<u>HKIFA members' feedback on SFC consultation on the Draft Guidelines on Disclosure of Inside Information (June 2010)</u>

Members support the SFC's initiative to make it a statutory obligation that listed companies must disclose price sensitive information ("PSI") to the public as soon as practicable. It should be able to reduce the risks of fund managers to inadvertently trade on inside information due to the failure of listed companies to identify price sensitive information and to make timely disclosure. Members also welcome the draft guidelines issued by the SFC which should be able to help listed companies identify PSI.

However, although it is understood that the draft guidelines are intended to elaborate on SFC's views (in particular in relation to analysts' research reports) and thus to give greater clarity to the market, members have reservations as to whether the approach adopted is the most appropriate.

The SFC has taken the approach to define "inside information" as having the same definition as insider information under the insider trading rules. In theory, whilst there may be more clarity to the market if both issuers and investors were to work off the same definition of "inside information", the reality remains that disclosure and insider trading are inherently different concepts and to merge the definitions may lead to less (and not more) disclosure by issuers. Therefore, SFC may wish to consider whether "inside information" should instead be defined more simply and broadly as "all material information related to the issuer (subject only to safe harbors)" versus the current proposed definition which is more prescriptive.

Furthermore, the proposed guidelines actually create a lot of uncertainties for fund managers. Thus, if SFC maintains that it would stick to its proposed approach, it is important that it helps address the following concerns/questions of the fund industry:

- The assessment of whether a piece of information is "inside information" is subjective and open to interpretation. Hence, there may be cases where a listed company may not think the information is inside information yet the recipient may think otherwise. However, given the severity of the consequences where a recipient acts on a piece of information and it is later found that such information is considered inside information, it is important for SFC to provide guidance on what measures recipients of information such as fund managers can take in order to ensure compliance as well as to protect themselves.

  It is understood that analysts are not allowed to use any inside information in producing their research reports. Therefore it is reasonable for fund managers to presume the research report is based on public information and hence may rely on it in making investment decisions. Similarly, listed companies are prohibited from providing inside information to analysts or selected investors. To avoid uncertainties, listed companies should be asked to upload any information or materials that they provide to analysts (include presentation in analysts' meeting) onto the HKEx website as well as their own investor relations website.

  Furthermore, guidance should be provided on the interaction between the disclosure regime and the insider dealing regime. Will a company's own breach of the disclosure regime have an impact on any proceedings against an entity which is suspected of insider dealing in securities of that company? For example, if an entity can show that (i) it made its decision based on information which it understands to be public, e.g. through analyst reports (which would normally be fine assuming the company is not in breach of the disclosure guidelines), and (ii) that it was the company's breach of the disclosure regime that allowed inside information to be contained in the analyst report, can this be used as a defense under the insider dealing regime where the entity had made its own assessment and had no reason to believe the analyst report contained inside information (even though as a matter of fact it did contain inside information)?

It would be helpful if SFC imposes a requirement on analysts and listed companies to add a standard statement in their reports or presentations that no material non public information is included in such materials. Although the regulations already require analysts not to use any material non public information in research reports, the standardized statements will make it explicit and clear to both the preparers and readers of the reports.

- Paragraphs 12 and 17-20 – The draft guidelines require that to be disclosable, information be "not generally known" and in providing guidance on this, the SFC noted that there may be times where information in analyst reports, press articles and other publications of wide circulation may still be considered "not generally known." The implication is that in reviewing an analyst report, for instance, investors cannot automatically assume that all information in such report is public and therefore tradable, unless an exemption applies under the insider trading rules. Can SFC consider an alternative to remove this requirement from the definition of inside information on the basis that issuer disclosure should not depend on whether the information is public? This alternative approach would broaden the scope of information that is disclosable by issuers. Additionally, it would relieve issuers from engaging in the vexing exercise of determining whether a piece of information is public or not.

