Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000

Summary of Public Comments and Administration's Response on Part XV of the Securities and Futures Bill

Clause no.	Respondent	Respondent's comments	Administration's response
Part XV – Disclosure of Interests			
General Commencement of Legislation	Group of nine investment bankers	Substantial advance notice (at least 6 months) must be given of the commencement date of Part XV to allow time for disclosure of "interests" not previously discloseable, of changes in respect of interests previously notified and of short positions.	Adequate time will be given before the Bill comes into force. The market is being consulted on the subsidiary legislation to be made under this Part to allow for ample time for consultation. We doubt 6 months is needed. Firms already gather the information for their own purposes such as for risk management. Following consultation the period allowed for disclosure on commencement has been extended to 10 business days. On commencement, only short positions of 1% or over give rise to a separate duty of disclosure.
General	Group of nine investment bankers, Law Society, ISDA	The Bill substantially expands the scope of the current disclosure requirements by requiring disclosure of: • Interests in unissued shares • Interests arising under cash-settled derivatives • Short positions (with no netting of long positions in same stock) • Changes in the nature of a person's interest. The proposed disclosure regime still goes considerably further than the equivalent legislation in other international markets. Information required to be provided will be of little real value to listed corporations, regulators and to investors and that any benefits from the wider disclosure are far outweighed by the cost burden created by the regime.	Due to the particular circumstances of Hong Kong there is a need for transparency in relation to derivatives. For example, the small market capitalization and small size of the public float for many listed corporations in Hong Kong, when compared to New York and London, makes it more possible to manipulate the Hong Kong market using derivatives. 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. At present, investors are being given an incomplete picture of dealings by substantial investors that may be misleading. See also comparison at **Annex 2** to paper No. 13/01. When it was originally suggested that the Securities (Disclosure of Interests) Ordinance ("S(DI)O") required amendment the SFC consulted its Advisory Committee on the proposed amendments. The industry representatives on the Committee recommended that <u>all dealings in any form of derivative</u> over the shares in the relevant listed corporation should be disclosed. 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

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			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. Similar calls are advanced by the smaller market players. Derivatives have been used to assist in manipulative schemes resulting in loss to investors. The international norm (based on the UK and Europe) is for greater transparency – to use disclosure as an instrument to improve the functioning of the securities markets. The disclosure requirements in the UK and the US are also wider in certain respects than in Hong Kong. For example under the Takeover Code in the UK and in the information to be provided in the US. Furthermore certain dealings which are permitted in Hong Kong are prohibited in the UK (dealings by directors in certain put and call options) or the US (short selling by directors and 10% shareholders). Disclosure is required as an alternative to prohibiting these practices in Hong Kong. The US Securities and Exchange Commission ("SEC") has confirmed to us that the reporting requirements in the US concerning cash-settled derivatives (section 13(d) of the Securities Exchange Act 1934 governing a beneficial owner of more than 5% of any class of equity security, and section 16(d) of the Act governing a beneficial owner of more than 10% of any class of equity security, respectively) include cash-only instruments to the same extent as other issuer equity securities by virtue of an amendment in 1996 to section 16 of the Securities Exchange Act 1934. The SEC also confirmed that any beneficial owner of more than 10% of 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 section 16(c) as prohibiting any short sales by these insiders. US securities laws do not prohibit short sales by persons holding 5% of a corporation, but the SEC has takes the view that, because of the range of matters that must be disclosed under section 13(d), any short sales would probably have to be reported in the filing to the SEC. The same analysis applies to a pledge of the securities in a secured transaction or the writing of call options. On the point questioning the value of the information, the rationale for requiring disclosure of interests and short positions in shares is not merely to require disclosure of control. The primary rationale is transparency. Companies and their shareholders are not only interested in persons who control voting rights – they are also interested in persons who take substantial economic interests in shares and whose transactions affect the price of those shares. As with the US SEC, when considering whether these interests should be disclosed, we 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

