Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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By email (yhcheung@legco.gov.hk) and by post

Our Ref.: C/CFC, M80858

The Hon Chan Kam-lam, SBS, JP
Chairman
Bills Committee on Securities and Futures (Amendment) Bill 2011
Legislative Council Secretariat
Room 614, Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr. Chan,

Bills Committee on Securities and Futures (Amendment) Bill 2011

Thank you for giving us the opportunity to explain our concerns regarding the Securities and Futures (Amendment) Bill 2011 ("the bill") to the Bills Committee at a meeting on 14 October 2011. We are pleased to see that the Bills Committee has taken note of some of those concerns and, in particular, asked the Securities and Futures Commission ("SFC") to provide the draft guidelines on the disclosure of price sensitive information ("PSI").

We have seen the papers produced by the Administration, which provide a comparison of certain aspects of the bill with the corresponding provisions in the United Kingdom, Australia and Singapore and which outline the scope of "officers" under the PSI regime.

As a follow-up to our meeting, and in light of the additional information now available, we should like to make some further comments on the bill and the SFC draft guidelines, for the Bills Committee's consideration.

The Bill

"Safe habour" provisions

1. In our submission of 10 October 2011, we asked for an additional "safe harbour" to cover the situation where a listed company has appropriate internal control procedures in place, has taken reasonable steps to ensure a specific issue has been properly considered and the directors, having carefully considered the circumstances (taking professional advice, where appropriate), have exercised judgement, with reasonable prudence and in good faith, concluding that certain information is not PSI and does not warrant a disclosure at that time. This should be so even if subsequently, with the benefit of hindsight (which will be available to the Market Misconduct Tribunal ("MMT")) that conclusion may turn out to be challengeable.

2. While there may not be an explicit provision to this effect in the PSI regimes of other jurisdictions, it is clear, even from the brief comparison made in the

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Administration's paper, that other jurisdictions offer more protection to companies than the quite specific and limited safe harbour provisions under the bill. In Singapore, for example, it would appear that some form of negligence, recklessness or intention must be established on the part of the company before a company can be held liable for a breach. It is not unreasonable that, at least, it should be required to be established that a company has not taken all reasonable steps to prevent breaches before it can be held liable. However, under the bill it would seem that if the SFC and MMT take a different view from the company on a matter involving a potentially significant degree of subjective judgement, the company will be found to be in breach.

3. While the UK and Australia do not have a similar provision to Singapore, the information provided indicates that they have broader safe harbours than Hong Kong is proposing to have. In the UK, for example, an issuer may delay the public disclosure of inside information, such as not to prejudice its legitimate interests provided that, inter alia, "such omission would not be likely to mislead the public". In Australia and Singapore no disclosure is required where, for example, a reasonable person would not expect the information to be disclosed, the information is confidential and "the information comprises matters of supposition or is insufficiently definite to warrant disclosure" or "the information is generated for the internal management purposes of the entity".

4. Prima facie, the proposed Hong Kong regime is stricter in this area than the other jurisdictions referred to and it is not clear why this should be. Therefore, the Institute proposes that:

   (a) (i) Similarly to Singapore, a company should not be held liable unless it can be shown that it did not take reasonable steps to prevent breaches; or

   (ii) it should have defence against actions for breach if it can show that it did take reasonable steps to prevent breaches; and/or

   (b) the safe harbour provisions should be extended to cover situations similar to those covered in the UK, Australia and Singapore, mentioned above.

Scope of the term "officer"

5. We also previously expressed reservations about the provision in the new section 307G(2)(b), introduced by the bill, under which an officer of the company could be held liable where the company is in breach and he or she "has not taken all reasonable measures from time to time to ensure that proper safeguards exist to prevent the breach". In this regard, we continue to have concerns about the scope of "officer" under the bill, as companies will need to rely on the SFC guidelines to drill down beyond the generic definition contained in Schedule 1 to the Securities and Futures Ordinance.