- Paragraphs 12 and 21-25 – To be disclosable, the draft guidelines require that information "materially affect the price of issuer's listed securities." The SFC's commentary on this suggests that information is material if (i) the information would likely impact a security's price, and (ii) the likely price change would be of a sufficient degree (and not mere fluctuations) – otherwise known as the "price impact" test. The alternative to the price impact test is the "reasonable investor" approach as the test for materiality – under this test, the focus is on whether there's a substantial likelihood that reasonable investors would consider the information important in making their investment decisions. The SFC may wish to consider the alternative test.

- Re Paragraph 19, members agree that listed companies should, as a matter of good practice, provide material information to the broadest possible group of investors through the appropriate channels. They can understand that analyst research reports, electronic subscription database and rumours in the market cannot be contended to be known to the public in all cases. However, it would be reasonable to expect that press reports (such as information published in a retail magazine or newspaper) are widely available to the public. Is it that what SFC wishes to cover here is press release since it is up to the press to select the release and not all releases are published? Thus, press release cannot be considered as “generally known to the public”. A clarification on this would be helpful.

- Paragraph 40 – It is agreed that listed companies should be required to disseminate any price sensitive information on the HKEx system, and in addition should also post the same information on the company's investor relations website, as suggested above. However, it is not practical to assume that HKEx website is the ONLY way to ensure information becomes publicly available. The investing public obtains information from the press more than from the HKEx website and the financial industry relies mostly on Bloomberg as the primary source of information and third party brokers to supplement. It is understood that there is a need to have an “official” channel for dissemination of inside information, however, SFC should recognise there are other channels and sources of information which can result in inside information being "disclosed" and be made public to the extent that anyone acting on that information would not contravene the insider dealing rules.

- Paragraph 19 - Regarding analyst research reports, there should be recognition that such reports are widely distributed and known to a wide range of investors through distribution channels (e.g. private bankers) or other technological means. In UK, a research report is considered publicly available information after it is issued. Even though it is published on a platform which is only available on payment of a fee, e.g. Bloomberg, it is considered published in a general public domain for the investment market to use, therefore the fund managers can presume it is public information and act on it (please refer to Appendix A for extract of UK rules). Members believe it would be reasonable for HK to follow this practical model and adopt the same approach. Furthermore, in HK, the availability of research reports is not restricted to institutional, professional or persons with above average financial resources, expertise or competence. Retail investors are able to get such information if they choose to pay for it. In practice, the fund industry operates such that retail investors do not have to pay for every piece of research but instead pay the fund managers (who in turn pay for such research) to make investment decisions on their behalf. Members therefore urges the SFC to clarify that the fund managers should be able to treat published research reports as widely circulated and “generally known” to the investment market (even though it may not represent the total population of the public) and thus unlikely to commit insider dealing based on the information in a research report.

- Paragraph 28 - This is similar to Paragraph 19. Although listed companies should make disclosure of material information to the broadest group (i.e. not assume information already in a research report constitute generally known to the public), fund managers should be able to rely on research reports as public information since analysts are prohibited from using inside information in their reports. The second part of Paragraph 28 is thus confusing. Can the SFC clarify its view and make this distinction clear in its draft guidelines?

- Paragraph 29 of the draft guidelines sets out a list of events that the SFC believes may be disclosable. Our members believe the following should also be included in this list: (i) Entry into, or termination of, a definitive agreement; (ii) Creation of a direct financial obligation or an obligation, direct or contingent, under an off-balance sheet arrangement, and triggering events that accelerate or increase such obligation; (iii) Impairment of goodwill; (iv) Notice of delisting or failure to satisfy a continued listing standard; (v) Unregistered sales of equity securities; (vi) Knowledge of error in previously issued financial statements or audit report; (vii) Modification to rights of security holders, etc.

- Paragraphs 61 and 62 - Except under certain circumstances, issuers are under no obligation under the draft guidelines to respond to press speculation or market rumors. Our members believe there is a better approach: in the event that an issuer is aware that a rumor (true or false) is likely to have, or has had, an effect on the trading of its securities or would likely have a bearing on investment decisions, the issuer should be required to publicly clarify the rumor.

