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Legal pitfalls that start-ups need to be aware of



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Funding – criminal and regulatory risks

What is Crowd-funding?

- Definition:

“use of **small amounts of money** obtained from a **large number of individuals or organisations**, to **fund** a project, a business or personal loan and other needs through an **online web-based platform**”

Funding – criminal and regulatory risks

Regulations of Crowd-Funding in Hong Kong

- From a regulatory perspective, there are two different groups:
 - P2P lending and Equity crowd-funding
 - reward/pre-sale crowd-funding and donation crowd-funding
- P2P Lending and Equity Crowd-funding involve financial returns and yields or return of investments and have attracted the attention of Hong Kong regulators
- reward/pre-sale crowd-funding and donation crowd-funding are generally unregulated in many jurisdictions including Hong Kong

Funding – criminal and regulatory risks

- No single and comprehensive piece of legislation that deals specifically with crowdfunding
- “Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities” – issued by SFC in May 2014
- Potentially subject to:
 - Restrictions under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (“**C(WUMP)O**”)
 - Restrictions under the Securities and Futures Ordinance (“**SFO**”)
 - Regulations under Money Lenders Ordinance (“**MLO**”)

Funding – criminal and regulatory risks

Restrictions under C(WUMP)O

- restrictions on offers of shares or debentures to the public
- For Hong Kong incorporated companies, any prospectus issued (under s.38) by or on behalf of the company, and for overseas companies, any prospectus distributed in Hong Kong (s.342) must:
 - comply with the content requirements under C(WUMP)O (the Third Schedule); and
 - be registered with the Registrar of Companies.

Funding – criminal and regulatory risks

Restrictions under C(WUMP)O

- Definition of “prospectus” covers any prospectus, notice, circular, brochure, advertisement or other document which:
 - Offers any shares or debenture of a company to the public for purchase or subscription; or
 - Invites the public to subscribe for or purchase any shares or debentures of a company
- A company which issues a prospectus that does not comply with disclosure and registration requirements, and every person who is knowingly a party to the issue, commits an **offence** under C(WUMP)O

Funding – criminal and regulatory risks

Restrictions under C(WUMP)O

- Available exemptions include:
 - Offer is made to professional investors (as defined in SFO)
 - Offer made to not more than 50 persons within a period of 12 months;
 - Total consideration payable for the shares or debentures does not exceed HK\$5 million within a period of 12 months

Funding – criminal and regulatory risks

Restrictions under C(WUMP)O

- Offer is made to professional investors (as defined in SFO)
- Professional investors (“**PIs**”) falls into the following three categories:
 - Institutional PIs (under para. (a) to (i) of the definition of PI in s.1 of Part 1, Schedule 1 to the SFO)
 - Individual PIs (under s.3(b) of the Securities and Futures (Professional Investors) Rules (“PI Rules”))
 - Corporate PIs comprising those falling:
 - under ss.3(a), (c) of the PI Rules
 - under s.3(d) of the PI Rules
- to make use of this exemption – restrict access to PIs only

Funding – criminal and regulatory risks

Restrictions under C(WUMP)O

- Offer made to not more than 50 persons within a period of 12 months
 - Limit on the number of offers made (not offers accepted)
 - To make use of this exemption – restrict access to 50 persons
 - Upper limit of 50 takes into account of offers by the same person in reliance on the same exemption made in the preceding 12 months

Restrictions under the SFO

Two areas:

- Prohibition on the issue of Unauthorised Invitations to the Public under section 103(1) of the SFO
- Prohibition on carrying on a “regulated activity” under the SFO without being licensed by the SFC

Restrictions under section 103(1) of the SFO

- Prohibition on the issue of Unauthorised Invitations to the public under section 103(1)

“... a person commits an offence if he issues, or has in his possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document which to his knowledge is or contains an invitation to the public-

(a) to enter into or offer to enter into:

(i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

(ii) a regulated investment agreement; or

(b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme,

unless the issue is authorised by the SFC under section 105(1).”

