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29 May 2001

Our ref
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The Secretary
Bills Committee on the Securities & Futures Bill
Legislative Council
8 Jackson Road
Central
Hong Kong

Dear Sirs

Part XV of the Securities & Futures Bill

The Group of financial institutions for which Linklaters is acting has already submitted a number of papers to the Bills Committee setting out comments in relation to the Bill, including Part XV (Disclosure of Interests).

We have now had an opportunity to review the papers submitted by the Administration to the Bills Committee on Part XV (Papers No. 13/01 and 13A/01). We have a number of comments on those papers, in particular as relates to the comparisons made with the laws of a number of other jurisdictions. We therefore attach a further short paper, together with a brief attachment setting out a comparison between the proposed disclosure regime in Hong Kong and in certain other countries as regards the scope of "interests" requiring disclosure, and whether short positions and changes in the nature of an interest are discloseable.

We would be grateful if you could bring this paper to the attention of the Bills Committee.

Yours faithfully

Linklaters

cc: Au King-Chi - Financial Services Bureau
Mark Dickens - Securities & Futures Commission

LINKLATERS ON BEHALF OF A GROUP OF FINANCIAL INSTITUTIONS

Comments on Administration's papers to Bills Committee on Part XV of the Securities and Futures Bill (Paper No. 13/01 and 13A/01)

1 In Paper 13/01, it is stated that the disclosure regime:

…"is designed to enable investors to identify the persons who control, or are in a position to control, interest in shares in listed corporations. It seeks to bring the level of market transparency in Hong Kong in line with international and regional standards…"

We agree that this should be the objective of a legislative regime that requires public disclosure by anyone who acquires an "interest" in a listed corporation's shares exceeding the relevant disclosure threshold. However, the Paper also acknowledges that the Bill represents a change in focus, to require disclosure of information about economic interests in shares, that can affect perceptions of the value of shares. It is this change of focus that, in our view, creates a regime that is unduly complex and administratively burdensome.

2 In these Papers, the Administration has made a number of comparisons with the disclosure regime of other international markets. We accept that, in relation to the notification threshold (5 per cent.), the timing of notification (3 business days) and the type of information to be included when making disclosure, the Hong Kong regime is in line with international market practice, and that some examples can be found of jurisdictions where the requirements are currently more onerous. For example, the disclosure threshold in most markets is 5 per cent., but (subject to certain exceptions) it is 3 per cent. in the UK.

3 However, the proposed disclosure regime in Hong Kong is wider in its scope than the laws of most other international markets in each of the following respects:

- treating interests in unissued share capital (e.g. convertibles) and cash-settled derivatives as "interests" in shares
- requiring separate disclosure of short positions
- requiring separate disclosure of changes in the nature of a person's interest (including stock loans)

The comparison with the laws of a number of other jurisdictions in this respect is attached.

4 In relation to cash-settled derivatives, the Administration argues in its paper that disclosures should be required because equity derivatives can be used to assist in manipulative schemes resulting in losses to investors. We consider that a general disclosure regime applying to all persons with a 5% "interest" in a company's shares is unlikely to be an effective tool for this purpose. First, because of the broad definitions of "interest" and of "short position", normal trading activities by securities houses, not effected for manipulative purposes or to acquire a controlling stake in the company, may trigger frequent disclosures. Identifying whether a particular disclosure relates to matters which should be of interest to investors and/or regulators will be a matter of considerable difficulty. Secondly, someone who is engaged in market manipulation is unlikely to comply with disclosure requirements. The Bill contains extensive powers for the SFC to investigate and to take action against market manipulation, and we suggest that an expanded regime will afford little if any additional assistance to the SFC in detecting and taking action against market manipulation.

Thirdly, we have already suggested to the Administration that if there are particular types of transaction that they believe should be announced to the market, or reported to regulators, we would be happy to explore this further, as this might provide more meaningful information to the regulators and the market. An example might be stock loans by a person who is the director and controlling shareholder of a Hong Kong listed corporation. We note that, in Taiwan, onerous requirements were introduced in 1999 for reporting to the Taiwan SFC of derivatives positions relating to Taiwan securities. This raised many queries and concerns and, following representations from ISDA, the requirements have been repealed, and replaced by legislation requiring information to be provided to the Taiwan SFC only on an exceptional basis.

5 In relation to cash-settled derivatives, the Administration indicate that "the reporting obligations of substantial shareholders and directors were extended to purely cash-settled derivatives in the U.S. in 1996". However, this is not correct under the basic disclosure regime in the U.S., which focuses on control and requires investors which are not passive holders but seek to influence the management of a company to disclose interests of 5% or more of the outstanding shares of the company. In fact, under this disclosure regime, "interest" in shares is defined much more narrowly to include only those shares where the person has the power to vote the shares or dispose of the shares. Only derivatives that are exercisable or convertible into shares within 60 days would be included in the calculation. In contrast, the provision in the U.S. securities laws relating to "insiders", including senior officers, directors and holders of 10% or more of the shares of a company, is not a disclosure provision. Rather it is a provision that seeks to discourage "insiders" from buying or selling a company's shares within any 6 month period by requiring such insiders to disgorge any profits that are made from the two "matched" transactions. Because derivatives can create the economic equivalent of selling or buying shares, transactions involving physical and cash settled derivatives are included in the determination of whether there are matchable trades within any such six month period. We do not believe that the U.S. requirements applying to "short swing profits" of officers, directors and 10% shareholders should be used as a basis to support extending to cash-settled derivatives the scope of the Hong Kong disclosure regime applying to anyone with a 5% "interest".