- Paragraph 67 - It is not practical to allow listed companies to only provide public information to analysts. Non-public information should be allowed to be provided to analysts so long as it is not price sensitive. It is the job of analysts to put together information about a company and then form their own views. The analysts may obtain public and non-public information on a company and it is their job to ensure such information is not inside information (or material) before they can use them to perform their analysis and form their views. Even their view then becomes price sensitive (i.e. when made public will materially affect the price), their view and any information in their report is not inside information, hence their recommendation would not constitute an offence. Fund managers may either rely on the analysts' view or disagree with the analysts' view in making their investment decisions. It would be helpful if the SFC can clarify whether Paragraph 67 intends to create a presumption in favour of analysts and users of analysts reports such that they can presume any information they receive from the company would not be classified as inside information and that the onus is on the company, not the analyst or users of the analysts reports to make a call on whether inside information has passed. If this is the case, we urge the SFC to clarify that fund managers should not be regarded as insider dealing if they rely on the analysts' report/ information to make investment decisions provided that the fund managers have no reason to believe that the company has breached their disclosure obligations and have allowed inside information to be contained in such report/ information (i.e. it's not known in the report/information that the information is material non-public or it is from an insider). Paragraph 67 only recognises “public information” and “inside information”. The factor of materiality in the non-public information should be recognised.

  The SFC provides that insider dealing is based on relevant information from a person whom he has reasonable cause to believe held the information as a result of being connected with the company. Would the SFC confirm that when the fund managers use research reports, they are able to presume that the analysts are not connected with the company?

- Paragraph 68 - Correcting some fundamental misconception or mistakes in an analyst report may have a price effect in the market. Can the SFC clarify whether a public disclosure obligation arise if the information which is used to correct the analyst report is non-public but in itself is not price sensitive (i.e. not inside information by definition in isolation)?

- Paragraph 71 - There should be a clear exception that so long as the impact of such external developments on the listed company can be ascertained without the need for further information, then that impact should not be disclosable inside information. Members think that the company should not have to do the work of investors. Investors, fund managers and analysts should be entitled to draw their own conclusions in relation to external developments without having to be concerned with whether the impact of the external developments on the listed company might be considered inside information.

(End)

Appendix A

FSA Handbook - Market Conduct MAR 1.2.11 -1.2.14:

In the opinion of the FSA, the following factors are to be taken into account in determining whether or not information is generally available, and are indications that it is (and therefore not inside information):

(1) whether the information has been disclosed to a prescribed market through a regulatory information service or RIS or otherwise in accordance with the rules of that market;

(2) whether the information is contained in records which are open to inspection by the public;

(3) whether the information is otherwise generally available, including through the Internet, or some other publication (including if it is only available on payment of a fee), or is derived from information which has been made public;

(4) whether the information can be obtained by observation by members of the public without infringing rights or obligations of privacy, property or confidentiality; and

(5) the extent to which the information can be obtained by analysing or developing other information which is generally available. [Note: Recital 31 Market Abuse Directive]

MAR 1.2.13 01/07/2005

(1) In relation to the factors in MAR 1.2.12E it is not relevant that the information is only generally available outside the UK.

(2) In relation to the factors in MAR 1.2.12E (1), (3), (4) and (5) it is not relevant that the observation or analysis is only achievable by a person with above average financial resources, expertise or competence.

MAR 1.2.14 01/07/2005

For example, if a passenger on a train passing a burning factory calls his broker and tells him to sell shares in the factory's owner, the passenger will be acting on information which is generally available, since it is information which has been obtained by legitimate means through observation of a public event.

(End)

<u>HKIFA members' feedback on FSTB's consultation on "Proposed Establishment of an Investor Education Council and a Financial Dispute Resolution Centre"</u>
(April 2010)

<u>Part I - Investor Education Council ("IEC")</u>

- Members are generally in support of the creation of an IEC which broadly covers a wide range of financial products and services. Currently, a lot of investor education initiatives are product-specific, it would be useful to start from a general financial literacy perspective.

- However, some members are concerned that since IEC will be established under the SFC, there may be a real or perceived bias to focus on securities investment-related issues rather than financial literacy as a whole.