Restrictions under section 103(1) of the SFO (con't)

- Section 103(10) of the SFO contains deeming provisions:

“For the purposes of any proceedings under this section-

- (a) an advertisement, invitation or document which consists of or contains information likely to lead, directly or indirectly, to the doing of any act referred to in subsection (1)(a) or (b) shall be regarded as an advertisement, invitation or document (as the case may be) which is or contains an invitation to do such act; and
- (b) an advertisement, invitation or document which is or contains an invitation directed at, or the contents of which are likely to be accessed or read (whether concurrently or otherwise) by, the public shall be regarded as an advertisement, invitation or document (as the case may be) which is or contains an invitation to the public.”

Restrictions under section 103(1) of the SFO (con't)

- online crowd-funding platform containing information inviting investment in equity or debt securities or in a collective investment scheme is likely to be regarded as an “invitation to the public” requiring SFC authorisation if there is not an available exemption

Restrictions under section 103(1) of the SFO – Available Exemptions

- Offers exempted under the Seventeenth Schedule to C(WUMP)O
- Offers only to professional investors – section 103(k) SFO

Restrictions under section 103(1) of the SFO — Offers not to the Public

- Offers not to the public
 - If the offer is structured not to be a public offer, it would not contravene with this provision
 - The SFC has not indicated expressly the number of offerees that would be considered as the public
 - But to rely on this, access to the information on the online crowdfunding platform has to be restricted

Restrictions on carrying on of a “regulated activity” under the SFO

- Offence for conducting “regulated activities” without being licensed or registered
- Types of regulated activities that might be involved with crowd-funding:
 - Type 1: Dealing in Securities
 - Type 4: Advising on Securities
 - Type 6: Advising on Corporate Finance
 - Type 7: Providing Automated Trading Services
 - Type 9: Asset Management
- Compliance with the SFC’s Code of Conduct for Persons Licensed by or Registered with the SFC

Restrictions on carrying on of a “regulated activity” under the SFO (con’t)

- Uncertainty on whether need to be licensed or registered
- E.g. “dealing in securities”

A person conducts “dealing in securities” if he, whether as principal or agent, makes or offers to make an agreement with another person, or induces or attempts to induce another person to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities

- Information posted on the website in relation to investment-based crowd-funding – likely falls within the definition

Restrictions on carrying on of a “regulated activity” under the SFO (con’t)

- Exemptions for “dealing in securities”:
 - Dealing with professional investors – not apply
 - Only available to person acting as the principal in the transaction
 - Only institutional investors
 - Person as principal, acquires, disposes of, subscribes for or underwrites securities – not apply
 - Only apply to person acting as principal
 - Uncertain whether “disposes of” covers marketing activities

Funding – criminal and regulatory risks

SFC takes action to halt ICO to HK public

- ICO issuer **Black Cell** Technology Ltd (**BC**) has halted its initial coin offering (**ICO**) to HK public and agreed to unwind ICO transactions after the SFC has voiced concerns that BC had engaged in (a) potential unauthorized promotional activities and (b) unlicensed activities
 - **S 103** – an offence for a person to issue, or to have in possession for the purpose of issue, in HK or elsewhere, an ad, invitation or document which is to his knowledge is or contains an invitation to the public, acquire an interest, or participate in, or offer to do so in a **CIS**, unless the issue is authorized by SFC or an exemption applies
 - **S 114** – an offence for a person to carry on a business in a regulated activity or **hold** himself **out** as carrying such a business in a RA unless the person is licensed or authorized by SFC

Funding – criminal and regulatory risks

- What is a Collective Investment Scheme (CIS)?
 - **4 elements** (a) must involve an arrangement re **property** (b) **participants** do **not** have day-to-day control over the management of the property even if they have the right to be consulted (c) the contributions, profits or income from which payments are made to them are **pooled** (d) the **purpose** of the arrangement is for the participants to participate in or receive profits, or income from the acquisition or management of the property
- The SFC found that BC had promoted an ICO to sell digital token (“KROPS”) to investors through its website **accessible by the HK public**, with the pitch that the ICO proceeds would be used to fund the development of a mobile application and holders of the tokens would be eligible to redeem equity shares of BC
- An interest in a CIS is regarded as “**securities**” as defined in SFO