6. The definition of "officer" is important because not only does it establish where liability may lie, but it also determines when inside information is regarded as coming to the knowledge of the company. This is because the triggering event for

when a disclosure must be made, under the proposed section 307B, is deemed to be when "information has, or ought reasonably to have, come to the knowledge of an officer of the corporation in the course of performing functions as an officer of the corporation….". So it is vital that there be no doubt as to who is caught by the definition of "officer" and, in our view, this should be confined to senior management. For this reason, the Institute believes that (i) the term should, preferably, be clarified in the bill itself, not just in guidelines and (ii) it should embrace the concepts in the UK Financial Services Authority Handbook, to which we referred in our 10 October submission, that is, a director or senior executive who (i) has regular access to inside information relating to the issuer; and (ii) has the power to make managerial decisions affecting the future development and business prospects of the issuer.

7. As indicated above, we are pleased to note that the Bills Committee asked to view the SFC draft guidelines, and to note also, from the Administration's paper, confirmation of the SFC's commitment to consulting the public on any guidelines. As we observed in our earlier submission, the SFC also plans to issue frequently asked questions ("FAQs"), which will cover some key issues, such as (i) how to define "significant" changes in fair valuations and "massive" losses arising from hedging activities, and at what point in time disclosure obligations arise (paragraph 33 of the consultation conclusions); (ii) what would constitute an "incomplete proposal" under safe harbour B (paragraph 34); (iii) what would satisfy the test of having taken "all reasonable measures" to ensure proper safeguards exist to prevent breaches (paragraph 66).

8. We are not clear whether the Bills Committee has had the opportunity to discuss the FAQs, or at least to ask the SFC to explain the overall framework, and to consider whether there will be sufficient certainty and safeguards in place for companies if they need to rely on FAQs for the type of information that the SFC intends to convey through this non-statutory, non-regulatory channel. In any event, we would suggest that the proposed FAQs be made available for review at the same time as the bill and the draft guidelines, so that the whole package of proposals can be considered in its totality.

9. Regarding the draft guidelines themselves, the Institute continues to have reservations about some of the proposed contents. We draw your attention to a few issues below.

SFC draft guidelines

(a) <u>Background</u>: Critical limitations on the advice SFC is prepared to give

10. While the SFC will offer a consultation service to assist companies to understand how to apply the disclosure provisions, the draft guidelines suggest that most questions will relate to the application of safe harbours and that the SFC "is not able to offer advice to a corporation on whether a particular piece of information is inside information" (paragraph 11).

While the SFC may wish to issue disclaimers on its advice, it should not decline altogether to give advice on whether certain information is in the nature of PSI. This highlights a deficiency in a system where companies will need practical assistance from the SFC to get accustomed to the regime, but the SFC is also the agency to take suspected cases of breaches to the MMT.

By way of comparison, under the current non-statutory PSI regime, the listing rules state: - *"The Exchange recognises that decisions on disclosure require careful subjective judgements, and encourages issuers to consult the Exchange when in doubt as to whether disclosure should be made"* (note 11 of rule 13.09).

(b) <u>What may constitute inside information</u>: "Relevant information" under the insider dealing regime vs. "inside information" under the PSI regime. The linkage is not clear.

11. Aspects of the fundamental definition of "inside information" remain unclear. While the definition is the same that of "relevant information" under the insider dealing regime (paragraph 14), the draft guidelines qualify the relevance of this connection by stating (paragraph 15), "… *the circumstances in which insider dealings are regarded to have taken place would be different from the context in which the obligation to disclose may arise and thus the interpretative guidance available from these decisions may not apply.*"

(c) <u>Inside information must be specific information</u>: When does a company need to correct inaccurate conjecture and when does it not?

12. The draft guidelines distinguish specific information, which, however, may not be precise and which needs to be disclosed, from mere rumour, vague hopes and worries, and unsubstantiated conjecture, which do not (paragraph 17(b)). At the same time, the guideline also suggests that analysts' reports, financial journals and media reports often fall short of providing information which is accurate, complete and not misleading and here disclosure of inside information is necessary (paragraph 33).

(d) <u>Inside information must be information that is not generally known</u>: When is information not generally known to the market required to be disclosed and when is it not?

