For discussion on **Paper No. 13/01**
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Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

Securities and Futures Bill
Part XV – Disclosure of Interests

INTRODUCTION

This paper outlines the major elements of Part XV of the Securities and Futures Bill (the "Bill"). Part XV modernises the regime for the disclosure of interests in securities which is presently in the Securities (Disclosure of Interests) Ordinance (Cap. 396) ("S(DI)O").

2. The S(DI)O was enacted in 1988 and was modelled on the disclosure of interests provisions contained in Part VI of the UK Companies Act 1985. It was last revised in June 1991 to apply to corporations, incorporated overseas, with securities listed on the Stock Exchange of Hong Kong ("SEHK").

3. In June 1998 the Securities and Futures Commission ("SFC") published a Consultation Paper on Proposed Amendments to the Securities (Disclosure of Interests) Ordinance[1]. In the paper, the SFC commented that the Hong Kong market had became more sophisticated and more diversified ways were being used to conceal interests in shares. The SFC recommended that the S(DI)O should offer more transparency in relation to price, securities dealings and persons who have an "economic interest in shares", to enable investors to make informed investment decisions. This represented a change in focus as the S(DI)O had formerly concentrated on providing the market with information about the "control" of listed corporations.

4. A Consultation Conclusions Paper was published by the SFC in April 1999. These conclusions formed the basis for the changes to the S(DI)O in Part XV of the Bill. The present proposal takes into account further market comments on the White Bill and views of the Legislative Council Subcommittee on the Securities and Futures Bill at the last legislative session.

5. A table comparing the provisions contained in Part XV of the Bill with existing law is at **Annex 1**.

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[1] The consultation period ran from June to September 1998. A total of 37 responses were received from representative bodies and market participants and conclusions of the consultation were published in April 1999.

POLICY OBJECTIVES

6. The overriding objectives of the new disclosure regime are two-fold: first, to give investors more complete, better and more timely information which is price-sensitive so they can make better informed investment decisions; and second, to minimise compliance burden where appropriate. It requires the disclosure of information that can affect perceptions of the value of shares. The regime is designed to enable investors to identify the persons who control, or are in a position to control, interests in shares in listed corporations. It seeks to bring the level of market transparency in Hong Kong in line with international and regional standards, taking into account the local market characteristics.

7. The market generally supports these objectives and the consultation conclusions. There is a consensus that for Hong Kong to maintain its competitiveness as an international financial centre, its disclosure regime must be kept up to date with market developments and be compatible with international standards.

8. In seeking to achieve these objectives, the Government appreciates that amendments should be weighed against the cost of complying with the additional disclosure requirements and the risk of the market being burdened with excessive information. The present proposals in Part XV seek to strike a balance between enhancing transparency and avoiding unnecessary disclosure and undue compliance costs.

Approach and methodology

9. Since the enactment of the S(DI)O in 1988, market participants have become familiar with the concepts in the current Ordinance. The Government recognises the need to minimise any uncertainty that may be caused by change of these concepts and the Bill therefore retains them as far as possible. Part XV also follows the drafting conventions in S(DI)O as far as possible to make the new disclosure regime easier to understand.

10. The sequence of some of the S(DI)O provisions has been rearranged and rationalized so that they now follow a more logical order. As a result of comments on the White Bill, all provisions formerly in Schedule 9 of the White Bill are now included in Part XV to make them more user-friendly.

11. Part XV is now separated into 13 Divisions –

(a) Divisions 2, 3 and 4 deal with the reporting obligations of substantial shareholders;

(b) Divisions 7, 8 and 9 deal with the reporting obligations of directors and chief executives; and

(c) other Divisions deal with matters such as maintenance of registers, investigations and imposition of restrictions on shareholdings in listed corporations.

MINIMISING COMPLIANCE BURDEN

12. One of the major objectives of the new disclosure regime is to reduce unnecessary compliance burden of the existing disclosure regime. The Bill includes a number of changes to minimise the disclosure burden, including -

(a) exempting substantial shareholders from disclosing small changes in their interests in shares – the *de minimis* exemption;

(b) exempting transactions between members of a wholly owned group of companies;

(c) removing the obligation on a parent company to aggregate interests of certain subsidiaries – those which are investment managers, custodians or trustees and manage their interests independently;

(d) exempting holders, trustees and custodians of collective investment schemes and providing for exemption of approved overseas schemes;;

(e) widening the exemption for security interests to include margin financing and security interests held by certain overseas persons;

(f) introducing more structured notification forms to facilitate disclosure and dissemination of information; and

(g) removing requirements to disclose particulars of registered shareholders and changes in those particulars (formerly sections 7(6) and (7) of the S(DI)O)).

The majority of comments received support these proposals. The following paragraphs explains these proposals in more details.

"*De minimis*" exemption

13. At present, the S(DI)O requires a person to make a notification where he acquires an interest in shares of a listed corporation which is equal to or more than 10% of its issued share capital, or if he ceases to have such an interest. If a person has a shareholding of 10% or more he must also make a notification if there is any change in the "percentage level" of his interest. The "percentage level" is calculated by expressing a person's interest in shares of a listed corporation as a percentage figure

and rounding the figure down to the next whole number. This practice is called the "rounding down rule"[2].

14. As a result of the rounding down rule, there are many cases in which a small change in interest would trigger a duty of disclosure (e.g. from 10.99% to 11.01%) whereas transactions between percentage levels of as much as 0.99% are not subject to disclosure (e.g. increasing an interest from 10% to 10.99%).

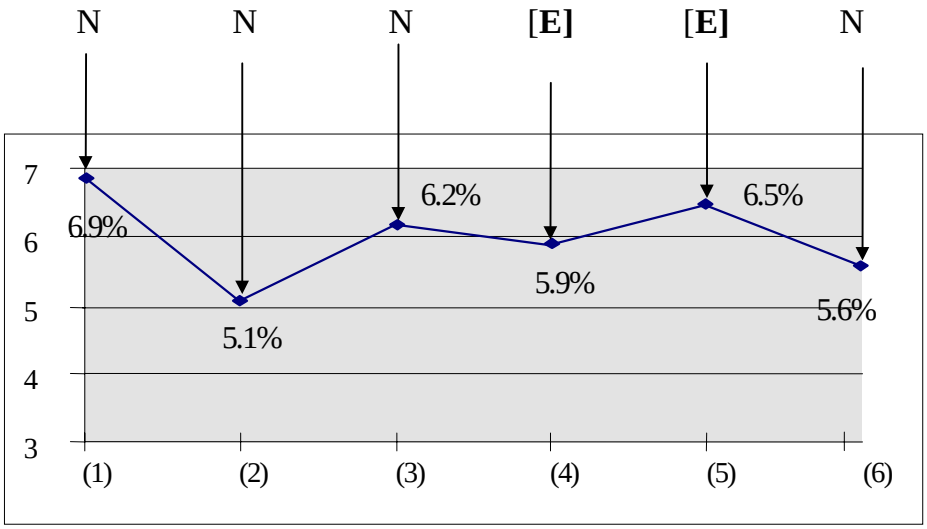
15. In response to representations that the rounding down rule creates a significant compliance burden for substantial shareholders whose interests in shares fluctuate around a particular percentage level, clauses 304(7) and (8) of the Bill create a new exemption for substantial shareholders ("*de minimis*" exemption). Where a change in a person's interest in shares involves crossing over a percentage level, the person needs not disclose the new interest if -

(a) the last notification was given because of crossing over of the same percentage level; and

(b) the difference between the new percentage figure and the percentage figure disclosed in the last notification is less than 0.5% of the issued share capital of the listed corporation concerned.

The following figure illustrates the exemption.

Figure 1



N : Notification required **[E] : Notification exempted**

[2] For example, if the percentage figure of a person's interest in shares is 11.3%, and this interest subsequently increases to 11.9%, he is not required to disclose the increase. This is because the "*percentage level*" of his interest remains at 11%. However, if his interest further increases from 11.9% to 12.1%, he will be under a duty of disclosure. This is because the "*percentage level*" of his interest changes from the 11% percentage level to the 12% percentage level.

Intra-group transactions

16. Presently, a transaction between two members of a group of companies that are substantial shareholders must be disclosed by either or both of the companies if the transaction results in its interest crossing a percentage level. However, if both companies are wholly owned subsidiaries there will be no real change in the persons who control or have an economic interest in the shares.

17. Clauses 304(9) and (11) of the Bill provide for a new exemption for transactions between a holding company and its wholly (100%) owned subsidiary, and those between the wholly owned subsidiaries of the same holding company. The exempted transactions would include stock borrowing and lending transactions within the same group.