  Furthermore, some have asked why there is a need to set up a separate Council when it seems that there are no material differences between its functions and those being discharged by the current SFC Investor Education Department? Also, as it is envisaged that the current IE team will move over to the new Council, it is likely that the approach and focus would bear a high degree of resemblance. Thus, what is the key value added of having a new set up? Also, can we expect that the current SFC IE department will be disbanded to achieve cost savings?

- Separately, some would like to know whether the IEC intends to liaise with the SFC in relation to developing particular financial education courses on particular types of securities, e.g. derivatives with a view that investors which complete those courses would then satisfy the knowledge and suitability requirements contemplated by the new investor characterization proposals set out in the SFC consultation paper on "Enhancing Protection for the Investing Public" published in September 2009.

<u>Part II - Financial Dispute Resolution Centre ("FDRC")</u>

- Members understand that arbitration decisions under the FDRC do not create binding legal precedents. However, if the intention of the FDRC is to streamline the complaint process, then should the FDRC have the ability to refer to the outcome of previous cases when assessing new complaints? For example, if the arbitrator consistently rules in favour of the financial institution in relation to complaints of a similar nature, then would the FDRC take this into account when a new complaint is filed based on similar circumstances? As financial institutions, members would be looking to strive for consistency in outcomes. What procedures are anticipated to ensure that the arbitrators will arrive at consistent decisions, particularly as such decisions are final and binding and cannot be challenged in the courts on the basis of merit?

- It is intended that it will be mandatory for all financial institutions who serve retail customers to join the FDRC scheme (is there a definition of retail customers? Can we take it that insofar if the financial institutions intend to only serve professional investors, they are not obliged to join?). As part of the Scheme, the financial institution must adhere to the mediation and arbitration processes set up scheme. There does not appear to be an ability for a financial institution to disapply or opt out of the scheme (either entirely or on a case by case basis). The concern is that the financial institution may wish to address a complaint through the court system rather than by way of arbitration if mediation fails in the first instance. Given that arbitration is final and binding on all parties, it is suggested that there should be a process in place for the financial institutions to also consider whether or not to use arbitration to settle the dispute. It may be that a complaint is of such significance that the financial institution would rather seek a judgment from the court of law and have the benefit of precedence in relation to that case.

- If the FDRC is not intending to deal with claims relating to regulatory breaches e.g. mis-selling, failure to adhere to client instructions (as highlighted in paragraph 4.4 of the consultation paper), then what kinds of complaints are the FDRC intending to address?

- In relation to the business of fund houses, the majority of complaints relate to loss of value of investment due to a fall in the fund prices which is predominantly due to market forces. Members are concerned that if FDRC will be dealing with claims of this sort, there will be an opening of floodgates as any investor who is willing to pay the nominal $100 fee will be able to submit a claim and force the financial institution to engage in the mediation/arbitration process which will be time/cost consuming for the financial institution. This is particularly the case where once an investor chooses to go to mediation/arbitration, the financial institution must comply and incur the associated costs in doing so. Members opine that the $100 administration fee to file a claim is perhaps too low and does not serve a sufficiently high monetary barrier to discourage claims which do not have much basis. Some members suggest to set the administration fee at a percentage (e.g. 5%) of the claim amount which the complainant will receive back in full should his claim succeed. The proposed schedule of fees for Mediation and Arbitration for investors is also too low (e.g. $500 for amount of claims less than $100k). The proposed higher fee for the financial institution also raises fairness issue as the investors should also be encouraged to resolve the issue with the institution and not simply passing the work to FDRC.

- Members understand FDRC intake officers shall be professionally trained with mediation knowledge and will assess claims based on the criteria set out in paragraph 3.10 of the consultation paper. Members also note that the FDRC intake officers have the discretion not to process a case where the claim appears to be frivolous or vexatious. There is no indication however, that these intake officers will have any financial services or industry knowledge or qualifications. Members suggest that such intake officers should be individuals who have the requisite financial services industry background and qualifications such that they can make an appropriate assessment as to whether a claim by an investor should proceed to mediation/arbitration. The concern is that if the intake officers do not have the appropriate expertise to sufficiently assess the validity of a claim in the financial services industry context, the financial institutions will be dealing with more claims that would otherwise be necessary if left to the court system.

