percentage applicable under Clause 3.1 and the Customer shall pay all such Additional Cash Margin in accordance with the demand."

In July1998 M. decided to speculate on the foreign exchange market. He opened an account for that purpose with the Ka Wah Bank Ltd ("the bank") and entered into a number of currency purchases. The three with which this appeal was concerned were to buy Japanese Yen for a total of US$1.l million at the rate of exchange prevailing at the time of the contracts.

M of course hoped that by the time he had to complete the contracts, the Yen would have risen in value against the dollar. In that case, his Yen would have been worth more than the US$ 1.1 million he owed. He did not particularly want to pay dollars or take Yen. What was no doubt contemplated was that the bank would net off the cross-debts and pay M the profit, if any, or debit him with the loss. As a matter of contract, however, the transaction was a sale of Yen by the bank in exchange for a payment in dollars.

In order to provide against the possibility that the Yen might go down as well as up, the bank required security in the form of a cash margin. In fact the bank was obliged by the regulatory system under which it operates (Leveraged Foreign Exchange Trading Ordinance, Cap. 451 and Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules, Cap. 451 sub. leg. D) to require certain minimum cash margins to be deposited.

The Yen dropped sharply against the dollar. M was showing a floating loss of about US$50,000 on the three contracts. The bank decided to ask under clause 3.2 for more margin. It tried to reach M on his mobile phone and the telephone of a friend in Hong Kong which he had notified to the bank. But no contact was made until more than a week later.

No instructions or additional cash margin were provided. So the bank treated his failure to pay as a termination event under the Agreement, which gives it a right of termination if "the Customer fails to pay any ... Additional Cash Margin." It closed out the three contracts and debited M with the losses.

On 25 September 1998 M sued the bank for damages for breach of contract. He said that the bank had not been entitled to terminate the three contracts because it had not been entitled to demand additional cash margin. He said that upon the true construction of clause 3, a cash deposit of US$70,000 held by the bank exceeded its entitlement. Yam J rejected this argument and dismissed M's claim. But the Court of Appeal accepted it. Against that decision the bank appealed.

M, who appeared in person before the Court of Appeal, somehow persuaded the Court of Appeal that when the value of the Yen declined, the "value of the contract" in US dollars went up. Keith JA said that when M was showing floating losses of US$50,000 on his three contracts, their "current value" had risen from US$1.1 million to US$1.15 million.

The Court of Final Appeal completely rejected the approach of the Court of Appeal holding that on the true construction of the Agreement:

(i) if the value of the Yen goes down, the value of M's rights under the contract goes down and the bank correspondingly requires more margin to maintain its security. How is the amount to be calculated? The Court of Appeal, proceeding on the theory that more margin was needed when the value of the contract went up, said that the bank was entitled to 5% of the increase. But once it is appreciated that one needs more margin if, and only if, the value of the contract goes down, a different approach is obviously necessary.

(ii) For the purposes of the formula, this must meant the value of the contract to M. If the calculation is made in US dollars, the value of the contract to the bank is always the same. It is entitled to US$1.1 million, no more and no less. But the formula contemplates that the value of the contract is something which will vary. So it must mean its value to M because he is entitled to Yen, and the US dollar value of his Yen will fluctuate.

(iii) The language of the Agreement makes it clear that the bank is entitled to a margin of 5% of the current value. If, therefore, the value of M's Yen has fallen, in dollar terms, to US$1 million, the bank is entitled to a margin of $50,000. If it has fallen to US$900,000, the bank is entitled to a margin of US$45,000.

(iv) It was not compatible with such a calculation that the M should be credited with the whole of his original cash margin, as if it had remained intact. On that basis, the bank would never be entitled to additional margin. 5% of the original value will always be more than 5% of any lower value. Plainly, therefore, what the formula contemplates is, so to speak, a new beginning, in which the bank will be covered for the current (or "floating") loss and provided with the same relative cash margin as it had at the beginning, to cover it against any future decline in the purchased currency.

