**For information**
**on 23 February 2009**

**Legislative Council Panel on Financial Affairs**

# Investor Protection under the Existing Regulatory Framework for the Securities Market

## Purpose

This paper provides some background information on investor protection under the existing regulatory framework for the securities market and sets out the responses to the issues raised by the Panel in this respect.

## Existing regulatory framework

2. The Government attaches great importance to investor protection. The Securities and Futures Ordinance (SFO), which sets out the regulatory framework for the securities market in Hong Kong, have specific provisions to protect the interests of the investing public and to ensure a fair and level playing field in the securities market. The regulatory objectives of the Securities and Futures Commission (SFC) include but not limited to maintaining and promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; providing protection for members of the public investing in or holding financial products; and minimizing crime and misconduct in the securities and futures industry (section 4 of th SFO).

3. Part XIII and Part XIV of the SFO prohibit insider trading and other types of market misconduct including false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, and stock market manipulation .

4. Part XV of the SFO imposes statutory obligations with regard to disclosure of interests in listed companies. These include disclosure obligations on substantial shareholders. That is, individuals and corporations who are interested in 5% or more of any class of voting shares

in a listed corporation must disclose their interests, and short positions, in voting shares of the listed corporation. As for directors and chief executives of a listed corporation, they must disclose their interests, and short positions, in any shares in a listed corporation (or any of its associated corporations) and their interests in any debentures of the listed corporation (or any of its associated corporations).

5. To facilitate regulation and operation of the securities market, the SFC is empowered under the SFO to publish codes, rules and guidelines, conduct investigation and take enforcement action. For example, SFC has published an Outline of Part XV which gives extensive guidance on the situations in which a Disclosure of Interests notice will have to be filed, and related matters. Also, privatisation of a listed company has to be conducted in compliance with the Codes on Takeovers and Mergers issued by the SFC, in addition to the relevant provisions of the Companies Ordinance.

6. To facilitate the proper regulation and efficient operation of the stock market, the SFC is empowered to approve Listing Rules which are made and administered by the Stock Exchange of Hong Kong Limited (SEHK). The Listing Rules prescribe the detailed requirements which have to be met before securities may be listed and also continuing obligations with which an issuer must comply once listing has been granted.

**Responses to issues raised by the Panel**

7. On the issues raised in paragraph 3 of the letter of 11 February 2009 from Clerk to the Panel, namely -

(a) decision-making process of the listed issuers such as privatization;

(b) disclosure of information by listed issuers such as substantial investment losses;

(c) whether the existing regulatory guidelines provide sufficient safeguard against misconduct of directors and ensure proper internal control of listed issuers in connection with major financial transactions; and

(d) measures in place for minority shareholders to monitor the corporate governance of listed issuers, such as the remuneration package of senior officers;

our responses are at **Annexes A – D**. In preparing the responses, we have consulted the SFC and the Listing Division of the Hong Kong Exchanges and Clearing Limited (HKEx).

**Financial Services and the Treasury Bureau**
**February 2009**

**Annex A**

**Decision-making process of the listed issuers such as privatization**

At present, privatisation of a listed company has to be conducted under the relevant provisions of the Companies Ordinance ("CO") and in compliance with the Codes on Takeovers and Mergers ("Codes") issued by the SFC under the SFO.

2. Generally speaking, a listed company can be privatised by way of a Scheme of Arrangement or a General Offer. If it is conducted through a General Offer, under Section 168 of the CO, once an offeror has obtained acceptances which in aggregate represent not less than 90% in value of shares for the offer is made within 4 months after submitting the initial offering documents, he may opt to exercise his power to compulsorily acquire securities to have the offeree company privatised. The Codes further require that the shares acquired by the offeror, together with the total shares purchased by the offeror and his concert parties within four months after posting of the initial offering documents, should amount to 90% of the disinterested shares.

3. As regards privatisation conducted through a scheme of arrangement, in accordance with Section 166 of the CO, the company concerned has to apply to the court and convene a meeting in a manner as directed by the court to put the scheme of arrangement to shareholders' vote. At such meeting, not only approval for the scheme of arrangement has to be obtained from shareholders, representing three-fourths of voting rights, present and voting either in person or by proxy, approval also has to be obtained from over half of the shareholders present and voting either in person or by proxy, and that the scheme of arrangement shall take effect only after the voting result has been sanctioned by the court.