Disaggregation of group interests for investment managers, custodians and trustees

18. At present, the shares in which a person is interested also include any interests in shares held by a corporation which he controls (see s.8(2) of the S(DI)O - now clause 307(2)). A person is taken to "control" a corporation if he either controls one-third or more of the voting power at general meetings of the corporation, or if the corporation or its directors are accustomed to act in accordance with his directions. This provision requires the holding company of a group of companies to aggregate and disclose all of the interests held by members of the group.

19. It is recognised that substantial shareholders whose interests in shares derive from their business of managing the investments of other persons, or safeguarding the assets belonging to other persons, should be treated differently from shareholders who control, or seek to influence the control of, interests in shares. Accordingly a new exemption is set out in clause 307(5). The exemption is available where shares are -

(a) held by a corporation;

(b) in the ordinary course of its business of an investment manager, custodian, or trustee; and

(c) if the corporation exercises its voting rights (in the listed corporation) independently from its holding company.

If all three conditions are met, a holding company is not required to aggregate interests in shares held by that corporation. This proposal reduces the compliance burden of a holding company with subsidiaries whose main business is the management of other people's assets.

Exemption for holders, trustees and custodians of collective investment schemes - provision for exemption of approved overseas schemes

20. Presently section 14(1)(b)(i) of the S(DI)O provides that for the purposes of disclosure, "an interest which subsists by virtue of" any unit trust or mutual fund corporation authorised under section 15 of the Securities Ordinance is to be disregarded. Market participants considered that this wording was vague and uncertain.

21. Holders of authorised collective investment schemes should be exempted from disclosure as they do not normally have any influence on how the schemes are managed. Further, as authorised collective investment schemes are usually managed by separately appointed fund managers, trustees of the schemes only occupy a "passive" position in practice. Therefore we propose that interests held by trustees of authorised collective investment schemes will be expressly disregarded for the purpose of disclosure.

22. However, fund managers appointed to manage collective investment schemes should be required to disclose their interests in shares as they are the real controller of the shares.

23. Clauses 314(1)(b) and (3) of the Bill therefore clarify that -

(a) interests held by a holder of a collective investment scheme authorised by the SFC (e.g. a unit holder) will be disregarded for the purposes of disclosure;

(b) interests held by a person as the trustee or custodian of such a scheme will be disregarded; and

(c) interests held by the fund manager of such a scheme are not disregarded (but they need not be aggregated by the holding company if it satisfies the requirements of clause 307(5) – see paragraph 19 above.)

24. In response to market comments on the White Bill, the exemption for collective investment schemes in clause 314(1)(b) has been widened to include holders, trustees and custodians of approved overseas schemes. The procedure for obtaining approval is set out in clauses 314(4) and (8) to (11).

Exempt security interests

25. At present, under section 14(1)(d) and 14(4) of the S(DI)O, persons who take shares as security for loans are exempted from disclosure only –

(a) if they are authorised banks, authorised insurers, licensed stockbrokers, exempt dealers or registered dealers;

(b) if shares are held by them as security only for the purposes of the loan; and

(c) if the loan is provided to the shareholder in the ordinary course of their business.

26. A large proportion of lending involving shares being pledged as security is done by margin finance companies in Hong Kong and banks or brokers that are based in other jurisdictions - such as the US or the UK. At the suggestion of market participants, the exemption in clause 314(5) is extended to include security interests held by licensed margin financiers. In addition, it is proposed that a corporation which is authorised under the law of another country (which is recognised for this purpose by the SFC), to carry on business -

(a) as a bank,

(b) as an insurance company, or

(c) in the activities of dealing in securities or providing margin finance;

is exempt if it holds the shares by way of security only for the purposes of a transaction entered into in the ordinary course of its business

New disclosure forms

27. In order to streamline the submission, and processing by SEHK of disclosures required under Part XV it is proposed that the standard disclosure forms be used in future (clause 315(5)). The use of standard forms will become even more important as electronic filing becomes the norm.

28. The SFC has exposed the proposed disclosure forms to the market for comments in February 2001. The SFC has tried to make the new forms as self-contained and as user-friendly as possible and there are detailed notes with each form explaining how the form should be completed.

Removal of requirement to disclose particulars of registered shareholders and changes in those particulars

29. At present a substantial shareholder is required to include in his notification the identity of each registered holder of shares and the number of shares held by each registered holder. In addition, if there is any change in the particulars of registered holders previously notified, he must disclose the change.

30. These provisions have been criticised for imposing a heavy burden on substantial shareholders as even very minor changes (such as the sale of one board lot of shares involving a change in the legal title, or the re-registration of stock following settlement by physical delivery) need to be disclosed under the S(DI)O. In addition, a change in registered shareholders does not necessarily involve a change in the

percentage level of a substantial shareholder's interest in shares. In practice, in Hong Kong, many shares are registered in the name of Hong Kong Securities Clearing Company ("HKSCC") Nominees Ltd. There is also limited value in knowing the name of the registered holder. Accordingly, it is proposed that a substantial shareholder should no longer be required to disclose these particulars.

31. The proposals in paragraph 30 are ahead of international standards as securities regulations in the U.K., U.S., Australia, New Zealand and Singapore still require disclosure of details of registered holders of shares.

ENHANCING MARKET TRANSPARENCY

Reduction in the substantial shareholder disclosure threshold

32. The Bill proposes to reduce the substantial shareholding disclosure threshold from 10% to 5% (clause 306(1)). The disclosure threshold of 5% is the same as in the Mainland, US, Japan, Singapore and other Asian markets. Majority of market comments received support the proposal which will bring Hong Kong in line with international standards.

Reduction in the notification period

33. The Bill shortens the notification period for disclosure from 5 days to 3 business days (clauses 316(1) and 339(1)). This is the same as in the Mainland and one day longer than in the UK, Australia and Singapore, but shorter than in the US. We believe the proposal of 3 business days will achieve more timely disclosure without placing too much pressure on the market. The market is generally supportive of the proposal.

34. However, longer periods have been allowed for notification where the requirement to notify is prompted by an external event. A substantial shareholder is given 10 business days to give notice –

(a) when a corporation becomes listed;
(b) when shares of a class in which he is interested become relevant share capital;
(c) on commencement of Part XV; and
(d) on a reduction in the disclosure thresholds.

35. A director or chief executive is also given 10 business days to give notice in similar circumstances -

(a) when a corporation becomes listed;
(b) on commencement of Part XV;

(c) when he first becomes a director or chief executive of the listed corporation; and

(d) when he has shares or debentures in a corporation at the time that it becomes an associated corporation.

Concert party agreements

36. Under sections 9 and 10 of the S(DI)O where parties enter into an arrangement under which they agree to buy shares in a particular listed corporation in order to exercise control over the company, they are each assumed to be interested in all the shares in the target company in which any other party to the agreement is interested. Thus, they must each notify not only shares in which they are directly interested themselves, but also the interests of other parties to the agreement.

37. The SFC has experienced cases in which the 25% public float required to be maintained by the SEHK has been breached or avoided by the controlling shareholder indirectly funding the acquisition of shares by others and then controlling the shares so acquired. Therefore, the scope of these provisions is extended in clause 308 to include any arrangement under which a controlling shareholder of a listed corporation provides a loan, or security for a loan, to enable another person to buy shares in the same listed corporation. There are exceptions for loans made in the ordinary course of certain businesses specified in clause 308(6). The market supports this proposal.

Discretionary trusts

38. Discretionary trusts are increasingly used by substantial shareholders and directors to hold their interests in listed corporations. In some instances the person founding the trust will retain indirect control over the shares which have been placed in the discretionary trust without retaining an "interest" in the shares. The use of discretionary trust schemes may obscure the control of listed corporations and reduce market transparency. The existing provisions are amended to improve transparency with respect to certain discretionary trusts.

39. A founder of the trust who retains a power to influence the discretion of the trustees is deemed by clauses 313(4) and 336(4) to be interested in shares held by the trust. The term "founder of the trust" is defined in clause 299(1).

Disclosure of pledges of shares

40. Presently lenders who hold shares pledged as security for loans are exempt from the requirement to disclose interests in the shares which are subject to the pledges unless the borrower has defaulted on the loans, and the lenders have enforced the security under the pledge (see paragraph 26 above). Enforcement of the security will result in the lender acquiring an interest in the shares which have been pledged and possibly the borrower ceasing to be interested in those shares.

41. During the financial turmoil at the end of 1997, the share prices of several listed corporations fell dramatically because banks and creditors holding shares pledged by substantial shareholders enforced security under loan agreements by selling the pledged shares in the market. The question was raised as to whether more transparency should be given to the market with respect to share pledges made by substantial shareholders, i.e. whether banks should be required to disclose interests when substantial listed shares are pledged to them, or substantial shareholders should be required to disclose share pledges and mortgages.