(v) It followed that the bank was entitled to deduct the US$50,000 floating loss from the cash margin it held and to require that the remaining sum be made up to 5% of the dollar value of M's Yen entitlement on the day of the demand. The money which the bank held as cash margin was insufficient for this purpose and it was therefore entitled, in default of payment, to close out the contracts.

Summary: It is apparent that the terms on which a margin call may be made should be studied and clearly understood if borrowing against fluctuating securities such as shares or currencies are to be undertaken. In the above case the formula (a multiplier of 5%), and the currency of value, appeared to be clear, but notwithstanding that, both the investor M and the Court of Appeal were able to come to an entirely different interpretation. Borrowing on margin is risky enough without misunderstanding the margin formula.

2. <u>**Legal fees- the enormous charge out rates for newly qualified and support staff**</u>

When instructing a large international legal firm in Shanghai recently on a China law matter, we were sent a schedule of billing and charge out rates for partners and qualified staff, as well as support staff. We were astonished at the level of some of the charges.

While we accept that a senior partner of a large international firm may be able to justify a charge out rate of US$650.00 per hour (say HK$5000.00 per hour) for major commercial law matters, such as IPO's etc, we were not impressed with the charge our rates for some qualified and support staff, whose charges will no doubt be added to the partners rate on major matters where a team is involved. The charges for consultants and legal assistants ranged from US$180.00 to $250.00 per hour, which at around HK$1500.00 to $2000.00 we think is high. These charges overall are quite beyond the ability of an individual client or a medium business to pay, and there is little doubt that major international legal firms pitch their services at large multi- nationals only.

We mention again that out charge our rates are in the region of HK$750.00 to $1200.00 per hour depending on the type of work involved, and if through our Hong Kong office around HK$2000.00 to HK$2,300.00.per hour.

3. <u>**Computer Software Contracts- has the customer any rights ?**</u>

All clients will have had the experience (as we have done recently) of buying a new computer complete with hardware and the software package. Later, there are glitches in the software, or as we experienced recently, Microsoft telephone back up service completely stalled the computer necessitating a complete re-installation of the whole software package. Their attempts to fix the problem were a complete failure, yet they and the retailer selling the package say they are not responsible; there is no guarantee of software, only hardware.

Is this the legal position in Hong Kong ?

The answer to the question is that it depends on the nature of the contract to purchase the hardware and software, and whether the sale is covered by the Sale of Goods Ordinance('Ordinance') which contains statutory warranties that the goods sold are of good merchantable quality when sold.

In Hong Kong, computers are more and more commonly used both at home and in business (including non-profit organisations, such as, government, charitable groups, etc). However, it is not clear whether the definition of "goods" in Cap 26 covers computer software and there is no Hong Kong case on the subject.

The following matters may be mentioned:

(a) Computer hardware is a tangible personal chattel and therefore should be goods within the definition of "goods" in Cap 26.

(b) As for a computer system comprising both hardware and software, *Toby Constructions Products Pty Ltd v Computa Bar (Sales) Pty Ltd,*[90] an Australian case, held that this was "goods" within the definition of the Sale of Goods Act 1923 (NSW) and the Trade Practices Act 1974. In this case, the plaintiff acquired a complete computer system comprising hardware and software and there were defects in the computer system.

(c) Quite clearly, a sale, without more, of a disk, should be 'goods' under the Ordinance. A fault in the software system would no doubt be covered by the statutory warranty as to fitness and quality.

(d) It seems that a manual, which say contained defective instructions, would also be " goods' and again there would be an implied warranty as to fitness.

(e) It is uncertain whether software downloaded from a Web site would be covered, as this is intangible information and probably not 'goods' under the Ordinance.

Summary: As the case quoted above is not applicable in Hong Kong, the position remains unclear, despite that fact that there is no logical reason why in the case of simple sale of a CD there should not be a warranty under the Ordinance. The Law Reform Committee has recommended that the definition of 'goods' in the Ordinance be amended to include software on a disk or other delivery mode. It is to be hoped this will happen, as otherwise the general public remain in a weak position with suppliers when faults are discovered in newly purchased systems.