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			derivatives to the investors. The existing disclosure regime already applies to many physically settled equity derivatives. The provisions relating to cash settled derivatives should not create any greater difficulties in disclosure than other derivatives. Through detailed working sessions with market participants, we are aware that they are principally concerned with the level of detail that had to be disclosed in respect of derivatives and whether that information may give others a commercial advantage e.g. enabling proprietary traders to "front run". This would disrupt their normal hedging activities. To address these comments, we have revised the White Bill to reduce substantially the amount of information that must be disclosed in respect of derivative transactions, but preserving the aggregate data for investors to have a clear picture of the major shareholding in a listed corporation. We believe the present proposal has struck a pragmatic balance between enhancing market transparency and facilitating market development. We have also introduced and extended a number of exemptions in the Bill to reduce the compliance burden to those who do not have a real interests in the shares of a listed corporation, e.g. in respect of "conduit" stock borrowing and lending activities and exempt security interests.
General	HKAB	For banking groups with significant securities dealing, asset management and custodial businesses, substantial on-going costs will be incurred in monitoring the level of interests, and very frequent disclosures may be needed.	Banking groups are entitled to the same exemptions as other financial groups such as the disaggregation exception (directed at fund managers, trustees and custodians who exercise control over their investments independent from their holding company) the exempt security interest exception, and the conduit stock borrowing and lending exception. To create a specific exemption for banks would undermine the objective of creating a level playing field. Banks already have to monitor their positions to ensure compliance with the existing legislation and for their own purposes.
General	Group of nine investment bankers	Errors or delays in compliance are likely to occur very frequently and it is objectionable in principle that any such error or delay, even though inadvertent, is a criminal offence.	We believe that this concern is overstated. The period allowed for disclosure only runs from the time that a person became aware of the facts and he only has to disclose what he is aware of. New disclosure forms have been designed which explain the disclosure obligations in plain language. SFC will continue to seek market input to improve these forms in order to ensure that the disclosure obligations are simple to operate in practice.
Stock borrowing and lending	Group of nine investment bankers, HKAB, Law Society	Part XV of the Bill will create significant difficulties for both borrowers and lenders of Hong Kong stock. The new legislation deems the borrower to have a "short position" in the amount of securities borrowed,	Notification of significant stock borrowing and lending ("SBL") is important information for investors and helps to monitor market integrity. A distinction must be drawn between lenders of stock and borrowers of stock. Under the existing law stock borrowers already have to make a disclosure then they borrow stock, or return stock borrowed. The requirement in Part XV that they also disclose their short position (the obligation to return the stock borrowed) ensures that the market is not misled. If a stock

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		because it must eventually return equivalent securities (definition of "short position" This may lead to numerous notifications being required. The overall result is very complex, and may discourage custodians from lending Hong Kong stock.	borrower only discloses that he has acquired an interest in shares the market might think that he is "long" in a stock whereas his position is in fact neutral – as he has to return the stock borrowed when the lender issues a recall. The requirement that persons disclose a change in the nature of their interest in shares has the effect of requiring disclosure by lenders of stock. Persons who act as a conduit between lenders and borrowers both borrow and lend shares themselves. In the Bill, it is proposed that these persons should not be required to disclose their SBL activities. However market participants have commented that the exemption was too narrow. The range of activities which are treated as SBL activities are very wide and involve a number of complex trading strategies and instruments. The SFC has therefore established a working group comprising of industry representatives to consider how the conduit SBL exemption should be refined and whether certain other SBL activities should be exempted. Because of the complexity of the issues, we would propose that any such exemptions would be contained in detailed rules to be made by the SFC following public consultation and subject to the normal vetting of the legislature. We plan to propose a Committee Stage Amendment to empower SFC to make such rules.
General	Law Society, Group of nine investment bankers	Welcome the simplification of the drafting by merging the Schedule 9 in the White Bill into Part XV which will certainly help the reader of this complex legislation.	We welcome the respondent's support for the redrafting of Part XV.
299(1) "relevant share capital"	Law Society, Group of nine investment bankers	Difficulties might arise from paragraph (b) in the definition of "relevant share capital". This refers to unissued shares of "any class" and clause 299(2) refers to the nominal value of issued share capital being determined by reference to the issued shares of "each class". Clause 305(1) also appears to require aggregation of interests in all classes of relevant share capital in determining the percentage level of a person's "interest". The same applies to Clause 305(4) in respect of "short positions". Suggest that the concept of aggregating unissued	The principle is that shares in the relevant share capital (issued or unissued) should be only aggregated with shares of the same class. We will consider whether this point needs to be further clarified.

