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 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 ("SDIO") 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

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			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. 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 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 taken 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 (in the Rules to be made under clause 365A - see further below) and exempt security interests (in clause 314(1)(e)).
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 bare trustee exemption, 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.

Clause no.	Respondent	Respondent's comments	Administration's response
General	HKGCC*	There should be improved disclosure of interest in shares which may be held through equity derivatives, especially cash settled derivatives. A person who is interested in shares, whether in connection with unit trust or mutual funds, derivatives or other investment portfolio, should not be exempted from disclosure requirements Duplicative layers of required disclosure which tend only to mislead should be removed. Overlapping areas in disclosure should be clarified.	HKGCC's comment demonstrates that there is support for greater disclosure – particularly in the area of derivatives. We have sought to minimize the disclosure obligations and have removed areas of disclosure which may be burdensome and of little value to investors in formulating our proposal. In line with this spirit, we propose Committee Stage Amendments (CSAs) on clauses 304(9), 304(11), 317(b), (c), 332(5), and 335(3) – (5) to remove the duplicate disclosure obligations involved.
General	Group of nine investment bankers*	A table comparing the proposals in Part XV with the disclosure requirements of a number of other jurisdictions is produced.	The Table shows that - • Interests in unissued shares and short positions are reportable in the US under section 13, and • a change in the nature of an interest is reportable in Singapore (See section 83 of the Singapore Companies Act) . Section 22 of the New Zealand Securities Amendment Act 1988 also requires substantial shareholders to notify changes in the nature of relevant interests. This shows that the proposals are not unique to Hong Kong and they have operated in other jurisdictions for some years. We have also produced a table at the Annex which shows a more balanced comparison with the provisions in the US.
General	Group of nine investment bankers*	Cash settled derivatives were not covered under the basic disclosure regime in the US. The provision in the US securities laws relating to "insiders" (senior officers, directors and holders of 10% or more of the shares of a company), is not a disclosure provision.	Two separate disclosure regimes operate side by side in the US – (1) Section 16(a) requiring disclosure by every officer, director and beneficial owner of more than 10% of a class of equity securities. This section was incorporated in the original Securities Exchange Act of 1934. (2) Section 13(d) requiring disclosure by the beneficial owner of more than 5% of a class of equity securities. This section was added in 1968 as part of amendments referred to as the Williams Act.

Clause no.	Respondent	Respondent's comments	Administration's response
			Section 16(a) clearly is a disclosure provision and should be included in any meaningful comparison. Section 16(a) operates to require disclosure of interests independently from section 16(b), which requires insiders to disgorge any short swing profits. In Lewis v. Mellon Bank, N.A., 513 F.2d 921 (3d Cir. 1975), the court held that Congress intended sections 16(a) and (b) to operate independently. Loss Seligman, Fundamentals of Security Regulation, 4th Ed. is the leading authority on securities laws in the US. The authors write of section 16(a) at page 632 - "This is pure disclosure, except that s.16(a) serves the further function of facilitating the enforcement of s. 16(b)." (emphasis added). The official forms for reporting section 16(a) disclosures also state that the primary purpose for the disclosures is for dissemination to the public – "The information will be used for the primary purpose of disclosing the holdings of directors, officers, and beneficial owners of registered companies. Information disclosed will be a matter of public record and available for inspection by members of the public." The comparison table at the Annex compares the proposals in Part XV with the reporting obligations under both s.13(d) and s.16(a) of the Securities Exchange Act of 1934. We believe that this table shows a more balanced comparison with the US provisions.
	Group of nine investment bankers*	Normal trading activities by securities houses not effected for manipulative purposes may trigger frequent disclosures. The proposals will not help to deter market manipulation as someone who is engaged in market manipulation is unlikely to comply with disclosure requirements. The disclosure obligations should be limited to particular types of transactions.	There is a large gap in the present disclosure regime because interests held through cash settled derivatives, interests in unissued shares and short positions were not covered by the current regime. As a result, investors are being given an incomplete picture of dealings by substantial investors that can be misleading. The proposals serve to rectify this deficiency. A more transparent market will help to deter market manipulations. In the example given in paragraph 54 of Paper 13/01, the two intermediaries involved were not knowingly participating in manipulation while the substantial shareholder was doing so. Disclosure by the intermediaries would have made the manipulative scheme transparent and unworkable.