4. The Codes further require that where any person who seeks to use a scheme of arrangement to acquire or privatise a company, the scheme must, in addition to satisfying any voting requirements imposed by law, be approved by at least 75% of the voting rights attached to the disinterested shares that are cast either in person or by proxy at a duly convened meeting of the holders of the disinterested shares. In addition, the number of votes cast against the resolution to approve the scheme at such meeting must not be more than 10% of the voting rights attached to all disinterested shares.

5. A scheme of arrangement is between a company and its shareholders. When an offeror intends to privatise a company by way of a

scheme of arrangement, he will firstly put forward the proposal to the board of the offeree company for its consideration. In fulfilment of its fiduciary duties, the board has to consider carefully the proposal and decide whether the proposal should be put forward to shareholders for their consideration and approval at a court-convened shareholders' meeting as well as a separate general meeting of the company. Under Rule 2 of the Takeovers Code, an independent board committee comprising all non executive directors who have no conflict of interest in the scheme has to be established and to give advice to disinterested shareholders about its recommendation of voting. The independent board committee would seek advice from an independent financial adviser who will set out its recommendation and the details of its analysis of the merits of the scheme in its letter to the independent board committee reproduced in the scheme document.

6. We believe that the above requirements have struck a balance among the interests of various shareholders. For the pursuance of privatisation proposal through a scheme of arrangement, the CO's requirement that support for the proposal must be obtained from over half of the shareholders mainly is to protect the interests of minority shareholders. Such requirement is similar to that adopted in other common law jurisdictions such as the United Kingdom, Australia and Singapore.

7. As a matter of fact, the Codes stipulate that the number of votes cast against the resolution shall not be more than 10% of the voting rights attached to all disinterested shares. This requirement, which renders additional safeguards for minority shareholders, is not provided by places adopting similar rules on takeovers and mergers such as the U.K., Australia and Singapore.

8. Apart from the above requirements protecting minority shareholders, at present, the CO and the SFO have empowered shareholders and the SFC respectively to apply to the court by petition to seek remedies. According to section 168A of the CO, any member of a company can make an application to the court by petition if he considers that his interests have been unfairly prejudiced. If the court consents to the petition, it may grant appropriate remedies, including making an order restraining the company concerned to continue such conduct, appointing a receiver to manage the company's property or business and awarding damages to such members, etc.

9. In addition, section 214 of the SFO provides that if there is evidence showing that the listed company concerned or its management has

conducted its business or affairs in an unfair manner prejudicial to other members, the SFC may, after consulting the Financial Secretary, by petition apply to the court for an order restraining the unfair act concerned and granting other remedies. Also, under section 385 of the SFO, where there are any judicial or other proceedings (other than criminal proceedings) which concern a matter relating to its functions, the SFC may, after consultation with the Financial Secretary, apply to the court to intervene in the proceedings, if it is satisfied that it is in the public interest for the SFC to do so.

10. We are in the course of rewriting the CO. One of the objectives of the rewrite exercise is to strengthen corporate governance and enhance the protection for the interests of minority shareholders. In the process of the rewrite exercise, we have also reviewed the requirements for takeovers and mergers in the CO and consulted the Standing Committee on Company Law Reform ("SCCLR") and relevant Advisory Group comprising professional bodies, business organisations, regulatory bodies and academics. The SCCLR and the advisory groups considered that the relevant provisions of the CO and the Codes have been generally working well. They have nonetheless recommended some technical amendments to individual provisions of the CO to enhance clarity. The proposals concerned are set out in the SCCLR Annual Report for 2007-08 which was publicised in early December 2008. The report is available for public reference at the Companies Registry's website. Relevant amendments will be incorporated into the Bill which is being drafted. We plan to conduct public consultation on the draft provisions of the Bill in the fourth quarter of this year.

**Annex B**

**Disclosure of information by listed issuers such as substantial investment losses**

**Securities and Futures Ordinance**

Part XV of the SFO imposes statutory obligations with regard to disclosure of interests in listed companies -

(a) **Substantial shareholders** – that is individuals and corporations who are interested in 5% or more of any class of voting shares in a listed corporation must disclose their interests, and short positions, in voting shares of the listed corporation; and

(b) **Directors and chief executives** of a listed corporation must disclose their interests, and short positions in any shares in a listed corporation (or any of its associated corporations) and their interests in any debentures of the listed corporation (or any of its associated corporations)

2. Section 214 of the Securities and Futures Ordinance empowers the SFC to petition the High Court to make a range of orders for regulating the conduct of the business or affairs of a listed issuer if it appears to the court that the business or affairs of the listed issuer has been conducted in a manner which is -

- ✧ oppressive to shareholders;
- ✧ involving defalcation, fraud, misfeasance or other misconduct;
- ✧ resulting in shareholders not having been given all information they reasonably expect; or
- ✧ unfairly prejudicial to shareholders.

