Legislative Council Panel on Financial Affairs

Consultation Conclusions on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations

Purpose

On 11 February 2011, the Administration published the consultation conclusions on the proposed statutory codification of certain requirements to disclose price sensitive information ("PSI") by listed corporations. We intend to take forward the legislative exercise by amending the Securities and Futures Ordinance ("SFO") (Cap. 571). This paper informs Members of the consultation conclusions.

Background

2. We launched the consultation on 29 March 2010 and submitted a paper (LC Papers No. CB(1)1728/09-10(03) to the Panel to brief Members on our proposals. The consultation was completed on 28 June 2010. We received 110 written submissions[1], about half of which were from listed corporations, while the others were mainly from trade bodies of the financial services, accounting and legal sectors as well as investor/consumer groups. We also conducted 8 briefings for organized groups, mostly trade and professional bodies, to introduce to them the legislative proposal and to listen to their views. These briefings were attended by a total of around 460 members of these organizations.

General Comments

3. The respondents generally supported the objective of the legislative proposal of cultivating a continuous disclosure culture among listed corporations. Certain professional bodies in the legal, accounting

[1] We have been receiving written submissions until late August 2010.

and financial fields, as well as consumer groups indicated general support to our proposed statutory regime. Noting that the lack of regulatory "teeth" in the Listing Rules has been an issue of public concern, supporters commented that reliance on non-statutory regulation raised doubt about enforcement effectiveness. A statutory regime could encourage compliance, enhance market transparency and provide better protection to investors. However, around 20% of the written submissions (mostly listed corporations, with a few trade bodies) did not support establishing a statutory regime. They opined that a statutory regime would lead to indiscriminatory disclosure of "half-baked" information and increase compliance cost.

4. We believe that a statutory regime is necessary to enhance market transparency and quality, to bring our regulatory regime for listed corporations more in line with those of overseas jurisdictions, and to sustain Hong Kong's position as China's global financial centre and a premier capital formation centre in the region. In light of the comments received, we have refined the legislative proposal to enhance clarity of the statutory disclosure requirements. In addition, the Securities and Futures Commission ("SFC") would improve its relevant guidelines. Appropriate safe harbours would be available to safeguard the legitimate interests of listed corporations in preserving certain information in confidence to facilitate its operation and business development. Our aim is to put in place a statutory regime to promote effective compliance with, and allow effective enforcement of, the disclosure obligations.

Comments on the Detailed Proposal

<u>Definition of PSI</u>

5. Under our consultation proposal, we would borrow the concept of "relevant information" currently used in the "insider dealing" regime in the SFO to define PSI. As such, PSI will be the same set of information currently prohibited from being used for dealing in the securities of the listed corporation concerned, and such information would be known as "inside information". Respondents generally agreed with this approach. As mentioned in the consultation document, the

SFC would issue Guidelines on Disclosure of Inside Information. It would also update such guidelines and provide additional guidance materials (e.g. in the form of frequently asked questions ("FAQs")), from time to time, to address comments and issues arising from the application of the statutory PSI disclosure requirements.

Disclosure Requirement

6. Under our consultation proposal, a listed corporation must, as soon as practicable after any inside information has come to its knowledge, disclose the information to the public. A number of respondents proposed revising the disclosure timing as "as soon as reasonably practicable" to allow time for listed corporations to verify all the facts and seek necessary advice, before making a decision on disclosure.

7. Our intention is that the timing of disclosure should cater for listed corporations' need to take time to verify the facts and seek professional advice as appropriate and reasonable in the circumstances of a particular case, and that the listed corporation should act reasonably in this regard. To make such intention more explicit, **we will revise "as soon as practicable" to "as soon as reasonably practicable" in the legislative provisions**. In addition, the SFC would explain in its guidelines that a listed corporation is allowed to take appropriate steps such as ascertaining details, conducting internal assessment and due diligence verification before making an announcement.

Safe Harbours

8. In formulating our consultation proposal, we were mindful of the need to strike a reasonable balance between ensuring market transparency and safeguarding the legitimate interests of listed corporations in preserving certain information in confidence to facilitate its operation and business development. As such, we have proposed that the following circumstances be covered by safe harbours-

Safe Harbour A – When the disclosure would constitute a breach against an order made by a Hong Kong court or any provisions of other Hong Kong statutes;

Safe Harbour B – When the information is related to an incomplete negotiation or proposal the outcome of which may be prejudiced if the information is disclosed prematurely;

Safe Harbour C – When the information is a trade secret; and

Safe Harbour D – When the Government's Exchange Fund or a central bank provides liquidity support to the listed corporation.

The use of each of these safe harbours would be subject to the prerequisite that the information must be kept in confidence.

9. Respondents generally found these four safe harbours necessary and useful.

10. A few respondents suggested that Safe Harbour A should not be lost in case of leakage by a third party, since the legal prohibition from disclosure by other legislation / the court would still be applicable even in the case of a leakage. We agree that Safe Harbour A should still be applicable in case of leakage of the PSI. **We would therefore make Safe Harbour A applicable irrespective of whether there is a leakage**.

11. For Safe Harbour B, some respondents asked that the phrase "outcome of which may be prejudiced if the information is disclosed prematurely" be removed as it would be uncertain whether a disclosure might prejudice the outcome. In the light of such concerns, **we would remove the phrase "the outcome of which may be prejudiced if the information is disclosed prematurely" from Safe Harbour B.** This would make Safe Harbour B consistent with the existing arrangement under the Listing Rules[2], and more in line with the takeovers regime.[3]

[2] Under the Listing Rules, subject to preservation of confidentiality, there is currently an exemption to PSI disclosure in cases of incomplete negotiations short of a decision. Note 2 to Listing Rule 13.09(1) provides that, "When developments are on hand which are likely to have a significant effect

12. A number of respondents sought clarification on when confidentiality regarding the PSI would be regarded as lost. Some respondents commented that a listed corporation might not know that a third party had leaked a piece of PSI and hence had concerns on the operation of the confidentiality prerequisites.