4. **China and the WTO- how can you distribute goods in China ?**

With the announcement of China's WTO accession, large numbers of companies and multi- nationals will be looking at ways to enter and access the China market.

Access for imported goods into China is a difficult and complex area, and it remains to be seen if the changes that China contemplates to its laws as a result of the WTO accession will be an improvement on the present situation.

We do not claim to be experts on the China law in this area, but the following summary of the issues involved, as we understand them, may at least identify the problems for importers.

(a) The provisions dealing with China's access arrangements are set out in the Protocol of Accession (POA) which sets out binding legal arrangements over China's accession. There are commitments there on specific goods and services.

(b) China' present law normally only allows the importing of foreign goods by PRC enterprises known as foreign trade corporations. (FTCs). It has been a highly controlled sector.

(c) Under the existing system, imported goods must be sold to Chinese import/export companies or PRC customers with a clearance to buy imported goods. Foreign enterprises (FIEs) or wholly owned foreign enterprises (WFOES) can normally only import goods for their own use, and can only sell what they produce.

(d) Distribution in China is heavily controlled- FIE's will have limited opportunities to set up distribution outlets or to operate a supply chain.

(e) Sino/Foreign joint ventures are an exception to the above rules.

(f) Holding Companies set up in China may act as sales agent and distributor for their own products- not other products. However, the capital requirement would be as high at US$30.00 Million.

(g) Under the POA China has promised to remove the limitation on market access, but only on a phased basis over three years in some cases.

(h) Some of the amendments to the existing law will include differentiation between trading, import/export and distribution rights, allowing all FIEs to engage in trading in three years, save for some exceptions, allowing WFOES to engage in supply chain activities such as retailing, wholesaling, franchising, storage, repair etc.

(i) Geographic and equity restrictions are meant to be removed within three years, but there will be restrictions still on chain stores.

(j) Approvals will continue to be a governmental process, and subject to restrictions.

Summary: We are skeptical about China honouring to the letter the undertakings in the POA and believe that consents to do anything in China will still be subject to vague and arbitrary approval procedures as they are now. Not much is expected to change in the next three years.

4. **Money laundering- is your business under an obligation to report dealings ?**

It is not as well known in Hong Kong as it should be, but both lawyers and those business's such as Banks, trustee and nominee companies, real estate agents, etc. and indeed anyone who handles financial and property transactions are under an obligation to report transactions of a client where the property handled, whether it be money or other property, represents the proceeds of drug trafficking or of an indictable offence. The failure to disclose such information to the Police or Customs department means that you commit an offence which is punishable by a fine of HK$50,000.00 or imprisonment for 3 years.

Other issues to highlight are as follows:

1. Solicitors confidentiality and client privilege are no defence;

2. Solicitors, and others, must report even the mere receipt of funds, absent any other dealing, if they even suspect on reasonable grounds that the funds are ' dirty money';

3. Under the Amendments to the legislation, reasonable grounds to suspect alone will be the test. The duty is very high and cannot be ignored.

4. Certain categories of persons are under an obligation to keep records of any remittance transaction over HK$20,000.00. Any person or business sending or receiving any money to or from a place outside Hong Kong as a business, may be defined as a remittance agent. If so defined, the agent must keep records of the transaction, including serial number, currency, amount, dates and times, and full details, including name and ID card, bank account, of the sender or remitter.

Summary: No business that is involved with acting for clients, whether it be as a lawyer, real estate agent, trustee, nominee, banker etc can afford not to carefully record and appraise transactions where money and property is dealt with. In addition, it will pay to have clients sign forms declaring that funds are clean where there is the slightest possibility that ' dirty money' is involved. However, that would not be enough of itself to avoid a prosecution if there were suspicious factors present.

5. **TAX ISSUES**

(a) Advance ruling by the IRD- tax losses.