- The intake officers seem to have quite a lot of power. Please clarify whether there is some sort of internal review of decisions made by the intake officers. For example, should rejections of claims be endorsed by the intake officer plus a senior manager of the FDRC? Also, if one puts oneself in the shoes of an intake officer, will there be a tendency for him/her to err on the side of caution and by default, take up a case rather than drop it? By not taking up a case, the case officer may have to do a lot of explaining re why such a decision is being made; whereas if he/she takes up the case, there is no need for making such an explanation. This goes back to a basic question, i.e. how will the case officers be evaluated – e.g. by the number of cases that are being taken on board or rejected? The evaluation criteria can skew the behaviour of the front-line gatekeepers.

- The FDRC may notify the SFC if it perceives a pattern of behaviour by an individual firm that may imply the presence of systematic regulatory breaches and that once referred to the SFC, the FDRC will suspend all complaints related to that financial institution pending the outcome of SFC's investigation. In members' experience, most complaints by investors will refer to some misconduct of the fund house or potential regulatory breaches (otherwise there is no or very weak ground of complaint). Therefore, it is not likely that the FDRC system will help to reduce the complaint cases to be investigated by the SFC. Does the FDRC have any guidelines as to the volume of complaints it receives before it refers the matter to the SFC? Furthermore, if the SFC subsequently finds that there is no wrongdoing on the part of the financial institution, are all pending FDRC complaints then dismissed or will the financial institution still need to continue with the mediation/arbitration process? It is important to carefully think through the process and the coordination between the regulators; or else financial institutions will be subject to a lot of uncertainty and investors would have to go through an unfriendly process where they may have to go back and forth between the various regulators.

- Can the financial institution take a more pro-active role in the use of the FDRC and mediation/arbitration? For example, if a consumer makes threat of litigation against a financial institution notwithstanding an offer for settlement from the financial institution, can the financial institution require the consumer to take the case to FDRC or can the institution itself initiate the case with FDRC?

- Since it is mandatory for financial institutions to join the scheme, and the current proposal is that the level of scheme membership fee is related to the number of disputes arising from the sector it belongs (rather than actual usage by the particular financial institution), there is a concern that some financial institutions which have few or no complaints will effectively be subsidizing other financial institutions which use the scheme much more. Members believe that it is fairer if the government or regulatory body funds the fixed costs of the FDRC while the users then get charged on a "pay as you use" regime. In this case, the financial institutions do not need to pay any scheme membership fee and will be encouraged to resolve disputes with the investors directly.

- The FDRC is limited to SFC and HKMA regulatees who deal with retail investors. It seems to create an unlevel playing field vis-a-vis the insurance industry and players in the MPF arena. Even though we understand that the insurance sector already has its own resolution mechanism, are there any attempts to ensure that there is consistency in the standards that are being applied across all the sectors? This is especially pertinent as there are increasing overlaps across sectors and products. There appears to be a mandatory membership fee for those involved in the scheme. Furthermore, what about product issuers who do not deal with retail investors; sometimes the loss to clients is caused by faulty products instead of the selling process. Should they be subject to the scheme as well?

- On the publication of statistics and synopsis, if mediation and arbitration is supposed to allow private resolution of disputes, it would be inappropriate to publish case summaries which would prejudice and set precedents for other claimants/cases. Especially for settlements which are often based on the commercial decisions of individual firms rather than the merits of the case, it would be misleading to publish synopsis of these bilateral agreements.

- On the sharing of information between the FDRC and regulators, clarification should be provided on what sort of information can be shared. Again, mediation and arbitration should be private, is the FDRC fully privy to the correspondence and information between the financial institution and the claimant? Would the willingness of a financial institution to settle be viewed as an implicit admission of wrongdoing if this information is passed to the regulators?

(End)