Regulations on Money Lending

- Carrying on of a money lending business requiring a money lender licence – section 7 of the MLO
- P2P Lending by individuals or businesses might constitute the carrying on of business as a money lender
- Individual or business required to be licensed money lender under the MLO
- Online lending platform

Regulations on Money Lending: MLO

- MLO – anyone wishing to carry on business as a money lender requires a licence
- “money lender” defined in section 2

“every person whose business (whether or not he carries on any other business) is that of making loans or who advertises or announces himself or holds himself out in any way as carrying on that business, but does not include-

(a) a person specified in Part 1 of Schedule 1; or

(b) as respects a loan specified in Part 2 of Schedule 1, any person who makes such loan”

Regulations on Money Lending: MLO

– Exemptions

- Exemptions – Schedule 1 to the MLO
- Examples for exempted loans:
 - a loan made bona fide by an employer to his employee
 - a loan made to a company secured by a mortgage, charge, lien or other encumbrance:
 - (a) which is registered, or to be registered, under the Companies Ordinance; or
 - (b) which would, in the case of a company incorporated by any other Ordinance or incorporated or established outside Hong Kong, be able to be registered under the Companies Ordinance if it were a company incorporated under that Ordinance

Regulations on Money Lending: MLO

– Exemptions (con't)

- Examples for exempted loans (con't):
 - a loan made by a company under a bona fide credit-card scheme operated by the company to any holder of a credit-card issued under that scheme; and
 - a loan made bona fide for the purchase of immovable property on the security of a mortgage of that property and a loan made bona fide to refinance such a mortgage
 - **a loan made by a company, firm or individual whose ordinary business does not primarily or mainly involve the lending of money, in the ordinary course of that business – P2P Lenders might rely**

Regulations on Money Lending

– Money Lenders Transactions

- Regulated under Part III of the MLO
 - Form of agreement – section 18
 - Duty of money lender to provide information to borrower and surety
 - Early payment by borrower
 - Illegal agreements – e.g. compound interest, prohibit repayment by instalments
 - Loan not recoverable unless money lender licensed

Regulations on Money Lending

– Money Lenders Transactions (con't)

- Restriction on money-lending advertisements
 - Must show the name of the money lender as specified in his licence in such manner as to be not less conspicuous than any other name
 - If shows the rate of interest: showed as a rate per cent per annum and in such manner as to be not less conspicuous than any other matter mentioned
 - Must show the money lender's licence no.
- Offence: a fine of HKD100,000 and imprisonment for 2 years for person to carry on business as a money lender without a license

Moonlighting and conflict of interest – criminal risks

- “Slash” career/Multiple jobs
- Full time job/part time job/Freelance/contract worker
- Moonlighting

Read carefully:

- Employment contract
- Employee handbook
- Code of conduct
- Restriction on outside activities
- Policy on conflict of interest and disclosure of conflict of interest

Moonlighting and conflict of interest – criminal risks

- Non-disclosure of conflicts of interest , apart from civil liabilities, may be a crime.
 - Fraud
 - Conspiracy to defraud
- Conflicts of interest arise in situations where personal interest of an employee interferes with the interest of the employer or when an employee has an interest that may affect the employee to perform its duties objectively and effectively.

Moonlighting and conflict of interest – criminal risks

s.16A of the Theft Ordinance (Cap 210):

“If any person by any deceit (whether or not the deceit is the sole or main inducement) and with intent to defraud induces another person to commit an act or make an omission, which results either —

(a) in benefit to any person other than the second-mentioned person; or

(b) in prejudice or a substantial risk of prejudice to any person other than the first-mentioned person, the first-mentioned person commits the offence of fraud and is liable on conviction upon indictment to imprisonment for 14 years.”