Legislative amendments some years ago allowed approaches to be made to the IRD for binding rulings on set fact situations. We were skeptical how effective this would be, but a review of the latest rulings on the IRD Web site have thrown up one or two interesting rulings, one of which touches on the use of tax losses by Hong Kong companies where there has been a change of shareholding. Complex rules in many commonwealth countries cover this topic, but section 61B of the IRD Ordinance refers only to a change of shareholding, the dominant purpose of which is to access the tax losses of a company.

In the example below, the IRD were apparently convinced that the changes to the shareholding and the anticipated profits from a new business was not aimed at solely using the tax losses. The fact that one of the existing shareholders was to remain and there was a transfer of loan accounts for a nominal sum in what appeared to be a re- structuring of the existing business appear to have been important factors, although a sale of the entire shareholding and the use of a business in a non – restaurant business may have attracted a different attitude from the IRD.

It is also interesting that the legislation makes reference to a change of shareholding as the trigger point, leaving open the possibility that a trust owning the shares which simply changed its beneficiaries would not, on the face of it, be caught be the legislation. Use of this loophole might however attract the application of the sister avoidance section 61A if the IRD ever were able to untangle and establish the beneficial ownership of the Company. However, we think there are opportunities to use tax loss companies in certain situations but obviously some care is necessary.

Background

X Ltd. was incorporated in Hong Kong on 30 July 1996. Its issued and paid up capital consisted of two shares of $1 each. One share was issued to Mr A. The other one share was issued to Mr B.

X Ltd. operated a Chinese restaurant business. It commenced business on 11 May 1997 and ceased operation on 9 March 1998

The audited accounts of X Ltd. covering the period from 30 July 1996 to 30 June 1998 showed accumulated loss of $7 million odd

As at 30 June 1998 Mr. A and Mr. B had advanced directors' loans of $6,500,000 odd and $600,000 odd to X Ltd. respectively.

New Arrangement:

The one share held by Mr. B in X Ltd. is proposed to be transferred to the other shareholder Mr. A. In addition, the director's loan from Mr. B in the amount of $600,000 odds would also be transferred to Mr. A for a nominal consideration of $1.

X Ltd. proposed to operate a completely new restaurant/karaoke business after the change of shareholding

X Ltd. would continue to be managed by Mr. A after the change of shareholding. Mr. B would continue to be a director of X Ltd.

The IRD ruled that the change of shareholding was not motivated by a desire to use the substantial tax loss in the new business.

(b) Management fees- are they still deductable ?

The latest cases make it clear that blatant attempts by a business to siphon off expenses as a deduction by using a service company which charges a fee, and then itself deducts expenses, such as boat expenses against its own income, are bound to fail. However, expenses incurred by the management company that are referable to business carried on by the business which is paying the management fee must, on general principals, be deductible to the management company. Obviously the fee for the services or the effective mark up over and above legitimate expenses is always an issue, but the IRD have always been prepared to allow mark ups of 5% to 10% in most cases.

In other cases the inter- position of a service company, for no commercial reason, has attracted use of the avoidance legislation in section 61 if the IRD Ordinance. However, legitimate use of a company, where the user is an independent contractor, free from control of the other party, will invariably be permissible. However, there are difficulties in certain areas, such as real estate sales persons, where in come cases the individual concerned may truly be independent. Use of a well prepared consultancy agreement is essential in these situations.

5. **TRUSTS - WILLS- there is a difference**.

We mention this matter as there can be a fundamental misunderstanding of the differences between a trust and a will.

A will takes effect only on the death of the person making it, and its provisions remain dormant in the meantime. A will however can be changed at any time.

By contrast, a Trust is set up by the Settlor during his lifetime by execution of a Trust Deed, and the property which is owned by the Trust comes under the control of the Trustee immediately. Although the terms of a trust deed can be varied, it is not possible in all cases to re- write the whole deed, as the interests of the beneficiaries, particularly if minors, are interests that must be protected by the Trustee.