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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, because it must eventually return equivalent securities (see paragraph (b) of the 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.	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 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 Blue Bill, it was 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 CSAto empower SFC to make such rules.
Stock borrowing and lending	PASLA*	None of the other global financial markets that have a formal securities lending market treat securities lending as a discloseable event. A securities lending transaction does not effect a 'change in the nature of interest' for the lenders, in view of their right of recall.	In Hong Kong securities lending is structured as follows - • All right title and interest in the securities borrowed and collateral delivered passes from one party to the other. • The party acquiring such right title and interest has no obligation to return or redeliver any of the assets so acquired but shall be required to redeliver equivalent securities or equivalent collateral. This shows that when securities are lent out , all right title and interest in the securities passes from the lender to the borrower, and the lender merely has a remote right to call for equivalent securities. There is clearly a change in the nature of the lender's interest when securities are lent out using the above structure.

Clause no.	Respondent	Respondent's comments	Administration's response
			The SEC has advised that the US stock lending is structured differently from that of Hong Kong. There is no passing of title nor a change in the form of beneficial ownership for stock lending in the US, so there is no reporting obligation. The SEC has, however, confirmed that a transaction which involved an outright transfer of title (as in the case in Hong Kong) would be reportable in the US.
Stock borrowing and lending	PASLA*	Many common transactions in the SBL and related markets would trigger disclosure, but not provide meaningful information. This will create an administrative burden.	We agree that this is a very complex area and the nature of each type of transaction needs to be considered carefully in the context of the disclosure obligations proposed. In this regard, the SFC has set up a Working Group, involving PASLA, and other industry representatives to consider the extent and nature of stock borrowing and lending (SBL) activities in the shares of companies listed in Hong Kong and how any exemptions might be framed. The balance between the disclosure burden and the value to investors of the information disclosed will be an element to be considered in framing the rules. In the light of the recommendations from members of the Working Group it is proposed that the provisions of clause 304(11) and (12) establishing a limited exemption for "conduit" stock borrowing and lending should be deleted and the Commission should be given powers to make rules establishing a simplified disclosure regime in relation to certain SBL transactions. This simplified disclosure regime would extend to – • "institutional investors" - the managers of local or overseas collective investment schemes or pension funds and local or overseas insurance companies; • "approved lending agents" – custodians or lending agents that are approved by the Commission; and • "regulated persons" - local brokers and overseas brokers in approved jurisdictions. Institutional investors and their approved lending agents, who make a disclosure when shares are authorised to be lent, and cease to be authorised to be lent, (if a change in the nature of the shares subject to a lending authorisation gives rise to a duty of disclosure) are relieved of the duty of disclosing any subsequent lending and return of those shares. Interests in shares of regulated persons that merely act as a conduit (i.e. regulated persons who borrow and on-lend the shares within 5 business days) would be disregarded.

Clause no.	Respondent	Respondent's comments	Administration's response
			Persons taking advantage of the simplified disclosure regime would be required to keep records of the shares borrowed/lent and returned. We propose a CSA, clause 365A, to empower SFC to make these 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 shares also be qualified by aggregating unissued shares of one class with issued shares of that class.	The principle is that shares in the relevant share capital (issued or unissued) should be only aggregated with shares of the same class. We propose a CSA adding a new clause 305(5)(b) to clarify that different classes of relevant share capital should not be aggregated.
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 have put forward CSAs to give effect to the proposal.

Clause no.	Respondent	Respondent's comments	Administration's response
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 (9) and (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. We have proposed CSAs in clause 304(9) to better reflect the policy intention. We propose that a wholly owned subsidiary of a holding company (both defined in Schedule 1) should have no reporting obligations (for transaction with other group companies or outside the group) provided the holding company complies with its duties under clause 307(2). This would mean that no disclosure would be required of shares lent within a group (however, the exemption in the Rules proposed for conduit stock borrowing and lending would not be available if the shares are retained in a group for more than 5 business days). Under clause 307(2) a holding company is required to aggregate all interests of its wholly owned subsidiaries and this, effectively, places the disclosure obligations for the group on the shoulders of the holding company. In this way investors will be able to see the interests in shares controlled by a group of companies whilst minimising the disclosure burden. A wholly owned subsidiary whose interest in shares is not aggregated with that of the holding company (i.e. under clause 307(5)) will not qualify for the exemption. If the wholly owned

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			subsidiary leaves the group (ceases to be controlled by the holding company) the holding company will cease to be interested in shares of the wholly owned subsidiary under clause 307(6). This will prompt a disclosure by the holding company under 307(6) and by the subsidiary under 304(9A).
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 SDIO. 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 have proposed CSAs in clause 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)	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.