Since the SFO came into operation in 2003, SFC has invoked Section.214 to seek orders from the court against the directors concerned in 15 cases. The court granted orders against the directors concerned in three of these cases, whereas the other 12 cases are being considered by the court.

**Listing Rules**

3. Under Main Board Listing Rule 13.09(1) (GEM Listing Rule 17.10), listed issuers have a continuous disclosure obligation to keep the Stock

Exchange of Hong Kong Limited (SEHK), members of the issuer and other holders of their listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new developments in the group's sphere of activity which is not public knowledge) which -

(a) is necessary to enable them and the public to appraise the position of the group; or

(b) is necessary to avoid the establishment of a false market in its securities; or

(c) might be reasonably expected materially to affect market activity in and the price of its securities.

4. This obligation is supplemented by an obligation under Note 11 to Main Board Listing Rule 13.09(1) for the issuer to notify the SEHK, members of the issuer and other holders of its listed securities without delay where to the knowledge of the directors there is such a change in the issuer's financial condition or in the performance of its business or in the issuer's expectation of its performance that knowledge of the change is likely to lead to a substantial movement in the price of its listed securities.

5. The timing of the release of an announcement to the market is crucial. The overriding principle is that information which is expected to be price-sensitive should be announced immediately it is the subject of a decision. That is a decision about whether the information has characteristics, in the prevailing market conditions, that would be reasonably expected to materially affect market activity in and the price of the issuer's securities i.e. the information is potentially price sensitive.

6. In periods of market volatility and turmoil it is observable that the market is more sensitive to information, both positive and negative, concerning the financial performance and financial condition of listed issuers, their subsidiary and other operations. This is a factor which should be taken into account in the assessment of whether information is potentially price sensitive.

7. Recognition that a listed issuer has an exposure to significant financial losses from investments in derivative currency instruments, whether or not those losses have crystallised, is one of many scenarios which might trigger an issuer's general disclosure obligation.

8. It is ultimately the responsibility of the Board of a listed issuer, collectively and individually, to ensure that the Company can comply with its general disclosure obligations by the creation and maintenance of internal controls that support the identification and escalation of a timely flow of reliable information to the Board or those directors authorised to ensure the issuer's performance of its continuous disclosure obligations. Such arrangements should allow them to make speedy decisions about the need for disclosure upon the emergence of developments or the occurrence of a development which might constitute potentially price sensitive information.

9. Consistent with the approach taken in other international securities markets, the Listing Division of HKEx monitors listed issuers' compliance with their general disclosure obligations through a number of means, including:

- ✧ Monitoring press, market rumours and stock analysts reports to detect (i) potential leakages of price sensitive information; and (ii) untimely disclosure of price sensitive information by listed issuers;
- ✧ Following up with listed issuers where the Listing Division has information (e.g. complaints or referrals by other regulatory bodies) of possible untimely or omission of disclosure of price sensitive information;
- ✧ Reviewing issuers' periodic financial results to identify, among others, whether issuers have disclosed their relevant price sensitive information on a timely basis; and
- ✧ Reviewing and commenting (pre and post vetting) upon listed issuers' ad hoc regulatory announcements to identify, among others, whether issuers have disclosed their relevant price sensitive information on a timely basis.

10. Where the Listing Division is made aware that a general disclosure obligation is triggered, for example, where an issuer has incurred or is exposed to the risk of a significant financial loss from an investment in a derivative currency instrument, the Listing Division will request the issuer to make immediate disclosure. A trading suspension may also be necessary until the disclosure can be made.

11. The SEHK works to both enforce the Listing Rules and promote compliance. The SEHK seeks to detect rule breaches quickly and each year makes enquiries and investigates several hundred potential rule breaches. A number of these enquiries and investigations concern possible failure by

listed companies to make timely and accurate initial or continuing disclosure of material price sensitive information as required by the Listing Rules. When the Listing Division has concerns about compliance with the continuous disclosure requirements it will gather the facts it needs in order to decide what further action, if any, may be appropriate in a particular case. Such actions include pursuing disciplinary investigations and then disciplinary proceedings against listed issuers and, in some instances, their directors. Where appropriate the SEHK will take action against wrongdoers for breaches of the relevant Listing Rule provisions.