A will however does contain provisions which are in fact "will trusts" established by the will, but there is less opportunity to amend the terms of those trusts, unless by consent of all beneficiaries, as the terms of the will are generally final and binding on all parties.

It is essential that all those settlors who set up trusts also make a will, as the will needs to cover the debt created by the transfer of assets to the trust, and it can also can contain provisions nominating who has the right to appoint new trustees of the trust.

A will can also set up a power of appointment, which is useful tool. As an example, you can grant you wife a power of appointment under a will and give her say $100,000.00 to divide it, at her discretion, and in such shares as she will determine, amongst children or other close family members as a class after your death. It means the wife, who will be closer to events after death, can use her discretion and not be tied down by fixed provision in the will. Such a power is similar to powers under a trust deed, and demonstrates that a will is an important planning strategy in its own right.

It should also be noted that a letter of wishes given to the trustee of trust has no legal status and in no sense is a will.

Close examination of a persons affairs is required to see which assets should be kept in the person's individual name, and dealt with by a will, and what assets should be transferred to a trust to be dealt with by its provisions. Tax and other legal issues are involved. We offer comprehensive advice on planning of this nature. Our costs for a simple will are HK$2000.00 to HK$3500.00, and our costs for Trusts range from HK$8000.00 in very simple cases to HK$25,000.00 in more complex cases.

MATTERS IN BRIEF:

1. Enduring Power of Attorney- for those who wish to have a person manage their day to day affairs after their death. Contact us for further details.

2. Assignment of Income from a property or investment- you do not have to transfer ownership of a property if you wish to assign the income to another party. The law in HK permits an assignment of the income itself, and not the property, which may have taxation advantages for the person transferring the right to the income.

3. Tax on property speculation in Hong Kong- we continue to be amazed and astonished that persons buying a property for investment(and possibly short term gain) continue to do so without adequate company resolutions setting out the purpose of the purchase, its classification as trading or capital stock, the investment and rates of return required etc. We have been involved in cases where the preparation of full and proper resolutions on the purchase(and on the sale- equally important) has saved the person from profits tax. We have standard forms and give advice over the issues involved.

4. The Hong Kong International Arbitration Centre has useful powers of Arbitration in disputes over Domain Names- it recently ruled that a company demonstrated bad faith and had attempted to use an existing domain name registered with the Hong Kong Domain Name Registration Co. Ltd. or HKDNR (previously administered as HKNIC) Part of the decision was that the pending nature of the existing users trade mark did not prevent a passing off action to protect the existing name. If

you do not have domain name registration for a product or service, you should obtain it immediately.

5. Hong Kong Estate Duty- holding of share register of an offshore company in HK. Care is needed where a substantial client may have property held by say a BVI company and the Company kit, including the share register book, is held in HK. Although we have not seen a case where the IRD has enforced its strict legal rights, technically if the share register is in HK the shares in the BVI company are Hong Kong property and liable for estate duty assessment. It is best to hold records outside HK in all cases, along with promissory notes that may relate to offshore debts.

6. What company or entity to use if you trade in China ? This is a complex issue, involving mixed questions of tax and law. Using a HK company may have substantial disadvantage from a tax perspective, and a multi- national company may well be better advised to invest direct and use its double- tax treaty with China, which in most case will be superior to the arrangements between HK and the PRC.

7. New Securities Ordinance- this was gazetted on the 28/3/2002 and consideration of the content of subsidiary legislation dealing with compliance matters is now under way. Of particular interest are the calling for submissions on the 16/5/2002 by the SFC from the public on new draft regulations dealing with disclosure of interests (replacing the old SDI Ordinance) Included in the draft are provisions lowering the disclosure threshold to 5%, disclosure of derivative interests, and non-exemption of trust companies.

We welcome any questions concerning any of the above matters.

OFFICE HOURS: We can be contacted on two telephone Nos : either 09-4764471 or 4764472 up to 6.00 PM HK time.