42. In the light of the market comments, the Bill clarifies the point at which interests in shares pledged to a lender cease to be exempt from disclosure. The principle is that the interest should be disclosed if the person holding the shares as security treats those shares as his own. The relevant provisions are now included in clauses 314(1)(e) and (6).

43. That is, an interest in shares held as security for a loan ceases to be an exempt security interest if –

(a) the lender is entitled to exercise voting rights following a default by the borrower and has shown an intention, or taken any step, to exercise the voting rights; or

(b) the power of sale is exercisable and the lender offers the shares for sale.

Consideration and terms of agreements

44. The S(DI)O does not currently require substantial shareholders to disclose consideration paid or received by them in relation to acquisitions or disposals of interests in shares. However, it does require directors of listed corporations to disclose consideration when they become, or cease to be, interested in shares or debentures.

45. Securities regulations in a number of other jurisdictions like the US, Australia and New Zealand also require substantial shareholders to disclose consideration. These regulations also require substantial shareholders to disclose agreements or the material terms of agreements pursuant to which they become, or cease to be, interested in shares.

46. For the purpose of improving market transparency and bringing Hong Kong's disclosure regime closer to international standards, we propose that substantial shareholders disclose the consideration payable or receivable by them in acquiring or disposing of interests in shares, whether the transactions take place on-exchange or off-exchange (clause 317(1)(f)). Similar provisions applying to directors are set out in clause 340(1)(g). In response to market's concern, these provisions have been modified to minimise the burden of disclosure, as follows –

(a) the present proposals no longer require disclosure of consideration in relation to dealings in derivatives (as compared to the White Bill); and

(b) substantial shareholders and directors will not be required to disclose agreements or the terms of agreements relating to off-exchange transactions.

47. On further consideration, as short positions are usually established through the use of derivatives, or through stock borrowing and lending (where only a premium is paid to the lender), we propose that the requirement to disclose consideration in respect of short positions should also be dropped. We will therefore propose Committee Stage Amendments to this effect.

Disclosure of persons who control corporate substantial shareholders

48. It is common in Hong Kong for private companies to be established to hold substantial shareholdings in listed corporations. If control of the private company is spread between several members of a family the provisions of section 8(2) of the S(DI)O may not apply and none of the shareholders need to disclose their interests.

49. Clause 317(4) of the Bill provides that an unlisted corporate substantial shareholder, when performing a duty of disclosure, should disclose details of any person in accordance with whose directions or instructions its directors are accustomed to act. This should reveal the identity of the real controller of the shares.

Investment managers and trust companies

50. At present Regulation 3(2) of the Securities (Disclosure of Interests) (Exclusions) Regulations provides an exemption for some investment managers. In practice, the scope of Regulation 3(2) is very limited and the exemption is rarely used. Regulation 3(1)(c) also provides an exemption for trust companies. Again, the scope of the exemption is limited as it only applies to locally incorporated trust companies that belong to a group that conducts banking, deposit-taking or insurance business.

51. To create a level playing field for all market participants, the exemption currently made available to SFC registered investment managers and trust companies under the Securities (Disclosure of Interests)(Exclusions) Regulations will be removed. The market supports the proposal.

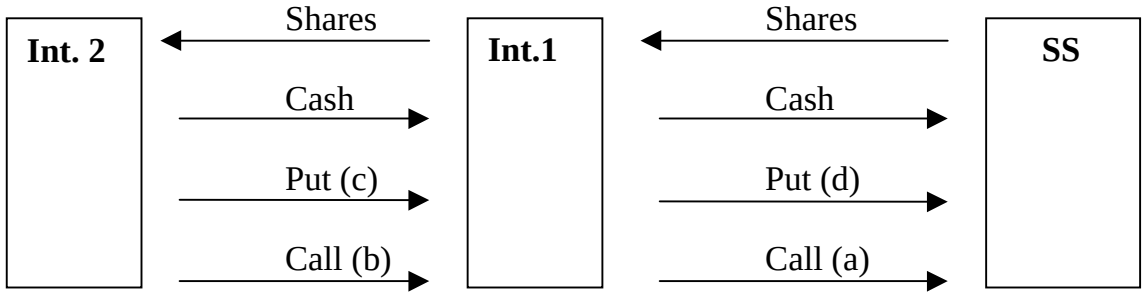
Disclosure for interests held through equity derivatives

52. Presently dealings in certain interests in shares which arise under equity derivatives are required to be disclosed under the S(DI)O. However, the dividing line between those which must be disclosed and those which need not be disclosed is somewhat arbitrary. There is also a large gap in the disclosure regime for interests held through cash settled derivatives, interests in unissued shares and short positions.

53. This gap has become increasingly significant with the growth of the derivatives market. Under the existing disclosure regime, investors are being given an incomplete picture of dealings by substantial investors. This incomplete picture can be misleading. For example, if a substantial shareholder purchases 100,000,000 shares in a company - as a hedge to cover an option which he has written under which he can be required to deliver 100,000,000 shares to a third party - the substantial shareholder is presently required to disclose only the purchase of the 100,000,000 shares. He will not be required to disclose the writing of the option. The market will be given the impression that the substantial shareholder is bullish on the shares whereas, if both transactions had been disclosed, it could be seen that his position is actually neutral.

54. The SFC consulted its Advisory Committee on the proposed amendments to S(DI)O to close the gap. The industry representatives on the Committee recommended that all dealings <u>in any form of derivatives</u> over the shares in the relevant listed corporation should be disclosed. The SFC has also experienced cases in which equity derivatives have been used to assist in manipulative schemes resulting in losses to investors. The following diagram illustrates one of these cases.

Figure 2



55. In this scheme a substantial shareholder ("SS") of a public company ("X Ltd.") saw an opportunity for profit if the shares in X Ltd. increased in price. First, he purchased a large number of shares in the market. These purchases were reported under the S(DI)O. SS had by then used up his available cash so he sold a large portion of his shares to an intermediary ("Int. 1") who in turn sold the shares to another intermediary ("Int. 2"). Both Int. 1 and Int 2. reported their purchases under the S(DI)O. SS used the proceeds of the sale to buy more shares. The public were impressed that Int. 1 and Int. 2 were investing in X Ltd. and the price of the shares went still higher.

56. However what was not reported was that the sales to Int. 1 and Int. 2 were both linked to a series of put and call options (derivatives). Under these options, namely -

(a) SS could require Int. 1 to sell all the shares back to him (i.e. he had a "call option");

(b) Int. 1 could require Int. 2 to sell all the shares back to it;

(c) Int. 2 could require Int. 1 to buy back all the shares (i.e. it had a "put option"); and

(d) Int. 1 could also require SS to buy back all the shares.

57. As a result of the call options at (a) and (b) above, neither SS nor Int. 1 had to report their sales of the shares – they both still had an "interest" in the shares they had sold – as the percentage level of their interest in shares in X Ltd. did not change. All the public knew was that SS, Int. 1 and Int. 2 were all buying shares.

58. As the S(DI)O does not require disclosure of put options, neither Int. 1 nor Int. 2 had to disclose that they had rights to sell the shares. The public only saw one side of the picture and thought that Int. 1 and Int. 2 were bullish on the company whereas, in fact, they were neutral.

59. Ultimately the price of the shares dropped. Int. 2 exercised its put option (c) to require Int. 1 to buy back the shares. Int. 1 also exercised its put option (d) to require SS to buy back the shares. SS was unable to pay for the shares that were then sold on the market. The price of the shares in X Ltd. plunged and those investors who had followed suit suffered losses.

60. This example illustrates a gap in the existing disclosure regime which covers a wide range of transactions and circumstances. Requiring disclosure of derivatives and changes in the nature of an interest in shares will help to ensure that investors have a more complete picture of dealings by substantial shareholders and directors in the future.

61. During the consultation exercise, the Hong Kong General Chamber of Commerce ("HKGCC") is concerned about the acceptability of derivatives of various types, and the way in which they are traded, in relation to market misconduct, as some of these would appear to have been intended and used specifically to disrupt one or more parts of the market. It points out that in the last few years there has been an enormous development in the use of derivatives of all types. The Hong Kong Institute of Securities Dealers also supports the extension of the disclosure regime to cover derivatives and short positions. At the same time we have received representation from large brokerage houses and investment banks that the disclosure regime should not be extended to certain derivatives because of concerns about compliance burden. We recognise the importance of derivatives in enhancing market liquidity and providing means for transferring risks for market participants, as well as the need for investors to have a more complete picture as to whether certain discloseable transactions represent a directional trade or a neutral trade. On balance, the Bill extends the scope of disclosure in respect of equity derivatives to require disclosure of shares in listed corporations in which a substantial shareholder, or a director, is interested through equity derivatives. The provisions are drafted so as to include interests in shares that are the underlying shares of cash settled derivatives and interests in unissued shares. Disclosure of short positions in shares in listed corporations will also be required.