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		shares also be qualified by aggregating unissued shares of one class with issued shares of that class.	
299(6)	Law Society, Group of nine investment bankers	In clause 299(6), the use of the term "substantial number", is not specific enough as it is unclear as to what type of basket derivative is excluded and what type of basket derivative is still caught. In the case where there was a very large basket and no single stock in the basket was of itself substantial, the exemption would not apply, and therefore the holder of the derivative would have an interest in all the underlying stocks.	We note the respondents' comments for the need to frame the exemption more precisely, e.g. with set percentages in defining what is a "basket". After further consultation with the market on the terms of the "basket" exemption. We propose that (1) baskets should not be limited to corporations listed in Hong Kong; and (2) that no one share should account for over 30% of the value; and (3) the percentage figure should apply at the entry point, otherwise subsequent fluctuations could create a discloseable interest. We are consulting the market and plan to put forward Committee Stage Amendments.
302 306	LCK	In view of the abnormally small public float of shares in Hong Kong listed corporations when compared with international standards, it would be more effective if the disclosure threshold were further reduced to 3 percent. Even if the disclosure threshold were lowered to 3 percent it will represent a higher percentage of the free float as compared with other developed markets.	We note that 3% is used as the threshold in the UK. However, 5% is the standard used in most developed jurisdictions such as the US, Australia, Singapore, etc. We believe it is appropriate to adopt 5% as the threshold in the Bill to make Hong Kong in line with other international financial centres. We have also received support from most respondents for reducing the disclosure threshold to 5%. This, together with the new disclosure requirements regarding derivatives and short positions, should as a package bring out market transparency on a par with other international financial centres.
304(1)(d)	HKAB	The requirement to disclose changes in the nature of a person's interest is likely to be particularly onerous. and would require a custodian to disclose its interest in a stock held. This would trigger a disclosure obligation by the custodian, as would the return of the stock at the end of the loan.	We have addressed the issues raised above in relation to stock borrowing and lending. The responsibilities of custodians will be specifically addressed by any rules to be made by SFC.
304(11)	Group of nine investment bankers	A change "in the nature of the interest" should be defined in such a way as <u>not</u> to include stock lending. The exemption shall also apply to intra-group borrowing and lending. There is a separate exemption, in clauses 304(9) and (10), for intra-group transfers, which could exempt the borrower, but this is not wide enough to cover a lender.	The extent to which conduit stock borrowing and lending, ultimate lenders and custodians should be exempt is being studied by the working group established by the SFC and industry participants. See our comments above on stock borrowing and lending. We agree in principle that all transactions between members of a wholly owned group of companies should be exempt. However, the interest is to be treated as remaining in the hands of the group company which first acquired the interest. That company must report (a) if there is a transfer of the interest outside the group; or (b) if a member of the group who holds the interest ceases to qualify as a 100% owned group member. The same approach will apply to short positions. We plan to propose Committee Stage Amendments to better reflect the policy

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			intention.
305(2)	Law Society, Group of nine investment bankers	Temporary rights under provisional allotment letters may give rise to notification obligations which are inadvertently missed and an exemption should be included for such temporary rights. Clause 305(2) seems to have the effect that a person who maintains his equity percentage following a rights issue still has to make a notification of a change in interest because the person has to calculate his interest by reference to the pre-rights issue share capital of the company. If so, an exclusion for such circumstances should be included.	This clause is based on the existing S(DI)O. The intention is that a person that takes up his rights (and whose percentage interest remains the same) will not have to make a disclosure whilst a person who does not take up his rights (and whose percentage interest changes) will have to make a disclosure. We plan to propose Committee Stage Amendments to clarify the intention. However if a person sells his rights, whether under a provisional allotment letter or otherwise, then that sale must be disclosed - rights under provisional allotment letters are no different from any other rights.
307(5)	HKAB	In the context of asset management, trusteeship and custodial business, the exception in clause 307(5) is of limited use, because it would not apply if the asset management, custodial or trustee functions are carried out in the authorized institution itself, rather than through a dedicated subsidiary. Furthermore, even if a banking group carries out its asset management, trustee and custodial functions through an entity separate from the authorized institution, it may still be unable to rely on the exemption from aggregation. It may be common to provide trusteeship, custodian and other agency functions through a single corporation, in which case the exemption would not apply. Consideration should be given to granting wider safe harbours from the disclosure requirements in Part XV in respect of investment managers, custodians and trustees (expanding on the exemptions in clause 314) or, failing this, to create a wider exemption from aggregation of interests in clause 307(5) by allowing the exemption to apply (irrespective of whether the asset management, custodial and trustee activities are	According to the present aggregation provisions, a holding company is taken to be interested in shares in which its subsidiaries are interested. It is quite a different matter to split up the interests held by one legal entity whether managed by separate individuals or managed by the same individual. The UK does not view "Chinese walls" as being effective for these purposes and nor does the SFC. The exemption in clause 307(5) has been created to relieve the obligation on a holding company who is deemed to be interested in shares in which its subsidiaries are interested. However, the exemption is only available provided the subsidiary exercises its rights in respect of the shares <u>independently</u> from the holding company. It appears that this critical element of independence is not present in the situations outlined in this submission and we do not support giving such exemption.