12. From HKEx's records, we are able to share the following information -

| | **2007** | **2008** | **Jan 2009** |
|---|---|---|---|
| Number of announcements made pursuant to issuers' general disclosure obligations | 1290 | 1399 | 175 |
| Number of "profit warning" announcements released | 54 | 274 | 91 |
| Number of "profit warning" announcements where follow up enquiries were made by the Listing Division | 15 | 75 | 18 |

13. Looking ahead we shall work together with the SFC and the SEHK on implementation of a statutory obligation to disclose price sensitive information, to be supported by a proportionate range of sanctions which would act as an effective deterrent to non-compliance. Such requirements are the central pillar of a properly functioning disclosure regime. In the near future the SEHK will work with the SFC to consult, as early as possible, on amendments to improve the current formulation of the disclosure of price sensitive information rule in the Listing Rules.

**Annex C**

**Whether the existing regulatory guidelines provide sufficient safeguard against misconduct of directors and ensure proper internal control of listed issuers in connection with major financial transactions**

To protect the interests of the investing public, Part XV of the SFO, as well as the Listing Rules, impose obligations with regard to disclosure of interests as discussed in Annex B. In addition, Part XIII and Part XIV of the SFO prohibit insider trading and other types of market misconduct including -

(a) false trading;
(b) price rigging;
(c) disclosure of information about prohibited transactions ;
(d) disclosure of false or misleading information inducing transactions; and
(e) stock market manipulation.

Apart from the above, there are two other major elements of the investor protection framework: periodic financial reporting and the obligations to establish and implement effective internal controls.

*Periodic financial reporting*

2. The Hong Kong accounting standard HKFRS 7 "Financial Instruments: Disclosures" is the primary source of regulation for periodic financial disclosure of foreign currency derivative transactions. As we understand the standard was introduced and amended against the background that, in recent years, the techniques used by companies for measuring and managing exposure to risks arising from financial instruments have evolved and new risk management concepts and approaches have gained acceptance. The objective of HKFRS 7 is to require companies to provide disclosures in their financial statements that enable investors to evaluate -

(a) the significance of financial instruments for the company's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the company is exposed during the period and at the reporting date, and how the company manages those risks.

3. HKFRS 7 requires disclosure of -

(a) the significance of financial instruments for a company's financial position and performance; and

(b) qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the company is exposed to risk, based on information provided internally to the company's key management personnel. Together, these disclosures provide an overview of the company's use of financial instruments and the exposures to risks they create.

*Obligations to establish and implement effective internal controls*

4. The SEHK works to promote a high-compliance culture with listed issuers through recommending, and enforcing the disclosure of, corporate governance practices. The Code on Corporate Governance Practices in the Listing Rules have set out, among others -

(a) the principle and expectation on a board of directors to ensure the company maintains sound and effective internal controls to safeguard shareholders' investment and company assets; and

(b) the principle and expectation on a company to have a formal schedule of matters specifically reserved to the board for its decision, and on the board to give clear directions to management as to the matters that must be approved by the board before decisions are made on behalf of the company.

5. A board of directors is expected to conduct periodic reviews of the effectiveness of its internal controls. Such review should cover all material controls including financial, operational and compliance controls and risk management functions.

**Annex D**

**Measures in place for minority shareholders to monitor the corporate governance of listed issuers, such as the remuneration package of senior officers**

*The Companies Ordinance*

The Companies Ordinance (CO) provides the legal framework for the operation of companies incorporated in Hong Kong. The Standing Committee on Company Law Reform ("SCCLR") conducted a Corporate Governance Review in 2000 – 2003 with a view to enhancing the corporate governance regime under the CO. A number of amendments have been made to the CO in recent years. For example, we introduced in 2005 several provisions to enhance shareholders' remedies and hence the protection for minority shareholders' interests, namely -

(a) members of a company may apply to court for an order for members of the company or their authorised representatives to inspect any records of the company;

(b) any members of a company may bring statutory derivative action before the court on behalf of the company in respect of "misfeasance"[1] committed against the company; and

(c) any members of a company, whose interests have been or would be affected, may apply to court to restrain a person from engaging a conduct that would or has constituted a contravention of the CO or a breach of his fiduciary duties owed to the company.