62. This change is an important part of the change in focus of the S(DI)O – moving from providing the market only with information about the "control" of listed corporations to offering more information to the market in relation to persons who have an "economic interest in shares" as such information is price-sensitive. The change should enable investors to make more informed investment decisions in the future and help deter market manipulative acts like those illustrated in Figure 2 above.

63. The provisions of Part XV concentrate on the number of shares in which a person is interested through the holding, writing or issuing of equity derivatives. Underlying shares are the shares in the relevant share capital of a listed corporation which may be required to be delivered under the equity derivatives, or by reference to the price of which the value of the equity derivatives is determined (in the case of cash settled derivatives).

64. Clause 302 provides that the interests to be taken into account for the purposes of disclosure under clause 301 are those in the relevant share capital of the listed corporation concerned and specifically provides that interests in such shares which are the underlying shares of equity derivatives are included. Clause 313(8) sets out circumstances in which a person is taken to have an interest in shares that are the underlying shares of equity derivatives and clause 313(9) is about the number of shares in which he is taken to be interested. Clause 313(10) sets out circumstances in which a person shall be regarded as ceasing to be interested in shares and clauses 313(11) to (14) are about the number of shares in which he is regarded as ceasing to be interested.

65. Similar provisions in clauses 333 – 336 require disclosure of interests in shares held through derivatives by directors and chief executives.

Short positions

66. The term "short position" is defined in clause 299(1). A person has a "short position" if he borrows shares under a stock borrowing and lending agreement, or if he holds equity derivatives under which -

(a) he has a right to require another person to take the underlying shares;

(b) he is under an obligation to deliver the underlying shares;

(c) he has a right to receive money if the price of the underlying shares declines; or

(d) he has a right to avoid a loss if the price of the underlying shares declines.

67. Separate provisions have been drafted which require disclosure of short positions. These follow the same methodology as the S(DI)O uses for long positions, with the events set out in clause 301 and the circumstances giving rise to the duty of

disclosure set out in clause 304. Clauses 303 and 334 both specifically identify the short positions to be taken into account.

68. A person (other than a director) with a short position will only be under a duty to give a notification if he is interested in 5% or more of the shares in a listed corporation i.e. he must be a substantial shareholder before he is under a duty to disclose a short position. The threshold for a change in a short position giving rise to a duty of disclosure is 1%. Thereafter, as with long positions, a disclosure is only prompted by a change in the short position that results in the short position crossing a percentage level, or ceasing to have a short position of at least 1%.

69. Short positions are rounded down to the next whole number and are eligible for the *de minimis* exemption in the same manner as long positions (see clauses 305(4) and 304(8)). The proposed disclosure regime will not permit netting-off of long and short positions for the purpose of calculating the percentage level of a person's interests.

Obligation to disclose changes in the nature of an interest in shares

70. At present, a substantial shareholder must give a notification if he acquires an interest in shares or ceases to have an interest in shares and <u>there is a change in the percentage level of his interest</u> (section 4(5)(b) of S(DI)O). There are situations where a person may enter into a transaction which dramatically changes the nature of his interest without changing the percentage level. Such transactions are not, at present, notifiable.

71. One situation is where a substantial shareholder exercises an option to take, say, 100,000,000 shares in a listed corporation. Before the exercise of the option he had a remote interest in 100,000,000 shares and after the exercise he owned 100,000,000 shares. Whilst the nature of his interest changed, the percentage level of his interest did not change and he is not required to give a notification.

72. Another example is stock lending. Whilst the term "lending" is used, the agreements between the lender and borrower make it clear that the "borrower" actually acquires full title to the shares – so that he can sell them. A stock borrowing and lending transaction is therefore little different from any other sale or purchase of shares. However, because the stock lender has a right to call for the same number of shares as those which have been lent, the percentage level of his interest did not change and he is not required to give a notification.

73. In both examples the information could be price sensitive but public investors are not given a full and complete picture to enable them to make informed investment decisions. At present they only see one side of the transaction. In the first example the person against whom the option was exercised would have to give notice – but not the person exercising the option. In the second example the borrower would have to give notice but not the lender. (Assuming the person against whom the

option was exercised, and the stock borrower, were substantial shareholders and their interests crossed a percentage level).

74. We therefore propose that any change in the nature of an interest in shares in which a substantial shareholder has a notifiable interest should be disclosed (clause 304(1)(d)). These changes would mean that a stock lender would have to give notice when he lends shares and also give notice when the shares are returned to him. The borrower will continue to be required to disclose the borrowing and return of the shares in the same manner as the existing requirements of the S(DI)O.

75. As a related matter, as a result of discussion with market participants, the Bill proposes that "conduit" stock borrowing and lending activities should be exempt from the disclosure requirement (clause 304(11)(iii)). Conduit stock borrowing and lending is the business of persons who intermediate between the ultimate lenders and the ultimate borrowers. There may sometimes be several persons in a chain who hold an interest briefly and requiring disclosure of all of their interests would not assist in transparency. It is proposed that the exemption be limited to shares that are borrowed from, and lent to, third parties the same day by a "qualified stock borrower and lender".

76. Stock borrowing and lending need only be disclosed if the borrower or lender is interested in more than 5% of the shares of a listed corporation. Many custodians also act simply as bare trustees so that they are not personally required to give a notification in respect of any agency lending which they transact on behalf of their clients. Accordingly, it is thought that the burden of disclosure will be limited. However, the SFC is still engaged in discussions with participants in the stock borrowing and lending industry concerning the precise scope of the exemptions. We plan to propose a Committee Stage Amendment at a later stage to enable the SFC to grant certain exemptions through subsidiary legislation, in order to allow adequate flexibility for the new regime to develop in tandem with the market. This is in line with the practice of regulators in overseas jurisdictions.

RESPONSE TO MARKET COMMENTS

77. Most of the comments received during the consultation are technical in nature. The bulk is from a group of international brokerage houses and investment banks ("the group") whose concern relates to the proposals to extend certain disclosure requirements to short positions, unissued shares and cash-settled derivative products. They consider that the proposals would increase the burden of disclosure compared to the existing disclosure regime and go further than the equivalent legislation in other international markets. They comment that the information required to be disclosed under the proposed regime for derivatives will be of little value to listed corporations and investors, and any benefits are outweighed by the cost burden created by the regime. They also expressed, concerns that disclosure of detailed information might reduce their competitiveness.

78. We have put forward the proposals with a view to close an information gap for investors. This is to address a unique Hong Kong problem in that our market capitalization and the public float of most listed corporations are relatively small by international standards, and thus incomplete information on shareholding positions may distort market prices easily. Dealings exceeding 5% of the share capital could have a profound effect on the market. Particularly, for a company with a large market capitalization, economic interests more than 5% of the share capital (which could be held through derivatives) may involve a large amount of capital flow in the market. These proposals have been put forward in response to calls from listed corporations in the light of their past market experience.

79. In light of comments from the group, we have been having constructive and detailed working sessions with them since exposure of the White Bill. Though these efforts, we have identified some genuine market concerns about the details of positions in derivatives to be disclosed which might reveal their hedging strategies to their competitors and hence expose themselves to the risk of being front-run. This might adversely affect the development of the derivatives market. We have also identified certain compliance problems, especially for large-scale multinational operations. To address these concerns, the Bill compresses the level of details to be disclosed by removing the requirement for substantial shareholders to disclose certain commercially sensitive information (e.g. the consideration, strike price, option premium and the option price of a derivative), but preserves the essential aggregate data for investors to have a clearer picture of the major shareholding positions in a listed corporation. The amendments aim to strike a pragmatic balance between enhancing market transparency and facilitating market development.

80. We also consulted the US Securities and Futures Commission ("SEC"), and confirmed that the reporting obligations of substantial shareholders and directors were extended to purely cash settled derivatives in the US in 1996 (see Annex 2 for more details). The SEC has also confirmed that such persons are also prohibited from short selling. In the UK a person is prohibited from dealing in derivatives (put or call options) issued in respect of the listed corporation of which he, or his spouse, is a director.

81. As with the US SEC, the SFC took the view that cash settled derivatives provide identical opportunities for profit predicated on the underlying stock price movement and have the same informational value as physically settled derivatives. We have been careful to work with market participants to ensure that the proposed regime is workable and will not impose a heavy burden on the market.

82. In response to comments from the group on the White Bill, we have already included an exemption for "conduit" stock lending and borrowing (see paragraph 75 above) to lessen the compliance burden of an intermediate party who merely borrow stocks for the purpose of lending to another, and to reduce duplicative interests being disclosed. However, after the publication of the Blue Bill, we received

further comments that the exemption may be too narrow and that the requirement for disclosing a change in the nature of an interest should exclude stock borrowing and lending.