Clause no.	Respondent	Respondent's comments	Administration's response
		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 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 CSA 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 SDIO. 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,	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	To the extent that it is necessary to extend the SDIO 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

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	Law Society, HKAB	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 corporation. Clause 320 should be restricted to interests in issued equity share capital only.	derivatives so the investigation must be directed towards the derivatives and the owner of the derivatives.
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 SDIO. 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 defense to any criminal proceedings that the requirement was frivolous or vexatious." These safeguards have been retained in Part XV (see clause 325).
320	HKSbA*	A listed corporation is not a regulatory body and failure to comply with its requests to supply information should not be a criminal offence. It is not fair that a person complying with such a notice is put to expenses to supply the information required without reimbursement.	Section 18 of the SDIO enables a listed company to commence an investigation to discover the true identity of persons having an interest in its shares. Under section 21 of the SDIO shareholders who together control 10% or more of the shares of a listed company can also require a listed company to commence an investigation under section 18. These powers have been in force in Hong Kong for over 10 years and has been operating without any problem. Similar provisions providing for investigations by listed companies are also found in the disclosure legislation in the UK, Australia and Singapore. The powers are necessary because blocks of shares are often held in the names of nominees, or companies, so that the identity of the persons having an interest in the shares of a listed company is concealed. Another reason for vesting the powers is to combat the secret acquisition of shares in a listed company through "warehousing", where a number of parties act in concert each acquiring an interest in shares in the company through nominees. The courts in Hong Kong, the UK and Australia have all recognized the importance of these powers. There are safeguards against abuse of these provisions by a listed company. First, the company's only remedy for failure to comply with a notice issued is for it to apply to the court

Clause no.	Respondent	Respondent's comments	Administration's response
			for restrictions to be imposed on the shares in which the person to whom the notice is addressed is interested. The court would not exercise its discretion to impose restrictions unless it was satisfied that this was appropriate and that a reasonable period had been given to comply with such a notice. Second, it is a defense to any criminal proceedings for a person to whom a notice is addressed to show that the requirement to give the information was frivolous or vexatious. It is noted that there is no provision in the SDIO, or in the equivalent provisions in the UK or in Singapore, for reimbursement of expenditure incurred by either the listed company (conducting an investigation of its own initiative, or at the request of minority shareholders) or the persons to whom notices are addressed. If a company had to reimburse expenses incurred by persons to whom notices were sent, then the question arises as to who should bear the costs of the investigation, whether it should be the shareholders generally or the persons whose actions (i.e. failure to disclose) prompted the investigation. In Australia there is provision in section 672D of the Corporations Law for regulations to "prescribe fees that companies and responsible entities are to pay to persons for complying with directions given" when carrying out an investigation under section 672A. Under section 672B the information must be provided within 2 business days and the fee is repayable if the information is not provided within that time. However, no regulations have yet been made under section 672D indicating that this has not given rise to a problem in practice. We note the divergent views expressed by Members on this issue at the meeting of the Bills Committee held on 21 May 2001. Some Members considered that the investigation created a cost burden on the brokers, which should be reimbursed. Others considered that the cost involved was part of the compliance cost for doing business in the securities and futures market. Subject to the advice of Members, we are prepared to consider a CSA along the line of the Australian regime, by providing SFC a rule-making power to prescribe fees that companies conducting the investigation are to pay to persons complying with the requirement.
350(2)(b) & 350(2)(c)	HKSA	Duties imposed on officers and agents of a corporation to attend before an inspector and to give	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

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		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.	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 SDIO 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")
Hong Kong General Chamber of Commerce ("HKGCC")
The Pan Asian Securities Lending Association Limited ("PASLA")
The Hong Kong Stockbrokers Association ("HKSbA")

* Refers to our response to comment not incorporated when Paper No. 13A/01 was last issued.