2. In addition, section 168A of the CO provides that any member of a company can make an application to the court by petition if he considers that his interests have been unfairly prejudiced. If the court consents to the petition, it may grant appropriate remedies, including making an order restraining the company concerned to continue such conduct, appointing a receiver to manage the company's property or business and awarding damages to such members, etc.

[1] It is defined as fraud, negligence, default in complying with any statutory provision or rule of law, or breach of duty as in section 168BB(2).

3. We are rewriting the CO. One of the objectives of the rewrite exercise is to strengthen corporate governance and enhance the protection for the interests of minority shareholders. We have consulted the SCCLR and several Advisory Groups comprising representatives of professional bodies, business organisations, regulatory bodies and academics and conducted three rounds of topical public consultation.

4. A number of proposals in the rewrite would help strengthen the protection of the interests of minority shareholders. These include:-

(a) requiring public companies to prepare more detailed directors' remuneration report as well as more analytical and forward-looking business review as part of the directors' report. This would enhance transparency of the operations of the company and improve disclosure;

(b) introducing more stringent rules to deal with conflicts of interests involving directors in various transactions of a company (such as making loans, contracts, etc.) and that disinterested shareholders' approval would generally be required for public companies; and

(c) codifying the directors' standard of care, skill and diligence. This would help clarify the directors' duties in law and provide consistent guidance to directors on the basic standards expected of them..

5. The above proposals will be incorporated into the draft Bill for public consultation in the fourth quarter of 2009.

*Listing Rules*

6. The Listing Rules apply to all listed issuers on the HKEx, disregarding their domicile. The Code on Corporate Governance Practices in the Listing Rules has set out principles of good corporate governance. For code provisions stipulated in the Code, listed issuers are required to state, in their periodic financial disclosures, whether they have complied with the code provisions for the relevant accounting period and, where the issuer deviates from any of the code provisions, the issuer is required to disclose its reasons for deviation.

7. Code Provision B.1.1 stipulates that listed issuers should establish a remuneration committee with specific written terms of reference

which deal clearly with its authority and duties. A majority of the members of the remuneration committee should be independent non-executive directors. The code provision also stipulates certain specific duties to be included, as a minimum, in the terms of reference of the remuneration committee. From HKEx's records, compliance with Code Provision B.1.1 among Hong Kong listed issuers during the year 2007 was approximately 97%.

8. The Listing Rules further stipulates certain ad hoc and periodic disclosure requirements in relation to remuneration of directors and senior management. These are set out in paras. 9 to 12.

Ad hoc disclosure requirements – where there are new appointments and/or changes to prevailing remuneration

9. Pursuant to Listing Rule 13.51(2), listed issuers shall include details of any newly appointed or re-designated director or supervisor in an ad hoc announcement which shall include, among others, amount of the director's or supervisor's emoluments and the basis of determining the director's or supervisor's emoluments and how much of these emoluments are covered by a service contract. Where there is a change in such information during the course of the director's or supervisor's term of office, the listed issuer must ensure that the change and the updated information regarding the director or supervisor is set out in the next published annual or interim report of the listed issuer (whichever is the earlier): Rule 13.51B(1).

Periodic disclosure requirements - Annual Reports

10. Directors' fees and any other emoluments payable to a director must be disclosed in the annual reports and accounts of the listed issuer on an individual and named basis: Paragraph 24 of Appendix 16 to the Listing Rules.

11. Listed issuers are also required to give a general description of the emolument policy and long-term incentive schemes of the issuer as well as the basis of determining the emoluments payable to their directors: Paragraph 24B of Appendix 16 to the Listing Rules.

12. Listed issuers shall also include a report on corporate governance practices (the "Corporate Governance Report") prepared by the board of directors in their annual reports: Paragraph 34 of Appendix 16 to the Listing Rules. The Corporate Governance Report shall contain, among

others, details of the directors' remuneration policy (Appendix 23 to the Listing Rules), which include -

(a) the role and function of the remuneration committee (if any) or the reason(s) for not having a remuneration committee;
(b) the composition of the remuneration committee (if any);
(c) the number of meetings held by the remuneration committee or the board of directors (if there is no remuneration committee) during the year to discuss remuneration related matters and the record of individual attendance of members, on a named basis, at meetings held during the year; and
(d) a summary of the work, including determining the policy for the remuneration of executive directors, assessing performance of executive directors and approving the terms of executive directors' service contracts, performed by the remuneration committee or board of directors (if there is no remuneration committee) during the year.