83. We note the concerns from the group, and in particular those members who are active in stock borrowing and lending, on the impact of the proposal on their business. We recognize that the range of activities which are treated as stock borrowing and lending activities are very wide and involve a number of complex trading strategies and instruments. The SFC has established a working group with industry representatives to further discuss the issue with the industry and try to identify further ways to refine the exemption. We are prepared to propose Committee Stage Amendments to the Bill to allow for necessary flexibility for the new regime to operate without stifling stock lending and borrowing business. As a first step, we will propose that the *de minimis* exemption (see paragraph 15 above) will also apply to changes in the nature of an interest. This is welcomed by the market. Because of the complexity of the issues and in view of the rapid development of the industry, we would propose that any such exemptions would be contained in detailed rules to be made by the SFC following public consultation. These rules would be subject to the normal vetting of the legislature. As mentioned in paragraph 76, we plan to propose a Committee Stage Amendment to empower the SFC to make such rules.

84. In response to market comments from the group, we have now removed the obligation to disclose the consideration paid to acquire shares looking back over 4 months, to reduce the compliance burden.

85. As mentioned in paragraph 26 above, we have also, in the light of comments from the group, extended the exception for "exempt security interests" to cover comparable corporations authorized under the law of another jurisdiction as recognized for this purpose by the SFC, if they hold the shares by way of security only for the purposes of a transaction entered into in the ordinary course of its business.

86. In considering comments from the group, we have to take into account voices from other market users. The HKGCC and other smaller market users have urged us to ensure that the market would not be susceptible to manipulation through the use of derivatives. We believe that we have made the best endeavours in accommodating requests from the group without neglecting the calls from other market users for greater transparency and hence a more fair market.

INTERNATIONAL COMPARISON

87. A summary of the relevant proposals in Part XV of the Bill in other major international jurisdictions is at **Annex 2**.

Securities and Futures Commission
Financial Services Bureau
11 May 2001

Securities and Futures Bill
Part XV

Comparison Table

In this table we use the term "substantial shareholder" to describe a person with an interest of 5% or more in the shares in the relevant share capital of a listed corporation. This term is not defined in Part XV. We use the term "Existing law" to mean that the drafting of the clause closely follows the section identified in the second column. However, there may be minor textual amendments.

Legend:

S(DI)O = Securities (Disclosure of Interests) Ordinance (Cap. 396)

Clause	Derivation in S(DI)O	Notes
	Division 1 – Preliminary	
299	**s.2**	**Interpretation of Part XV**
		This clause contains definitions used in Part XV of the Bill and includes the following new definitions :
"associated corporation"	"associated corporation"	Self contained definition to replace definition in S(DI)O referring to s.129 of Companies Ordinance. Extended to all corporations not simply companies incorporated in Hong Kong.
"cash settled equity derivatives"	--	New. Used in clause 317(2) and 340(2) in connection with provisions relating to the calculation of number of underlying shares of equity derivatives.
"contract multiplier"		New. Required in connection with calculation of number of underlying shares of stock futures contracts. Used in clause 313 (9) -(13) and 336 (9) – (13).
"custodian"	--	New. Required in connection with the new exemption permitting disaggregation of certain group interests in clause 307(5).
"duty of disclosure"	--	This term was previously defined in s 3(1) of the S(DI)O but is defined more widely in the Bill, and now extends to directors and chief executive officers.
"equity derivatives"	--	New. This definition is one of the foundation stones for the extension of the disclosure regime to require disclosure of all interests in shares which are the underlying shares of derivatives. It is intended to cover all types of derivatives.
"founder of the trust"	--	New. This definition ensures that a person who sets up a discretionary trust and retains an influence over the management of the trust assets is required to disclose that he has an interest in the shares in which the trust is interested. Used in clauses 313(4)(b) and 336(4)(b).

Clause	Derivation in S(DI)O	Notes
"issued equity share capital"		New. The definition of "issued share capital" follows the former definition of "relevant share capital" and is used in clause 305 as the denominator when calculating the "percentage level" of a person's interest.
"listed corporation"	"listed company"	"Listed corporation" replaces "listed company" to highlight the fact that the Bill applies to listed corporations not incorporated in HK.
"notifiable interest"	--	New. Because of the use of the term "notifiable interest" in clause 304 we have defined this term in the Bill. This definition is not used for directors.
"off-exchange transation"	--	New. Used in connection with the details of the consideration that has to be disclosed in sub-clause 317(1)(f) and (g), 340(1)(g) and (h).
"on-exchange transaction"	--	New. Used in connection with the details of the consideration that has to be disclosed in sub-clause 317(1)(f) and (g), 340(1)(g) and (h).
"physically settled equity derivatives"	--	New. Used in clause 317(2) and 340(2) in connection with calculation of number of underlying shares of equity derivatives.
"register of interests in shares and short positions"	"Register of interests in shares"	Minor change in defined term to reflect the extension of the registers to cover short positions.
"register of directors' and chief executives' interests and short positions"	--	New. Defined term added to reflect the regime for substantial shareholders.
"relevant event"	--	New. This definition lists the events, or changes, which give rise to a duty of disclosure in specified circumstances to create a short phrase for referring to those events.
"relevant exchange company"	--	New. Anticipates that there may be more than one.
"relevant share capital"	--	Limb (a) follows the existing definition. Limb (b) extends the definition to cover unissued shares as part of the extended regime to require disclosure of interests in shares through all types of equity derivatives.
"relevant time"	--	New. Different definition from that in section 3(4) of the S(DI)O. The "relevant time" is simply the time when the relevant event happened – not the time when a person became aware that the event had happened (as at present).
"short position"	--	New. Limb (b) only applies to the borrower of stock under a stock borrowing and lending agreement.
"specified percentage level"	--	New. A 1% level is fixed as the threshold for disclosure of short positions.
"stock futures contract"	--	New. Required in connection with calculation of number of underlying shares of stock futures contracts - a type of equity derivatives.

Clause	Derivation in S(DI)O	Notes
"target corporation"		Clarifies a term used in s.10 of S(DI)O now clause 308.
"trustee"	--	New. Required in connection with the new exemption permitting disaggregation of certain group interests in sub-clause 307(5).
"underlying shares"	--	New. This term links the new definition of "equity derivatives" to the familiar term "shares in the relevant share capital" (the words that are used in clause 301 to prompt disclosure). The definition is different for substantial shareholders and directors. Paragraph (b) is adapted to fit the wider disclosure obligations of directors who have to disclose interests in all shares of the listed corporation and any associated corporation – not merely "shares in the relevant share capital".
299 (2) – (5)	s2 (4) – (7)	Existing law.
299 (6)		New. This provision has the effect of qualifying the definition of "underlying shares" so that persons holding financial instruments which provide exposure to a basket of shares (e.g. a Hang Seng Index futures contract) do not have to disclose their interests in the underlying shares of that instrument.
300	**s.2A**	**Exemptions**
		Sub-clause (3) is new. Provision for exemptions also being given in respect of derivatives. A wider class of persons can apply and be granted exemption to allow for the varied nature of equity derivatives.
	Division 2 – Disclosure of interests and short positions	
301	**s.3**	**Duty of disclosure : cases in which it may arise**
		Subsections 3(1) and (2) of S(DI)O have been consolidated into sub-clause (1) with the removal of reference to knowledge. The time for giving a notification now only runs from the time when a person has knowledge – see section 316. As a consequence of this change it has been possible to simplify some very complex provisions in the S(DI)O. Sub-clauses (4) – (6) are new and provides for disclosure of short positions.
302	**s.4**	**Interests to be disclosed**
		Existing law with clarification that interests in shares includes interests which a person has through derivatives.
303		**Short positions to be disclosed**
		New. This section effectively repeats s.4(1) of S(DI)O but applies it to short positions.
304	**s.4**	**Circumstances in which duty of disclosure arises**
(1) (a)	4(4)	Existing law.
(1)(b) & (c)	4(5)	Existing law except that the events covered are both clause 301(1)(a) & (b) .
(1)(d)		New. Requires disclosure where there is a change in the nature of an interest. This would operate to require disclosure where, for example, a person exercised an option to get shares or require another person to take those shares. It would also require disclosure of a person "lending" shares. Sub-clause (11) amplifies.
(2)	7(2) & (4)	Follows S(DI)O but is drafted following the pattern of sub-clause (1).