Securities and Futures Commission
Financial Services Bureau
27 September 2001

Annex

Supplementary public comments on Securities and Futures Bill
HK/US disclosure regimes – Comparison Table (for substantial shareholders)

	Part XV Securities & Futures Bill	**s.13 - US Securities Exchange Act**[i]	**s.16 - US Securities Exchange Act**
Who is required to report ?	Persons who are interested in 5% or more of any class of voting shares	Beneficial owners[ii] of 5% or more of any class of equity securities[iii]	Beneficial owners of 10% or more of any class of equity securities[iv]
Is disclosure required of interests in unissued securities ?	Yes – see definition of "relevant share capital"	Yes – "if the unissued security belongs to a class of securities that has already been registered under the Exchange Act"[v]	Yes – "if the unissued security belongs to a class of securities that has already been registered under the Exchange Act"
Is disclosure required of physically-settled derivatives ?	Yes – see paragraph (a)(i) of definition of "underlying shares"	Yes – see definition of "equity securities"	Yes – see definition of "equity securities"
Is disclosure of interests purely cash-settled derivatives required ?	Yes – see paragraph (a)(ii) of definition of "underlying shares"	No	Yes[vi] – see also definition of "pecuniary interest" and "derivative securities".
Is disclosure required of "short positions"?	Yes – see clause 303[vii]	Short sales may trigger a requirement to amend the Schedule 13D. [viii]	The SEC interprets s.16 as prohibiting any short sales by 10% owners, directors and officers of a company.
Must changes in the nature of an interest e.g. Stock borrowing and lending ("SBL") be disclosed ?	Yes – but there will be certain exemptions for pledges and SBL in certain circumstances.	Yes – material changes may trigger a requirement to amend the Schedule 13D – see notes 11 and 12 below	Transactions reflecting a mere change in the form of beneficial ownership without changing a person's pecuniary interest in the relevant equity securities are not reportable. However a change due to the exercise or conversion of rights under a derivatives security is reportable. [ix]
When is notification required ?	(1) Initial notification (at 5%) (2) Has to notify acquisitions and disposals resulting in the percentage level of his interest passing through a whole % band.	(1) Initial statement of beneficial ownership (2) Statement of every material change[x] in facts set out in initial statement.[xi]	(1) Initial statement of beneficial ownership; (2) Statement of changes in beneficial ownership; (3) Annual statement (including reporting of exempt interests)
Is there a prescribed form of notification ?	Yes – 3 forms proposed for substantial shareholders	Yes – Schedule D or short form Schedule G	Yes – Forms 3, 4 and 5
Who can take action for false or misleading disclosures ?	Secretary for Justice and SFC can prosecute. Financial Secretary or Court can impose restrictions.	Shareholders, the company, rival bidders and the SEC can take action for false or misleading disclosures[xii]	Shareholders, the company, and the SEC can take action for false or misleading disclosures

[i] Two separate reporting regimes in the U.S. Securities Exchange Act of 1934 operate side by side in the US. Section 16(a) was included on the original Exchange Act in 1934 but was heavily modified in 1991 and again in 1996. Section 13(d) was added in 1968 and the original intention was to ensure disclosure of a change of corporate control in the context of tender offers. However the provisions of both sections 13(d) and 16(a) are of general application and a person may be required to report under both sections. The 1962 Report of the Jenkins Committee on Company Law in the UK commented on the success of s.16(a) in the U.S. and recommended that a beneficial owner of 10% of the equity capital of a company listed in the UK should also be required to disclose his identity and report his dealings. In 1967 the UK Companies Act was amended as a result of these recommendations and this, ultimately, formed the basis for the disclosure provisions enacted in Hong Kong as the S(DI)O.

The US Securities Acts are broadly drafted, establishing basic principles and objectives. The US Securities Exchange Commission ("SEC") is given wide powers to make rules to implement the provisions of the Exchange Act and has issued a large number of rules in relation to both sections 13(d) and 16(a). The Rules made by the SEC under the Securities Exchange Act are available at http://www.law.uc.edu/CCL/sldtoc.html

[ii] For the purposes of section 13(d) a "beneficial owner" of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares voting power and/or investment power (which includes the power to dispose, or to direct the disposition of), such security. A person is deemed to be a beneficial owner if he has a right to acquire beneficial ownership of such security within 60 days through the exercise of any option, warrant or right. (see Rule 13d-3). I. A. Tokley writes "The American legislation defines "beneficial ownership" in such a way that it is the equivalent, in general terms, to the English term "interests" and the Australian term "relevant interests"" (*See Company Securities -Disclosure of Interests, Butterworths 1995 (page 177 – note 18))*.