6 In the United Kingdom, the types of derivative interests that are relevant for disclosure purposes are the same as in Hong Kong at present. As noted in the paper from the Administration, the UK regulators considered whether to expand the disclosure regime to cash-settled derivatives in 1995, and decided not to make a change in this respect.

It is noted by the Administration that the UK Code on Takeovers and Mergers requires disclosure of dealings, by 1% shareholders, in securities of the offeror or the offeree company during a takeover, and dealings in derivatives relating to those securities. This is similar to the requirements under the Hong Kong Code on Takeovers and Mergers that require disclosure of dealings during an offer period, although they only extend to dealings in securities or derivatives by the offeror, the offeree and their associates. As the Code on Takeovers and Mergers illustrates, there may be specific circumstances in which detailed disclosures, including disclosures relating to derivatives, are justified. However, we remain unconvinced that it supports the argument for a broadly-based disclosure regime that may require disclosure of cash-settled derivatives in all circumstances, irrespective of whether the company is engaged in a takeover bid.

7 In relation to transactions by directors, Hong Kong law already requires disclosure of all interests in shares of the listed corporation, irrespective of the amount of the interest. Disclosure is already required of interests in debentures issued by the company, and (under the Model Code issued by the Stock Exchange) disclosure of interest in warrants to subscribe for equity securities is also required. We therefore believe that the existing law is in line with international market practice. As noted in the Administration's paper, there is a prohibition in United Kingdom on directors dealing in options relating to the company's shares. However, to say that "directors are prohibited from dealing in derivatives in the UK" goes too far. The prohibition would not apply to cash-settled derivatives, nor does it prohibit directors from acquiring rights to subscribe for the company's shares, for example under an employee share option scheme.

In the U.S., there are requirements to include cash-settled derivatives transactions in matching purchases and sales by "insiders" of a listed corporation, but as noted above these requirements do not apply to the basic disclosure regime requiring investors with a 5% "interest" to disclose their interests in a corporation.

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Comparison of the shareholding disclosure requirements in various jurisdictions against the proposed regime in Hong Kong

Country	Hong Kong	Singapore	Australia	UK	United States
WHAT IS A NOTIFIABLE INTEREST?	• includes unissued voting share capital (e.g. convertibles)	No. Only includes issued voting shares of companies listed on SGX-ST.	No. Australian Corporations Law applies to substantial holdings of "relevant interests". A person with a relevant interest: • holds the securities; or • has the power to exercise, or control, the voting rights of the securities; or • has the power to dispose of, or control, the disposal of the securities. Section 608(8) is specifically limited to a relevant interest in issued securities. The concepts of "power" and "control" are defined broadly for the purpose of determining relevant interests.	No. Only includes issued share capital of a class carrying voting rights in all circumstances at general meetings of the company (Section 198(2) of the Companies Act 1985).	Yes
	• includes purely cash settled derivatives	No (unless the derivatives carry a right to exercise or control the exercise of votes).	No. In the case of purely cash settled derivatives, the person does not hold the underlying security or have the opportunity to control the voting rights of security and therefore would not trigger disclosure. Only if the terms of the derivatives are such that the holder economically/practically controls the disposal of the shares underlying the derivative would the	No. Purely cash settled derivatives are not discloseable, unless they allow the holder to control the voting on the underlying security, this situation is not usual.	No[1]

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[1] No such requirements apply under the disclosure regime applicable to substantial shareholders with a 5% interest, under Section 13 of the Securities Exchange Act 1934. Section 13 relates to beneficial owners. The key to beneficial ownership for that purpose is voting power and/or the power to dispose. This would not apply to cash settled derivatives.

Country	Hong Kong	Singapore	Australia	UK	United States
			person have a relevant interest.		
WHAT OTHER DISCLOSURES ARE REQUIRED?	• short positions	No. Various derivative interests over voting shares are discloseable, but these are all interests to acquire voting shares or exercise or control the exercise the votes attached to the shares (i.e. long interests).	No. Section 608(8) of the Corporations Law clarifies that, like the current Hong Kong regime, long positions in relation to physically settled options would be discloseable but short positions would not be discloseable.	No. Short positions are not covered by the disclosure regime in the UK. The position under Part VI of the Companies Act is the same as that under Hong Kong's existing regime. Long interests in shares arising under physically settled derivatives must be disclosed, however short positions are not discloseable for example writers of call options or holders of put options, which are to be physically settled.	Yes in certain circumstances. Short sales kept open for more than twenty days would probably require reporting by shareholders with a 5% interest.
	• changes in nature of a person's interest (including stocklending and exercise of an option)	Yes. Any change in a substantial shareholder's interest in voting shares (including stocklending) is discloseable, and this includes a change in the nature of the interest (even if the number of shares to which the interest relates remains the same).	No.[2]	No. Changes in the nature of an interest are not discloseable under the UK disclosure regime. The only requirement is to disclose changes in the information included in prior notifications, which would include a change, to the person's knowledge, in the identity of the registered holder of the shares. As long as no such change takes place or the person with the interest is not aware of such a change, an event such as a stock loan or exercise of an option does not trigger a disclosure obligation.	No

KEY: Yes = same as in Hong Kong No = no such requirement in this jurisdiction.

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[2] While a change in nature does not itself trigger disclosure, if subsequent transactions (e.g. an increase of at least 1% in the person's interest) give rise to a disclosure obligation, the person is required to notify certain changes in the nature of the interest occurring since the previous disclosure.