Clause	Derivation in S(DI)O	Notes
(3)	6(2)	Follows S(DI)O but is drafted following the pattern of sub-clause (1).
(4)		New. The sub-clause sets out the circumstances in which short positions described in sub-clause 301(4) must be disclosed.
(5)		New. The sub-clause sets out the circumstances in which short positions described in sub-clause 301(5) must be disclosed.
(6)		New. The sub-clause sets out the circumstances in which short positions described in sub-clause 301(6) must be disclosed.
(7)		New. The sub-clause establishes an exception under which substantial shareholders may be exempted from the obligation of disclosure when their interests in shares fluctuate by less than 0.5% across a particular percentage level.
(8)		New. The sub-clause is drafted following the pattern of sub-clause (7) providing the same exception for changes in a short position.
(9)		New. This sub-clause establishes a new exemption for transactions in interests in shares between members of the same group of companies.
(10)		New. The sub-clause is drafted following the pattern of sub-clause (9) providing the same exception for transactions in short positions between members of a group of companies. The terminology is slightly different.
(11)		New. This sub-clause qualifies sub-clause (1)(d) – disclosure where there is a change in the nature of an interest.
(12)		New. This provision explains who is a conduit stock borrower and lender qualified for the exemption under sub-clause (11).
(13)		New. This provision explains the term "percentage figure" for the purposes of the exemption for small fluctuations in the level of a person's interest in (7) and (8).
305	**s.5**	**Percentage level in relation to notifiable interests and short positions**
(1) – (2)	5(1) – (2)	Existing law extended to the new provisions.
(3)		New. Provision to ensure that there is no netting off of short positions and long positions in sub-clause (1).
(4)		New. Establishes a system for calculating the percentage level of short positions – modelled on sub-clause (1).
(5)		New. Provision applying to short positions modelled on sub-clause(2).
306	**s.6**	**Notifiable percentage level and specified percentage level**
(1)	6(1)	The notifiable percentage is reduced to 5% instead of 10%.
(2)		New. Establishes a threshold for disclosure of short positions – modelled on sub-clause (1).
307	**s.8**	**Notification of family and corporate interests and short positions**
(1)	8(1)	Existing law extended to cover short positions.
(2)	8(2)	Existing law extended to cover short positions. This provision would require the holding company of a group of companies to aggregate and disclose all of the interests held by members of the group.

Clause	Derivation in S(DI)O	Notes
(3) – (4)	8(3) – (4)	Existing law.
(5)		New exemption. Under this sub-clause a parent company need not add the interests (and short positions) of a subsidiary to its own interests (and short positions) where certain conditions are met.
(6)		New. This sub-clause clarifies a point which is implicit in the S(DI)O (but not spelt out) – namely the parent company in a group is taken to cease to be interested in shares in which companies it controls are interested, when it ceases to control those companies.
(7)		This sub-clause is intended to clarify the point that spouses, children under 18 and controlled companies are taken to be interested in shares in the same circumstances as a person to whom clause 313 applies.
(8)		New. This provision explains the term "investment managers" used in the exemption in sub-clause (5).
308	**s.9**	**Agreement to acquire interests in particular listed corporation**
(1)	9(1)	Sub-clause (1)(a) is existing law but (b) is new. The scope of a "concert party agreement" under section 9 of the S(DI)O has been extended.
(2) – (5)	9(3) - (6)	Existing law.
(6)		New. This provides an exception to the new sub-clause (1)(b) for loans made in the ordinary course of business.
(7)		New. This provision defines the term "controlling person" for the purposes of sub-clause (1)(b).
309	**s.10**	**Interests of parties to agreement**
(1) – (3)	10(1) – (3)	Existing law.
310	**s.11**	**Duty of parties to agreement acting together to keep each other informed**
(1) – (2), (4)	11(1) - (3), (6)	Existing law.
(3)	11(3)	Existing law. Paragraph (b) of section 11(3) of S(DI)O has not been retained as details of the registered owner are no longer required to be disclosed.
(5)	11(8)	Existing law. 3 business day disclosure period adopted.
311	**s.12**	**Circumstances in which persons have interests in shares or short positions by attribution**
(1)(a)	12(1)	Existing law.
(b) & (c)		New. Provisions modelled on s.12(1) but covering changes in the nature of an interest and short positions.
(2) – (6)	12(2) – (6)	Existing law extended to cover changes in the nature of an interest and short positions.
312	**s.15**	**Notification by agents**
312	15(1)	Existing law extended to cover short positions.

Clause	Derivation in S(DI)O	Notes
	Division 3 – Interests and short positions to be notified or disregarded	
313	**s.13**	**Interests and short positions to be taken into account for the purposes of notification**
(1) – (3)	13(1) – (2)	Modelled on existing law but extended to cover short positions, as necessary.
(4)	13(3)	Paragraph (a) existing law extended to cover short positions. Paragraph (b) is new and requires that the founder of a discretionary trust (see the definition "founder of the trust") who retains an influence over the management of the trust assets is required to disclose that he has an interest or a short position in the shares in which the trust is interested.
(5) – (7), (15) – (16)	13(4) – (8)	Existing law.
(8)		New. This sub-clause spells out that a person who is the holder, writer or issuer of equity derivatives is taken to have an interest in shares which are the underlying shares of the equity derivatives in certain situations. Sub-clause (8) deals with long positions.
(9)		New. Provisions designed to identify the number of shares that are the underlying shares of equity derivatives in which a person is taken to be interested. Sub-clause (9) is related to sub-clause (8) and deals with long positions.
(10)		New. This sub-clause states that a person shall be regarded as ceasing to be interested in shares in certain situations. Sub-clause (10) deals with long positions.
(11)		New. Provisions designed to identify the number of shares that are the underlying shares of cash settled equity derivatives in which a person is taken to cease to be interested. Sub-clause (11) is related to sub-clause (10)(d) and deals with long positions.
(12)		New. Provisions designed to identify the number of shares that are the underlying shares of stock futures contracts (one type of equity derivatives) in which a person is taken to cease to be interested. Sub-clause (12) is related to sub-clause (10)(e) and deals with long positions.
(13)		New. Provisions designed to identify the number of shares that are the underlying shares of equity derivatives in which a person is regarded as having a short position. Sub-clause (13) is the equivalent of sub-clause (9) but deals with short rather than long positions.
(14)		New. Provisions designed to identify the number of shares in which a person is regarded as having a short position under a securities borrowing and lending agreement.
314	**s.14**	**Interests to be disregarded for the purpose of notification**
(1)	14(1)	Existing provision redrafted to remove uncertainty regarding the scope of section 14(1)(b)(i) of the S(DI)O, the Bill clarifies interests to be disregarded. There is also provision for exemption of overseas collective investment schemes. Related sub-clauses are (3) and (4) and (8) to (11) which explain this exemption. Sub clauses (1)(b) now makes it clear that an interest in shares, acquired by an intermediary as agent for a client, that he holds for not more than 3 business days, is to be disregarded.
(2)	14(2)	Existing law.

Clause	Derivation in S(DI)O	Notes
(5), (7)	14(4), (5)	Existing law extended to cover corporations similarly authorised in other countries.
(6)		Clarification of the point at which share pledges must be disclosed. The wording adopted in sub-clause (6) is similar to that adopted in the UK Companies Act 1985.
	Division 4 – Requirements for giving notification	
315	**s.7 & 54**	**Notification to be given**
(1), (4) – (7)		New.
(2)	7(1)(b)(ii) and (8)(b)	Amendment of existing law. Removed the requirement for SEHK to be notified first.
(3)	54	Existing law. The SFC proposed to prescribe 2 forms for use under clause 315 : Form 1 - Individual Substantial shareholder Notice Form 2 - Corporate Substantial Shareholder Notice
316	**s.7**	**Time of notification**
(1)	3(1)(2) and (4); 7(1)(a)	As explained above in relation to clause 301, the time for giving a notification now only runs from the time when a person has knowledge.
(2)	6(2); 7(3)	In practical terms the effect of these provisions is the same as the existing law except that a person is given 10 business days to give notice in the specified circumstances.
(3) and (4)		Timing for the new disclosure obligations in clauses 301 (5) and (6).
317	**s.7**	**Particulars to be contained in notification**
(1)	7(5) to (7); 15(2)	(a) This sub-clause sets out the particulars that must be given in the disclosure forms.
(2)		New. Sub-clause (2) requires a person to give a limited breakdown of his derivative interests.
(3)		New. This requires that there is no netting off of long and short positions. Short positions must be separately stated in the form.
(4)		New. The requirement for corporate substantial shareholders to disclose their controlling shareholders is to improve transparency.
(5)	10(4)	Paragraphs (d) and (e) are new.
(7)		New. This reflects concern expressed during the public consultation that details of the consideration paid or payable for derivatives may be commercially sensitive.
318	**s.17**	**Duty to publish and notify Monetary Authority of information given under Division 4**
		Existing law.

