CB(1)1476/06-07(04)

For LegCo Financial Affairs Panel meeting on 7 May 2007

Issues related to section 378 of Securities and Futures Ordinance (Cap 571) ("SFO")

(a) The policy considerations underlying SFC's existing practice in applying section 378 of the SFO with regard to disclosure of information.

Section 378 of the SFO requires that secrecy be maintained by the persons to whom the secrecy obligation under section 378 of the SFO applies. The secrecy obligation exists as a safeguard –

(i) of the public interest that the SFC should not be compromised in its operations and the pursuit of its regulatory objectives by the leakage of confidential information;
(ii) of the right of all persons, whether individuals or corporations, to be presumed innocent until proven guilty;
(iii) of the reputation of individuals and the goodwill of firms investigated by the SFC or undergoing disciplinary proceedings;
(iv) of commercially sensitive information that intermediaries, and others cooperating with the SFC, would be unwilling to disclose to the SFC if there were a danger that the information would be misused;
(v) of the integrity of the market, for example by keeping price-sensitive information secret pending its release (e.g. in an announcement by a listed corporation) to the market; and
(vi) of the status of Hong Kong as an international financial centre, by ensuring that the SFC complies with international standards of confidentiality comparable to those observed by its counterpart regulators in all major markets internationally.

Section 378(1) contains the obligation to preserve secrecy. It provides that a specified person[1] *"shall preserve and aid in preserving secrecy with regard to any matter coming to his knowledge by virtue of his appointment under any of the relevant provisions,[2] or in the performance of any function under or in carrying into effect any of the relevant provisions, or in the course of assisting any other person in the performance of any function under or carrying into effect any of the relevant provisions"*. However, the *chapeau* to section 378(1) provides that the secrecy obligation applies *"[e]xcept in the performance of a function under, or for the purpose of carrying into effect or doing anything required or authorized under, any of the relevant provisions"*. This important exception will be discussed further below.

[1] A "specified person" is defined in section 378(15) as including the SFC, persons working for the SFC and anyone assisting such persons in the performance of any function under or carrying into effect any of the relevant provisions.

[2] The term "relevant provisions" is defined in Schedule 1 to the SFO as meaning the SFO, subsidiary legislation made under the SFO and certain provisions in Parts II and XII of the Companies Ordinance.

Section 378(2) provides that certain matters are not covered by the secrecy obligation at all. These include the disclosure of information in accordance with a court order.

Section 378(3) lists a number of persons to whom the SFC may disclose information despite the secrecy obligation. Such persons include a liquidator appointed under the Companies Ordinance and the Securities and Futures Appeals Tribunal.

It is the exception in section 378(1) that concerns us here. The SFC's key functions are specified in section 5 of the SFO. Section 5(1)(g) provides that it is one of the SFC's functions *"to maintain and promote confidence in the securities and futures industry in such manner as it considers appropriate, including by the exercise of its discretion to disclose to the public any matter relating or incidental to the performance of any of its functions"*. Section 6(2)(d) of the SFO provides that in performing its functions the SFC *"shall have regard to…the importance of acting in a transparent manner, having regard to its obligations of preserving secrecy and confidentiality…"*.

The SFC will not normally make public the fact that it is or is not conducting a statutory inquiry or investigation, or any of its findings or conclusions, save in exceptional circumstances or where required to do so by law. Such disclosure is decided on a case-by-case basis in the light of the following functions and objectives of the SFC:

- to maintain and promote confidence in the securities and futures industry (section 5(1)(g) SFO);
- to provide protection for members of the public investing in or holding financial products (section 4(c) SFO);
- to minimize crime and misconduct in the securities and futures industry (section 4(d) SFO); and
- to reduce systemic risks in the securities and futures industry (section 4(e) SFO).

The exceptional circumstances may arise, for example, in the following cases:

(i) Where the matters under inquiry or investigation have become the subject of public concern, speculation or rumour. In such cases, it may be desirable for the SFC to make public the fact of its inquiry or investigation in order to allay concern, or contain the speculation or rumour and thereby maintain public confidence.

(ii) Where publicity is unavoidable. For example, investigations into suspected criminal offences may lead to the SFC having to make enquiries amongst the general public and thus attract publicity.

It should be noted that it is impossible to set out an exhaustive list of the exceptional circumstances, and each case will turn on its particular facts.

It should also be noted that disclosure of the fact that an inquiry or investigation is underway (or not) can only be decided by at least two Executive Directors of the SFC in consultation with its Chief Executive Officer. In 2006, the SFC

disclosed the fact that it was conducting an inquiry on five occasions. It did so in general terms in relation to each of the three broker failures (Whole Win Securities, Tiffit Securities and Wing Yip Company) and regarding the listed Ocean Grand Holdings Limited/Ocean Grand Chemicals Holdings Limited and PCCW (see answer (c) below). In each case, this was to reassure investors and the general public that appropriate action was being taken without revealing any of the details of the inquiry.

However, it is important to appreciate that in no circumstances will the details of an ongoing case ever be disclosed. This is to avoid prejudicing the inquiry or investigation or causing reputational damage to the company in question in circumstances where it may not yet have had an opportunity to be heard on the matter.