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		carried out in separate corporations) if there are Chinese Walls in place.	
307(7)	Law Society	Clause 307(7) is not clear. As well as parents having an interest in shares held in the name of children, this language would appear to extend the notification obligation to the children because they are deemed to have an interest in shares in which parents or their parents' controlled companies have an interest. It would also cause overlapping notifications to be made by subsidiaries. We recommend this section be deleted or clarified.	Clause 307(7) does not have the effect suggested in this submission. We however agree that it should be deleted to avoid doubts as the provisions of clause 313 make it clear when a person is taken to be interested in shares. We will propose a Committee Stage Amendment to this effect.
314(6)(a)	HKAB	It may be uncertain as to whether the chargee has evidenced an intention to exercise the voting rights (as in clause 314(6)(a)(ii)(A). In the light of sub-subparagraph (B), sub-subparagraph (A) appears unnecessary and should be deleted to remove the uncertainty.	Whether or not a chargee has evidenced an intention to exercise voting rights (e.g. has written or stated that he will exercise the rights) or has taken any step to do so (e.g. has served notice of default under a charge) are, potentially, distinct and separate and each should be preserved.
314 (6)(b)	HKAB	The trigger in clause 314(6)(b) for the interest ceasing to be an "exempt security interest" is uncertain. The chargee may be interested in selling the shares if it can reach an acceptable price, and may have preliminary discussions with possible purchasers over a protracted period of time. However, unless and until the chargee sells the shares through an on-market transaction, or enters into a firm and legally binding commitment to sell the shares in an off-market transaction, we believe that the benefit of the "exempt security interest" exemption should remain.	If the trigger point is actually selling the shares, as HKAB suggests, then this is a step backwards from the present S(DI)O. The point when the chargee should disclose his interest is when he starts to treat the shares as being his – i.e. when he starts to market as being for sale. At that point all the "insiders" (brokers and persons who are offered the shares) will know about the fact that the chargee is enforcing its security rights against the substantial shareholder – and the rest of the market should be told about it as the chargee will in effect be interested in the shares.
320	Group of nine investment bankers, Law Society, HKAB	Clause 320 extends the power of investigation by the company from anything which is an "interest in shares" to cover interests in equity derivatives. The burden of complying with the notice in giving particulars relating to equity derivatives might be very considerable, and most of the information provided would be unlikely to be of interest to the listed	To the extent that it is necessary to extend the S(DI)O to require disclosure of equity derivatives then it must follow that the investigation provisions also be extended in parallel to cover equity derivatives. Interests in shares held though derivatives have no existence outside of the derivatives so the investigation must be directed towards the derivatives and the owner of the derivatives.

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		corporation. Clause 317 should be restricted to interests in issued equity share capital only.	
320	Group of nine investment bankers, HKAB	It is unclear what would constitute a "reasonable time" where the information being sought is very extensive and therefore very time-consuming to provide. There is no justification for extending the powers of a listed corporation to make enquiries going beyond enquiries as to interests in share capital and going back over a period of as long as 3 years Such extensive powers could be open to abuse (for example, by a corporation issuing inquiry notices to competitors to tie up resources and oblige them to incur significant costs).	This provision is based on existing law. There is no definition of "reasonable time" in s.18 of S(DI)O. The words must be given their normal meaning and what period is reasonable must be considered in the light of all of the circumstances. For example, in a court case in the UK (**re TR Technology Investment Trust plc [1988] BCLC 256),** Hoffmann J when commenting on the equivalent provisions in the UK, on which the provision was based, said : "There are two safeguards against abuse by the company. First, the company's only remedy for failure to comply is an application for restrictions under Pt. XV and the grant of that remedy is within the discretion of the court. Second, it is a defence to any criminal proceedings that the requirement was frivolous or vexatious." These safeguards have been retained in Part XV (see clause 325).
350(2)(b) & 350(2)(c)	HKSA	Duties imposed on officers and agents of a corporation to attend before an inspector and to give the inspector "all assistance in connection with the investigation which they are reasonably able to give" could be onerous and there is a potential danger that advisors may in effect be pressed into doing the work of inspectors for them on an unpaid basis. There should be some safeguards to ensure that demands placed on advisors are kept within reasonable bounds.	This provision follows the existing law. The inspector must be given adequate power to satisfactorily exercise his function. The assistance that a person required to give to the inspector must be reasonable. If he thinks a request is unreasonable, he can apply to the court for a declaration on the extent of the assistance that he is reasonably able to give. There have only been 4 such investigations to identify the ownership of a listed corporation since the S(DI)O came into effect nearly 10 years ago.

Details of Submissions Referred to in the Comment / Response Table

Respondent
Hong Kong Society of Accountants ("HKSA")
Hong Kong Association of Banks ("HKAB")
International Swaps and Derivatives Association ("ISDA")
Linklaters & Alliance representing - Bear Stearns Asia Limited - Credit Suisse First Boston (Hong Kong) Limited - Dresdner Kleinwort Wasserstein - Goldman Sachs (Asia) L.L.C. - Merrill Lynch (Asia Pacific) Limited - JP Morgan - Morgan Stanley Dean Witter Asia Limited - Salomon Smith Barney Hong Kong Limited - UBS Warburg ("Group of nine investment bankers")
Low Chee Keong, Associate Professor in Corporate Law, School of Accountancy, The Chinese University of Hong Kong ("LCK")
Securities Law Committee of the Law Society of Hong Kong ("Law Society")

Securities and Futures Commission
Financial Services Bureau
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