Clause	Derivation in S(DI)O	Notes
319	**s.15**	**Offences for non-compliance with notification requirements**
		Existing law. Sub-clause (5) extended to cover equity derivatives specifically.
	Division 5 – Listed corporation's powers to investigate ownership	
320	**s.18**	**Power of listed corporation to investigate ownership of interests in its shares etc.**
		Existing law extended to cover equity derivatives and short positions where appropriate.
321	**s.20**	**Duty to notify relevant exchange company, Commission and Monetary Authority of information given under section 320**
		Existing law.
322	**s.21**	**Listed corporation to investigate ownership of interests in its shares etc. on requisition by members**
		Existing law.
323	**s.22**	**Listed corporation to report to members**
		Existing law. Period changed from 15 days to 10 business days in sub-clause (2) and (4). Period changed from 3 days to 3 business days in sub-clause (6).
324	**s.23**	**Duty to deliver report prepared under section 323 to relevant exchange company, Commission and Monetary Authority**
		Existing law.
325	**s.24**	**Offences for failure to provide information required by listed corporation and power to impose restrictions**
		Existing law extended to cover equity derivatives where appropriate.
326	**s.27**	**Inspection of reports**
(1)	27(1)	Existing law.
	Division 6 – Keeping of register	
327	**s.16**	**Register of interests in shares and short positions**
(1)	16(1)	Existing law. Sub-clauses (12) and (13) are new.
328	**s.19**	**Registration of interests and short positions disclosed under section 320**
		Existing law extended to cover short positions specifically and not limited to present interests.

Clause	Derivation in S(DI)O	Notes
329	**s.25**	**Removal of entries from register**
		Existing law extended to cover short positions where appropriate. Period changed to 10 business days in sub-clauses (2) and (6).
330	**s.26**	**Otherwise, entries not to be removed from register**
		Existing law.
331	**s.27**	**Inspection of register**
		Existing law with charges updated.
	Division 7 – Disclosure of interests and short positions of directors and chief executives	
332	**s.28**	**Duty of disclosure by director and chief executive**
(1)	28(2)	Paragraphs (a) to (d) are existing law.
		Paragraphs (e) and (f) –are new.
		The provisions in s.28 S(DI)O setting out <u>how</u> the duty of disclosure must be performed have been moved to clause 338 and 340 to create a similar regime to that for substantial shareholders.
(2)	28(1)	Paragraph (a) is new, requiring disclosure of directors' interests and short positions when a corporation first becomes listed.
		Paragraphs (b)(i) and (c)(i) are existing law but (b)(ii) and (c)(ii) requiring disclosure of short positions on commencement and on becoming a director are new.
		Paragraph (d)(i) is existing law (s.28(2)(e)) but (d)(ii) – short positions - is new.
(3) – (4)	28(5), (7)	Existing law.
(5)		New. This sub-clause is similar to clause 304(11) for substantial shareholders.
333	**New**	**Interests to be disclosed by director and chief executive**
		New. This sub-clause is similar to clause 302 for substantial shareholders.
334	**New**	**Short positions to be disclosed by director and chief executive**
		New. This clause is similar to clause 303 for substantial shareholders.
335	**s.31, Schedule, paragraph 4, 5**	**Notification of family and corporate interests and short positions by director and chief executive**
		Existing law extended to cover short positions where appropriate. Sub-clause (8) clarifies a point which is implicit in S(DI)O.

Clause	Derivation in S(DI)O	Notes
	Division 8 – Interests and short positions to be notified by director and chief executive or disregarded	
336	**s. 31(7); Schedule, Part I**	**Interests and short positions to be taken into account for the purpose of notification by director and chief executive** Modelled upon existing law. Sub-clause (1) effectively replaces s.31(7) S(DI)O but is modelled on clause 313(1) being the equivalent provision applying to substantial shareholders. Sub-clause (4)(b) is new and requires that the founder of a discretionary trust (see the definition "founder of the trust") who retains an influence over the management of the trust assets is required to disclose that he has an interest, or short position, in the shares in which the trust is interested.
337	**Schedule, Part I**	**Interests to be disregarded for the purpose of notification by director and chief executive** Modelled on existing law and follows clause 314 in terms of drafting.
	Division 9 – Requirements for giving notification by director and chief executive	
338	**s.28 & 54**	**Notification to be given by director and chief executive** The provisions in s.28 S(DI)O setting out <u>how</u> the duty of disclosure must be performed have been moved to clause 338 but have been amended to adopt a similar regime to that for substantial shareholders. Clause 338 is modelled on clause 315. The SFC proposed to prescribe 4 forms for use by directors and chief executives under clause 338 : Form 3A - Director's Notice - interests in shares of listed corporation Form 3B - Director's Notice - interests in shares of associated corporation Form 3C - Director's Notice - interests in debentures of listed corporation Form 3D - Director's Notice - interests in debentures of associated corporation
339	**Schedule, Part II**	**Time of notification by director and chief executive** The provisions in Part II of the Schedule to the S(DI)O setting out <u>when</u> the duty of disclosure must be performed have been moved to clause 339 but have been amended to adopt a similar regime to that for substantial shareholders. Clause 339 is modelled on clause 316. 5 days reduced to 3 business days.
340	**Schedule, Part III**	**Particulars to be contained in notification by director and chief executive** The provisions in s.28, and Part III of the Schedule to the S(DI)O, setting out <u>what</u> particulars must be disclosed have been moved to clause 340 but have been amended to adopt a similar regime to that for substantial shareholders. Clause 340 is modelled on clause 317. The provisions of clause 340(1) are different from clause 317(1) in that they also cover debentures and shares in associated corporations of the listed corporation. Sub-clause (4) is new. The requirement to give details of the consideration paid for shares in the previous 4 months has been dropped in relation to substantial shareholders but has been retained for directors.

Clause	Derivation in S(DI)O	Notes
341	**s.32**	**Duty to publish and notify Monetary Authority of information given under Division 9** Existing law.
342	**s.28**	**Offences for non-compliance with notification requirements by director and chief executive** Existing law adapted to reflect the removal of the requirement that the SEHK must receive the notice first.
	Division 10 – Keeping of register of directors' and chief executives' interests and short positions	
343	**ss. 16, 29, 30 and Schedule, Part IV**	**Register of directors' and chief executives' interests and short positions** Existing law extended to cover short positions and details applicable to substantial shareholders' registers where appropriate. 3 days changed to 3 business days in sub-clause (5). 14 days changed to 10 business days in sub-clause (9).
344	**New**	**Removal of entries from register of directors' and chief executives' interests and short positions** New. This clause follows the pattern of clause 329 in respect of substantial shareholders.
345	**New**	**Otherwise, entries not to be removed from register of directors' and chief executives' interests and short positions** New. This follows the pattern of clause 330 in respect of substantial shareholders.
346	**s.30 and Schedule Part IV**	**Inspection of register of directors' and chief executives' interests and short positions** Follows the pattern of clause 331 rather than paragraphs 23 and 24 of the Schedule to the S(DI)O for consistency.
	Division 11 – Power to investigate listed corporation's ownership	
347	**s.33**	**Power to investigate ownership of listed corporation** Existing law extended to cover short positions and equity derivatives where appropriate. Sub-Clause (5) removes limit on contribution to costs.
348	**s.34**	**Investigation of contraventions of sections 332 to 340** Existing law extended to cover equity derivatives specifically.
349	**s.35**	**Inspector's powers during investigation** Existing law extended to cover short positions and equity derivatives specifically.
350	**s.36**	**Production of records and evidence to inspectors** Existing law extended to cover short positions and equity derivatives where appropriate.
351	**s.37**	**Delegation of powers by inspectors** Existing law.

Clause	Derivation in S(DI)O	Notes
352	**s.38**	**Obstruction of inspectors** Existing law extended to cover short positions and equity derivatives where appropriate.
353	**s.39**	**Inspector's reports** Existing law.
354	**s.40**	**Expenses of investigation of affairs of corporation** Existing law. Right of appeal provided for by sub-clause (3) is new.
355	**s.41**	**Power to impose restrictions on shares etc in connection with investigation** Existing law extended to cover equity derivatives.
356	**s.42**	**Power to obtain information as to those interested in shares, etc.** Existing law extended to cover equity derivatives and short positions.
357	**s.43**	**Privileged information** Existing law (s.43 (a) of the S(DI)O is covered by sub-clause 368(4) and (5)).
	Division 12 – Orders Imposing Restrictions on Shares etc. under section 319, 325 or 355	
358	**s.44**	**Consequence of order imposing restrictions** Existing law extended to cover equity derivatives where appropriate.
359	**s.45**	**Offences for attempted evasion of restrictions** Existing law extended to cover equity derivatives.
360	**s.46**	**Relaxation and removal of restrictions** Existing law extended to cover equity derivatives. Sub-clauses (3) and (7) are new and clarify that the Financial Secretary has the necessary standing. Sub-clauses (11) to (15) are new and ensure that the court has the necessary flexibility to make appropriate orders with regard to equity derivatives that may lose their value if rights are not exercised within a fixed time frame.
361	**s.47**	**Further provisions on sale by court order of restricted shares, etc.** Existing law extended to cover equity derivatives. Sub-clauses (4) and (6) are new and clarifies that the Financial Secretary has the necessary standing. In sub-clause (5) greater discretion is given to the court to ensure that the disclosure has been made in accordance with the Ordinance before releasing the proceeds of sale.