[iii] The term "equity security" is broadly defined under the Exchange Act to include any stock or similar security, security convertible into stock, warrant or right to subscribe for or purchase stock and any other security of a similar nature. Equity securities of a company thus include, in addition to the Common Stock, any preferred stock, any convertible debentures and all warrants and options to purchase Common Stock. A slightly extended definition applies to s.16 (covering "any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so." - see Rule 3a11-1.)

[iv] Solely for the purposes of determining whether a person is a 10% owner of a class of equity securities the SEC borrowed the definition of "beneficial owner" from Rule 13d-3 (Note 2 above) with a number of exceptions for banks, registered brokers etc.. However, an extended definition of "beneficial owner" is used to determine <u>what</u> securities holdings must be reported under s.16(a). The focus is whether the stockholder has a "pecuniary interest" in the equity securities. "Pecuniary interest" means the opportunity to profit or share directly or indirectly in any profit from a transaction in the equity securities. This extends to "derivatives securities". The term "derivative securities" is defined in Rule 16a-1 to include "securities with a value derived from the value of an equity security" . (see Rule 16a-1 paragraph a2). Under Rule 16a-4 both derivative securities and the underlying securities to which they relate are deemed to be the same class of equity securities – but each must be reported separately.

[v] Confirmed to the SFC by the SEC. The substantial shareholders provisions of Part XV are only concerned with interests in voting shares in listed companies so the effect of these provisions is similar under both regimes.

[vi] Confirmed to the SFC by the SEC. See also the 1996 SEC Release No. 34-37260 available at www.sec.gov/final/37260a.txt.

[vii] The term "short position" is defined in the Bill and bears a meaning that is wider than the term "short sale" used by the SEC. The SEC takes the view that under Rule 16.C4 you can establish a short position using a derivative "put" as long as you hold an equivalent number of shares. Turning to disclosure, as opposed to prohibition, as the US requires disclosure of derivatives, and most short positions are a sub-category of derivatives, both regimes require disclosure in one way or another.

[viii] The SEC have informed the SFC that it may, for example, represent a change in purpose (within Schedule 13D item 4) a "transaction" in the subject security (item 5) as well as a "contract, agreement understanding, or relationship . . .with respect to . . . securities of the issuer" (item 6).

[ix] See Rule 16a-13 and Loss Seligman, Security Regulation, 3rd Ed. 2001 Supplement p.248. In Hong Kong the provisions requiring notification of a change in the nature of an interest are directed at requiring disclosure on exercise of an option and therefore the effect of the US provisions is similar. Part XV is also directed at requiring disclosure of SBL transactions. In Hong Kong

SBL transactions are structured so that there is an outright transfer of title to the shares being “lent”. The SEC has told the SFC that in the U.S. SBL transactions are structured differently - so that title does not pass outright. There is not even a change in the form of beneficial ownership so that these provisions do not prompt a reporting obligation of SBL transactions in the US. However, the SEC has informed the SFC that, in the US, a transaction that involved an outright transfer of title would be reportable. Accordingly, the reporting requirements in respect of Hong Kong style SBL appear to be the same. The SEC also takes the view that equity swaps are reportable.

[x] Under Rule 13d-2 an acquisition or disposition of beneficial ownership of securities in an amount equal to one percent or more of the class of securities shall be deemed "material" for the purposes of section 13; acquisitions or dispositions of less than those amounts may be material, depending upon the facts and circumstances.

[xi] The extent of the facts that are required to be disclosed under section 13 are far greater than those required to be disclosed in the Bill (see clause 317). In addition to the number of shares that a reporting person owns and his identity, a Schedule 13D notification must include the background of the beneficial owner; any plans to acquire more shares; the source of funding for the acquisition; the purpose of the acquisition and (if the purpose is to obtain control) details of his plans; details of any associates; details of any arrangements in relation to the shares including any loans, options, puts or calls, guarantees of loans etc.

[xii] See sections 18 and 20(A) Securities Exchange Act. See also IA Tockley - Company Securities -Disclosure of Interests, Butterworths 1995 (page 184 and cases cited)).