Moonlighting and conflict of interest – criminal risks

Background of a recent case on failure to disclose conflict

- an ex-manager of a media company was convicted of two counts of fraud in relation to awarding work orders to a company owned by his father (and the ex-manager also has an interest in the company) without declaring his interests in the transaction.
- D was the facilities executive and later promoted to the position of facilities manager of a company (the “**Employer**”) and he was empowered to award work orders to contractors and service providers of equipment and facilities for the Employer.
- In January 2007, D set up S Co and his father was the proprietor of S Co. While D did not declare his and/or his father’s interest in SCo to the Employer, D induced the Employer to include and maintain S Co in the Employer’s list of approved suppliers and made purchase orders with S Co between August 2007 and February 2014. Then, the Employer made payments to S Co for the provision of goods and services, and S Co later made some payments to D and his family members.

Moonlighting and conflict of interest – criminal risks

- Payments totalling over HK\$19 million for work orders were made by the Employer to S Co and such payments resulted in benefit to D and his family members.
- In the Employer's code of practice for employees, employees are prohibited from purchasing goods or services on the Employer's behalf from suppliers who are related to him or his family members or make such purchase that would give benefit to himself. If there is any potential conflict of interest, employees are obliged to report to his manager. Therefore, since D did not declare his and/or his father's interest in S Co to the Employer, D acted in breach of the code on avoiding conflict of interest.
- D was charged with fraud by the ICAC, contrary to s.16A of the Theft Ordinance.
- D was convicted of fraud and sentenced to 6 years and 8 months' imprisonment.

Moonlighting and conflict of interest – criminal risks

- Section 9(1) of the Prevention of Bribery Ordinance (POBO)(Cap 201)
- It is a criminal offence for an agent who, without lawful authority or reasonable excuse, solicits or accepts any advantage as an inducement to or reward for doing or forbearing to do any act in relation to the agent’s principal’s affairs or business.
- Section 9(2) of the POBO provides that it is an offence for any person who, without lawful authority or reasonable excuse, offers any advantage to any agent as an inducement or a reward for the agent doing or forbearing to do any act in relation to the agent’s principal’s affairs or business.
- An “agent” (not the “agent” under Agency law in the civil law context of “principal and agent”) as defined under POBO includes an employee. The definition of “advantage” is also broadly defined under POBO and includes money, gift, reward, commission or rebate. The “principal” under POBO includes and usually mean the employer.

Moonlighting and conflict of interest – criminal risks

- Accordingly, if an employee (an agent), receives a salary or payment (an advantage) from someone (the “offeror” of the advantage) for the employee doing or not doing something in relation to the principal’s (the employer’s) business or affairs, then unless there is lawful authority or reasonable excuse, it could be a breach of s.9 of the POBO.
- It follows that if an employee is moonlighting or “slashing” for a reward or salary and the moonlighting is in the same line of business of the employer company, that might be an offence under s.9 of the POBO.

Moonlighting and conflict of interest – criminal risks

- For actions or conduct of the employee that qualify as an act “in relation to his principal’s affairs or business”, the induced or rewarded conduct must be “aimed at the principal’s affairs or business” and has to be a conduct that “subverts the integrity of the agency relationship to the detriment of the principal’s interests”.
- However, such prejudice to the principal’s interests need not involve any immediate or tangible economic loss to the principal or benefit to the agent at the principal’s expense.
- Applying this interpretation to an act of moonlighting by the employee, if an employee moonlights and receives a reward for doing something that relates to the employer’s business, if such moonlighting or outside job does not cause harm to the principal’s interests, then there should be no violation of s.9 of the POBO. It would only be a crime if the employee’s moonlighting activities would subvert the agency relationship between the employer and the employee to the detriment of the employer’s interests.

Moonlighting and conflict of interest – criminal risks

- However, sometimes it is not clear or apparent whether the employee's moonlighting conduct would be detrimental to the employer's business or not, and might arouse a suspicion as a possible breach of the law.
- To avoid any misunderstanding or suspicion of a breach of s.9 of POBO that might lead to a complaint to the Independent Commission Against Corruption that might in turn lead to an investigation, the better way is for the moonlighting employee to disclose the moonlighting conduct and reward received and sought a permission from the employer.
- Under section 9(4) of the POBO, if an agent solicits or accepts an advantage with the permission of the principal, being permission which complies with s.9(5) of the POBO, neither the agent nor the person who offered the advantage shall be guilty of an offence under section 9 of the POBO.