Clause	Derivation in S(DI)O	Notes
	Division 13 – Miscellaneous	
362	**s.48**	**Liability of members for offences by corporations** Existing law. Section 48(1) S(DI)O is now clause 378(1).
363	**s.51**	**Method of giving notification and delivering report** Existing law supplemented by more comprehensive provisions.
364	**s.52**	**Form of registers and indices** Existing law.
365	**s.53**	**Regulations by Chief Executive in Council** Existing law. Paragraph (b) specifically provides for prescribing interests to be disregarded as anticipated by clauses 314(1) and 337(1).

INTERNATIONAL COMPARISON

Due to the differences in the disclosure regimes in overseas jurisdictions, we will present a summary of the relevant proposals in the Bill as they are relevant in the overseas jurisdiction, instead of presenting a country by country comparison.

Disclosure threshold

2. In 1994, the Asian Development Bank commissioned a comparative study of the securities regulations and practices of 13 countries in Asia including Hong Kong. In the discussion paper issued by the study group in July 1994, "Securities Market Regulation & Supervision" (the "ADB Paper"), it was recommended that countries in the Asian region should adopt a 5% disclosure threshold[1].

3. Furthermore, a review of the securities regulations of other jurisdictions shows that Hong Kong's 10% threshold is the highest among international and regional centres -

• The U.K. :	3%[2]	The U.S. :	5%[3]
• Australia :	5%[4]	New Zealand :	5%[5]
• Japan :	5%[6]	Singapore :	5%[7]
• Malaysia :	5%[8]	Thailand :	5%[9]
• Indonesia :	5%[10]	The P.R.C. :	5%[11]

Notification Period

4. The S(DI)O requires a person under a duty of disclosure to perform that duty within 5 calendar days next following the day on which the duty arises[12]. Therefore, if a duty of disclosure arises on the 1st day of a particular month, notification must be made to the SEHK and the listed company concerned no later than on the 6th day of that month.

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1 Section E of the ADB Paper at p.29.

2 Section 199(2) of the U.K. Companies Act 1985.

3 Section 13(d)(1) of the U.S. Securities Exchange Act 1934, as amended.

4 Section 708 of the Australian Corporations Law.

5 Sections 2 and 20 of the New Zealand Securities Amendment Act 1988.

6 The Securities and Exchange Law, Cabinet Order for the Enforcement of the Securities and Exchange Law, and Ordinance of the Ministry of Finance Concerning the Disclosure of the State of Large Holdings of Shares.

7 Section 81 of the Singapore Companies Act.

8 Section 69D of the Malaysian Companies Act 1965.

9 Section 246 of the Securities and Exchange Act B.E. 2535.

10 Article 87 of the Capital Market Law 1995 of Indonesia.

11 Article 47 of the Interim Regulations on the Administration of Stock Issuance and Trading promulgated by the State Council in April 1993.

12 Section 7(1)(a) of, and Paragraph 14(1) of the Schedule to, the S(DI)O.

5. The ADB Paper recommends that a 2 days' notification period be adopted[13].

6. The notification period adopted by other jurisdictions is as follows -

- The U.K. : 2 business days[14]
- The U.S. : 10 days[15]
- The P.R.C. : 3 working days[16]
- Singapore : 2 days[17]
- Malaysia : 14 days[18]
- Indonesia : 10 days[19]
- Thailand : 1 business day[20]
- Australia : 2 business days[21]
- New Zealand : Notification must be given as soon as the person knows, or ought to know, that he is or ceases to be a substantial security holder, or as soon as he knows, or ought to know, that any change in his interest takes place[22].

Disclosure of consideration

7. U.S. laws require detailed particulars to be disclosed by substantial security holders. These include the source and the amount of funds or other consideration used, or to be used, in the purchase of securities. Substantial security holders are also required to classify the source of funds and to file copies of all written agreements, arrangements, understanding or proposals relating to the borrowing of funds, acquisition of control or transfer of securities.

8. Australian regulations require substantial shareholders to disclose the consideration they paid in the acquisition of interest in voting shares and with respect to any change in such interest. With respect to interests acquired off-exchange, substantial shareholders are required to provide a copy of the contract, scheme or arrangement that gives rise to the duty of disclosure. If the relevant interest was acquired other than because of a contract, scheme or arrangement or where such contract, scheme or arrangement was not in writing, a memorandum must be attached to the notification disclosing full particulars of the circumstance giving rise to the duty of disclosure.

9. Where the substantial security holder is a beneficial owner of voting securities, New Zealand regulations require him to disclose the consideration and other terms of any transaction as a result of which he becomes a beneficial owner. If the person concerned is

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13 Section E of the ADB Paper at p.29.

14 Sections 202(1) and 220(2) of the U.K. Companies Act 1985.

15 Section 13(d)(1) of the U.S. Securities Exchange Act 1934, as amended.

16 Article 47 of the Interim Regulations on the Administration of Stock Issuance and Trading promulgated by the State Council in April 1993.

17 Sections 82 to 84 of the Companies Act of Singapore.

18 Sections 69E, 69F and 69G of the Companies Act of Malaysia.

19 Article 87 of the Company Law of Indonesia.

20 Section 246 of the Securities and Exchange Act of Thailand.

21 Sections 709(4), 710(4) and 711(4) of the Australian Corporations Act.

22 Sections 20(4), 21(4) and 22(4) of the New Zealand Securities Amendment Act 1988.

not a beneficial owner of voting securities, he is required to provide a copy of each contract, agreement or instrument pursuant to which he becomes interested in the relevant securities. Where there is no such document, he is required to provide a memorandum specifying the material terms of any trust, agreement, arrangement or understanding pursuant to which the interest arises.

Disclosure of interests in shares through equity derivatives

United Kingdom

10. In the UK, Part VI of the Companies Act 1985 governs the disclosure obligations of substantial shareholders and directors. In Part VI there is no specific mentioning of equity derivatives. However, sections 208 (2) and (5) contain provisions (identical to sections 13 (2) and (5) of the S(DI)O) which make it clear that a range of derivative interests must be disclosed.

11. In 1995 the Securities and Investments Board (the SIB") considered whether to introduce arrangements for disclosure of economic interests in shares. However, the SIB took the view that the need for change was reduced by the introduction by the London Takeover Panel of a new Rule 8.3 requiring disclosure of such interests during offer periods.

12. One of the reasons that the Panel introduced Rule 8.3 in 1996 was stated to be because persons with large positions in derivatives might influence the outcome of a takeover bid and it was concerned that there was not sufficient transparency under the previous rules. The Panel was also concerned that positions in derivatives may have a significant influence on prices and, indirectly, through associated hedging, the location of the stock.

13. The issue of disclosure does not arise in relation to directors in the UK as directors are prohibited from dealing in derivatives in the UK.

United States

14. In the US there are two separate provisions requiring disclosure of interests in shares - including interests held through derivatives[23]. The SEC takes slightly different approaches under the separate provisions with respect to derivatives, as follows.

<u>Directors and 10% shareholders</u>

15. Every officer, director, and beneficial owner of more than 10% of a class of equity securities must file with the SEC a statement of ownership regarding such security. Derivative securities and non-derivative securities must be disclosed separately. Derivative securities are described as "puts, calls, options, warrants, convertible securities, or other rights or obligations to buy or sell securities".

16. Recently, the SFC has asked the SEC whether the disclosure provisions in the US apply to purely cash-settled derivatives. According to the SEC, it adopted in 1996 amendments that apply the reporting provisions to cash-only instruments to the same extent as other issuer equity securities. Also, in the US, any beneficial owner of more than 10% of

[23] Sections 13 and 16 of the US Securities Exchange Act 1934, as amended.

any class of equity security as well as the issuer's directors or officers, may not sell the security if he does not own the security sold. The SEC interprets that section as prohibiting any short sales by these insiders.

5% shareholders

17. Generally, the extent of the disclosure obligations imposed in the US are greater than in Hong Kong. A 5% shareholder must give information including - the number of shares that he owns; his identity and background; the source and amount of the consideration; the purpose of the acquisition and his plans for further acquisitions. It also includes information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, etc.

18. Although the provision relating to persons holding 5% of a listed corporation does not prohibit short sales by persons, the SEC has taken the view that, because of the range of matters that must be disclosed, any short sales would probably have to be reported in the filing.