13. Again, where information e.g., in media reports is incomplete or contains material omissions, the guidelines indicate that this information cannot be regarded as generally known and full disclosure is required by the company (paragraph 22). This would suggest that one way to get a company to provide more, and potentially sensitive, information is to issue an incomplete report. Also the draft guidelines do not seem to distinguish information that is not generally-known, but which is not price sensitive, from information that is not generally-known and is price sensitive. Furthermore, the SFC's expectation on listed companies, in terms of keeping track of reports by third parties on the company, is not made clear.

14. Information is generally known if it consists of readily-observable external developments and general public information. Where, say, real property values fall (an example of possible PSI under paragraph 34) due to a change in macro-economic/market conditions, this is readily observable, but it would be likely to adversely affect the expected earnings (another paragraph 34 example) of property investment companies, in particular. Is this generally known and, therefore, outside the definition of "inside information" or is it disclosable, as a change or expected change in business performance (a further paragraph 34 example)? This is not clear.

(e) <u>Inside information is information that is likely to have a material effect on the price of the listed securities</u>: What information about external factors affecting a company's share price, is a company expected to process before deciding on disclosure?

15. The test of whether information is likely to materially affect the price is a hypothetical one. Also the exercise in determining how a general investor would behave if he is in possession of such information has to be an assessment (paragraph 27).

16. The draft guidelines indicate that the actual magnitude of the share movement once the information is made public is not conclusive in indicating the extent of probable change brought about by disclosing such information. Companies need to also ascertain to what extent the investors' response is attributable to the mixed impact of the information being released and other extraneous factors or considerations. This seems to be wisdom after the event. How can the impact of future extraneous factors or considerations be taken into account when making a decision on PSI disclosure?

(f) <u>Management accounts</u>: It is necessary to distinguish information about the "day-to-day activities" of a corporation and "significant events and matters which are likely to change a corporation's course or indicate that there has been a change in its course"? But what about the many events that fall in between these extremes?

17. Citing an insider dealing tribunal ("IDT") case, the draft guidelines indicate the need to make the above distinction. However, there are many transactions that fall short of changing a corporation's course, but it is not clear whether they would be regarded as day-to-day activities either. A company may, for example, engage in hedging on a very regular basis and, due to widely-reported market volatility, the value of the relevant hedges may vary significantly and, potentially, affect the profit or loss of the company. Should disclosures be made with each significant mark-to-market fluctuation or only at certain times and, if so, when (paragraph 30)?

18. Knowledge of substantial losses or profits made by a corporation, even though the precise magnitude is not yet clear, may be inside information (paragraph 31). However, it could be dangerous if listed companies are asked to make a vague statement on financial performance, based on preliminary information. More

guidance/ benchmarks should be provided on what should be regarded as "substantial". In the mainland, for example, a difference of over 50% in profits/losses as compared to the previous corresponding period requires disclosure (paragraph 31).

19. In the above situation, citing another IDT case, the draft guidelines state that, to constitute inside information, the difference between the results which the market might predict and the results the directors or officers know must be significant. Again, what should generally be considered as "significant" here (paragraph 31)? This is the kind of important information that we understand may be included in FAQs, which is why we believe it to be essential that the whole package of proposals be made available for review at the same time.

(g) <u>Examples of possible inside information concerning the corporation</u>: The SFC provides a number of examples where a disclosure obligation may arise. In principle, this is helpful, but some are so generic as to raise more questions than they answer.

20. Among the examples requiring further clarification/ elaboration are (paragraph 34):

- Changes in auditors or any other information related to the auditors' activity
- Changes in accounting policy
- Changes in investment policy

We hope that the Bills Committee will consider the above concerns and will request the Administration to make every effort to accommodate the suggested changes to the bill and to address the significant areas of uncertainty in the proposals generally.

Should you have any questions on this submission, or require clarification of any points, please do not hesitate to contact me at the Institute.

Yours sincerely,

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c.c. The Hon. Paul Chan Mo-po, MH, JP