Moonlighting and conflict of interest – criminal risks

Facts

- Chan, TVB celebrity host
- hosted a popular programme “Be My Guest” on TVB
- Hosted 150 episodes for TVB without receiving any remuneration for such work (he did not need to appear in front of cameras but did so voluntarily to host the show)
- New Year eve of 2009

Moonlighting and conflict of interest – criminal risks

- Chan hosted a special episode of “Be My Guest” talk show at a countdown event at a shopping mall (the “Additional Be My Guest Show”)
- This Additional Be My Gust Show was arranged by a company that was run by the co-defendant, Tseng Pei Kun
- The shopping mall’s request for the “Additional Be My Guest Show” met with approval from TVB. TVB allowed Chan and another artiste Lai Yiu-cheung to perform together in the Additional Be My Guest show

Moonlighting and conflict of interest – criminal risks

- Had Chan refused to perform the Additional Be My Guest Show, it might have been necessary for TVB to arrange another programme as a substitute. This might significantly influence the audience ratings of the live broadcast of the main show (the countdown)
- The shopping mall paid HKD 160,000 to Tseng's company for the Additional Be My Guest Show
- From this, Chan received HKD 112,000 for hosting the show

Moonlighting and conflict of interest – criminal risks

- Chan did not report the receipt of money to his employer, TVB nor seek permission to accept such funds from Tseng's company.
- According to the employment contract with TVB (Chan was the GM(Broadcasting)), Chan cannot undertake any work outside of his employment, whether paid or otherwise unless written permission was given.

Moonlighting and conflict of interest – criminal risks

- Chan was then investigated by the ICAC, arrested and charged with the offence under s.9 of POBO
 - Chan, being an employee and thus an agent of TVB, without lawful authority or reasonable excuse, accepted from Tseng an advantage consisting of HK\$112,000 fee as an inducement or reward for or otherwise on account of Chan's doing or having done an act in relation to his principal's affairs or business "namely participating and performing in the Additional Be My Guest show which was produced and broadcast by TVB

Moonlighting and conflict of interest – criminal risks

- Tseng was also charged with offering an advantage to an agent.
- Both Chan and Tseng were charged with conspiring for an agent to accept an advantage.

Moonlighting and conflict of interest – criminal risks

- Section 9(5) provides that the permission shall:
 - (a) be given before the advantage is offered, solicited or accepted; or
 - (b) in any case where an advantage has been offered or accepted without prior permission, be applied for and given as soon as reasonably possible after such offer or acceptance,and for such permission to be effective, the principal shall, before giving such permission, have regard to the circumstances in which it is sought.

Moonlighting and conflict of interest – criminal risks

- What amounts to an “informed consent” of the principal for an agent to accept an advantage?
- Unfortunately, there is no provision or definition in the POBO on what amounts to an “informed consent” or minimum disclosure by an employee for the purpose of the employer’s permission.
- The Court considered this recently and approved that the employee’s disclosure to obtain an employer’s permission “must be adequate and full in the sense that the principal must be specifically advised, or it be otherwise made so crystal clear that he could not deny he ought to have known.”

Moonlighting and conflict of interest – criminal risks

- The disclosure must be adequate and timely and a general and vague disclosure that the agent is receiving commissions will not meet the objective.
- Accordingly, depending on the policies of the employer, if an employee only disclosed that he was moonlighting and would be paid, but without disclosing how much the employee was receiving, that may not be sufficient for the purpose of availing a defence of lawful authority under s.9 of POBO.

Trade description risks

“Dear Backers,

We wish all of you a Happy New Year and a successful and joyous 2018. We understand your frustration with the delays. We are working full time and are committed to getting [X] into the hands of backers.