(b) What measures are in place to assure the public, that the SFC, in discharging its obligations under section 378 of SFO, has struck a right balance between the need to preserve secrecy on one hand, and the need to disclose information in the public interest on the other hand?

The provisions in section 5 and section 378 as described in answer (a) above provide the framework within which the SFC may disclose confidential information in certain circumstances. The SFC is obliged to strike a balance between the need to preserve secrecy on the one hand and the need to disclose information to the public to maintain and promote confidence in the securities and futures industry on the other hand, within the parameters as set out under the law. As stated above, disclosure of the fact that an inquiry or investigation is underway (or not) can only be decided by at least two Executive Directors of the SFC in consultation with its Chief Executive Officer.

The SFC endeavours to operate in a manner which is open and transparent and discloses as much information as it can within these parameters and given the fact that it is a law enforcement agency but takes a strict view of section 378 given the potential risk of criminal prosecution and imprisonment for breach. In addition to the sparing disclosure of the fact that the SFC is conducting an inquiry or investigation in the limited circumstances described in answer (a), the SFC discloses on a regular basis information in the form of press releases, speeches, newsletters such as the Enforcement Reporter and SFC Alert, quarterly and annual reports, and various investor brochures and the Dr. Wise column. The SFC also explains its regulatory policy and philosophy in its Regulatory Handbook. All of this is on the SFC's website which is replete with information about its activities.

(c) Members recall that when the Panel discussed cases of alleged market misconduct e.g. the Melco International development Limited (meeting on 3 April 2006) and issues related to change in shareholding involving PCCW Limited (special meeting on 23 November 2006), representatives of SFC advised at the meetings that they were bound by the secrecy provision under section 378 of SFO and could not therefore disclose information on

cases in question. However, some members consider that as section 378 does not impose an absolute obligation on SFC to preserve secrecy, SFC should be invited to re-consider its policy on disclosure of information and with reference to the two aforesaid cases and other cases as deemed appropriate by SFC, to advise whether and what further information on such cases can now be disclosed.

The SFC had due regard to and considered the matters discussed in answer (a) above in deciding what (if any) information could appropriately be disclosed in relation to the Melco and PCCW matters.

With regard to the PCCW matter, Members are referred to the LC paper No. C (1)531/06-07(01) in which the SFC disclosed the fact that it commenced an investigation under section 182(1) of the SFO into whether PCCW or persons connected with PCCW may have provided any false or misleading information to the market contrary to section 384 of the SFO. The fact of the investigation was disclosed in line with the confidentiality policy adopted by the SFC as discussed in answer (a) above. The SFC will not, however, disclose further details of the investigation in accordance with the policy.

As stated in the LC paper No. C (1)531/06-07(01), the Takeovers Executive of the SFC (the "Executive") intended to publish a statement concerning the concert party ruling in respect of PCCW, subject to confidentiality considerations as provided under section 16.3 of the Introduction to the Takeovers Code. Section 16.3 of the Code provides that, *"[s]ubject to confidentiality considerations, it is the policy of the Executive to publish its important rulings and interpretations of the Codes, and the reasons for them, so that its activities may be understood by the public. There may be announcements of rulings in specific cases where the rulings are considered to have general application, or statements of policy which may take the form of Practice Notes setting out in greater detail the Executive's practice and interpretation of the Codes"*. The publication of such a statement is the performance of one of the SFC's functions and is not inconsistent with the confidentiality policy adopted by the SFC under s.378 of SFO.

(d) Whether regulators of overseas jurisdictions are bound by similar secrecy provision and if yes, the nature of such statutory obligation and any discretionary grounds or circumstances under which the regulators may disclose information on specific cases.

The SFC's policy of not disclosing the fact that it is conducting an inquiry or investigation into any matter save in exceptional circumstances is in line with the practice adopted by other major regulators.[3] The UK Financial Services Authority ("FSA") will make a public announcement that it is or is not investigating a matter where there has been public concern, speculation or rumour and it is necessary to make an announcement in order to maintain public confidence in the financial system, protect consumers, prevent widespread

[3] The US Securities and Exchange Commission is even stricter and does not disclose such information at all.

malpractice or help the investigation itself e.g. by bringing forward witnesses. The Australian Securities and Investments Commission ("ASIC") will make such an announcement when it is in the public interest to do so e.g. where there has been a major corporate collapse. Both the FSA and ASIC are subject to confidentiality requirements under their respective laws that are similar to those applicable to the SFC under section 378 of the SFO.[4]

Securities and Futures Commission
April 2007

[4] Section 349(1) of the Financial Services and Markets Act 2000 provides that the confidentiality requirement in section 348 does not prevent the disclosure by the FSA "of confidential information which is (a) made for the purpose of facilitating the carrying out of a public function; and (b) permitted by regulations made by the Treasury under this section". Section 127(3) of the Australian Securities and Investments Commission Act 2001 provides that "the disclosure of information by a person for the purposes of…performing the person's functions as…a member, staff member or ASIC delegate…is taken to be authorized use and disclosure of the information".