Looking back at the 2.5 years since the Kickstarter campaign, [X] went from functional prototypes at the start of the campaign to tens of production-ready units. The current challenge is financial. The long development delays exhausted our funds, although we further invested in R&D much more than the US\$1.5M that we raised via crowd funding (total from both KS and IGG).”

Trade description risks

- Trade Description Ordinance (Cap 362)
- TDO prohibits false trade descriptions to “products” – which includes goods and services.
- A “trade description” means an indication, direct or indirect, and by whatever means given, with respect to the goods or services or any part of them. This includes anything that tells of the goods or services or any part of them, in whatever form (e.g. statements, advertisements, etc.) and communicated through whatever means (e.g. media, verbal and even by conduct).
- Under section 7 and 7A of the TDO, traders have to provide accurate descriptions to the products and services without any false or misleading information.
- A trader wrongly accepts payment for a product if, at the time he accepts, he (1) intends not to supply the product, (2) intends to supply a materially different product, or (3) has no reasonable grounds to believe that the product can be supplied within a specified or reasonable time frame.

Trade description risks

- “Traders” are given a broad meaning to include any person who carries on a commercial practice in Hong Kong, notwithstanding the practice is directed to overseas consumers. Directors and other officers of a body corporate may also be liable if the body corporate commits an offence under the Ordinance. The maximum penalty is HK\$500,000 and imprisonment for 5 years.
- Enforced by the Customs and Excise Department.
- A civil compliance-based mechanism is in place to encourage compliance by traders.
- Booklet on cases under the TDO

Trade description risks

Case 1

- A Japanese chain restaurant offered for sale coupons under advertising gimmick “2 hour of all-you-can-eat barbecue buffet for two persons” via an online group buying company.
- The advertisement on the website specified that “carbonated fruit wine, fruit juice, green tea were unlimited supply for drinking” and besides “Japanese sweet potato, squid mantle, squid neck, teppanyaki beef and sea snail with herbs, spicy cool ramen were unlimited supply for eating”.
- However, the restaurant failed to provide some of the mentioned food and beverages as stipulated on the advertisement.
- The restaurant was convicted and fined HK\$36,000 for supplying a barbecue buffet with a false trade description.

Trade description risks

Case 2

- A Chinese medicinal herbs shop sold 4.45 taels of Chinese medicinal herbs claimed to be Cordyceps to a customer. Value of the goods was \$16,320. However, examination by the Government Laboratory revealed that the Chinese Medicinal herbs sold contained no Cordyceps sinensis.
- A sole proprietor of the shop was convicted for supplying Chinese medicinal herbs with a false trade description. He was sentenced to carry out 160 hours of community service and to offer the victim \$16,320 as compensation.

Trade description risks

Case 3 (Wrongly accepting payment)

- A proprietor of a storage and removal company still received payments from customers knowing that the company was going to close and after the company had been wound up.
- Customers visited the alleged company and found that it had already been wound up and could not get back the stuff stored in the company. At the end, the company did not refund to the customers.
- The proprietor was convicted for wrongly accepting payment in the course of business and sentenced to 6 months' imprisonment and ordered to pay \$10,000 as compensation to the victim.

Trade description risks

Case 4

- A private education centre offered a range of interest classes and school admission interview courses for primary and secondary school students. After making pre-payment, consumers found the centre had closed down suddenly and failed to provide the courses.
- The centre failed to return the payments to its centre members.
- The company was convicted for wrongly accepting payment in the course of business and fined HK\$48,000 and ordered to pay HK\$21,994 as compensation to the victims.

Trade description risks

Case 5 (Accepted Undertakings)

Conduct believed to constitute an offence:

- An online company did not deliver electrical and sportswear products at an agreed time after accepting payment from consumers. The shop did not make refund to customers because of insufficient cash flow. The shop was believed to have committed the offence of wrongly accepting payment.

Undertakings of trader:

- The operator of the company undertook not to engage in conduct of that kind, or any conduct of a substantially similar kind, in the course of any trade or business for two years, and to put in place with measures for implementing the undertaking and complying with the requirements under the TDO.



Q&A

THANK YOU





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