13. Leakage of PSI occurs where there is widespread circulation of details which are significant and reasonably specific. The SFC will provide further elaboration in its guidelines in relation to the reasonable precautions expected to be undertaken by listed corporations for preserving the confidentiality of the PSI. To address the concern that the listed corporation might not be aware of a leakage, **we would provide a defence for the relevant listed corporation if it can prove that it has taken reasonable measures to monitor the confidentiality and it has made disclosure as soon as reasonably practicable when it became aware of the leakage.** The effect is that under such circumstances, the listed corporation would not be regarded as breaching the PSI disclosure requirement before it becomes aware of the leakage.

14. There may be certain circumstances that a disclosure of PSI would mean a contravention against a court order or legislation in other jurisdictions – especially if the concerned listed corporation has major business activities outside Hong Kong. We therefore proposed under the consultation document to empower the SFC to grant a waiver to listed corporations if they face disclosure prohibition arising from court orders or legislation of another jurisdiction.

15. There was a general consensus among the respondents that it would be useful to empower the SFC to grant waivers. A few

---

on market activity in or the price of any listed securities, it is the direct responsibility of the directors to ensure that such information is kept strictly confidential until a formal announcement is made. To this end the directors must ensure that the strictest security is observed within the issuer and its advisers and if at any time it is felt that the necessary degree of security cannot be maintained or that security may have been breach, an announcement should be made…". Note 4 to Listing Rule 13.09(1) states that "The question of timing of the release of an announcement to the market is crucial, having regard to its possible effect on the market price of the issuer's listed securities. The overriding principle is that information which is expected to be price-sensitive should be announced immediately it is the subject of a decision...".

[3] Under the Codes on Takeovers and Mergers and Share Repurchases, subject to the preservation of confidentiality, the corporation as a target is not required to make disclosure when it receives an approach to an offer except under certain specified situations. The corporation is not required to justify the reason for not making disclosure.

respondents suggested that the allowable scope of the waiver should be extended to cover rules made by administrative agencies or other entities, to cater for the possible need of enterprises whose major operations were outside Hong Kong.

16. We appreciate the practical concerns faced by enterprises which might be subject to administrative orders in places outside Hong Kong. However, having regard to the need to ensure market transparency and to avoid abuse of the waiver arrangements, we consider that such administrative orders must have certain legal basis. **We would therefore extend the scope of the waiver to include situations concerning prohibition made by a law enforcement authority of a place outside Hong Kong or a government authority of a place outside Hong Kong exercising a power conferred by legislation of that place.**

Obligations of officers and listed corporations

17. Under our consultation proposal, a listed corporation shall disclose a piece of PSI when an officer[4] of the listed corporation has, or ought reasonably to have, come into possession of that PSI in the course of performing his function as an officer. Every officer of a listed corporation is required to take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the breach of a disclosure requirement. In case a listed corporation has breached the disclosure requirement, an officer will also be in breach if (a) the corporation's breach is a result of his intentional, reckless or negligent act; or (b) he has not taken all reasonable measures to prevent the breach.

18. Most respondents providing comments on the disclosure obligation suggested deleting the phrase "ought reasonably to have". Some listed corporations commented that individual officers should not be held liable so long as they have considered, in good faith, whether a particular piece of information needs to be disclosed.

[4] Part 1 of Schedule 1 to the SFO defines an "officer", in relation to a corporation, to mean "a director, manager or secretary of, or any other person involved in the management of, the corporation".

19. Our intention of including the phrase "ought reasonably to have" is to avoid listed corporations evading from the disclosure obligation by (a) arguing that the PSI has been channelled to the officers but has not been read; or (b) deliberately keeping PSI away from being accessed by the officers of the listed corporation. We consider that it would prejudice the interests of the investing public if PSI could be withheld on grounds that the directors believe in good faith (which is a subjective test) that the information is not subject to the statutory disclosure requirement. Indeed, if a reasonable man will not regard a piece of information as PSI, the disclosure obligation will not be triggered. In light of market feedback, **we would specify such an objective test in the Bill, and replace "come into possession" with the narrower concept of "come to knowledge".**

SFC's Guidelines

20. Respondents generally welcomed the SFC issue guidelines on disclosure of inside information. In response to the respondents' feedback, the SFC would update its guidelines and issue FAQs from time to time to facilitate compliance. It would also extend the initial period of its informal consultation service from 12 months to 24 months.

Sanctions

21. We proposed that civil sanctions be imposed on breaches of the statutory PSI disclosure requirements and that alleged breaches should be handled by the Market Misconduct Tribunal ("MMT"). The respondents generally support a civil regime. There was also a general consensus among the respondents for the MMT to handle cases of alleged breaches. Many listed corporations commented that the proposed civil sanctions were already strong measures and would be highly deterrent. There were a few respondents proposing a criminal regime, to enhance the deterrence effect. A political party was of the view that it would be easier to sanction persons breaching the disclosure requirement under civil proceedings than in criminal proceedings. As mentioned in our consultation document, we would keep under review the effectiveness of the statutory regime, and consider the need for creating additional sanctions, including criminal sanctions, in the light of local and

international market experience.

22. Our consultation proposals included the following civil sanctions to be imposed by the MMT –

(a) a regulatory fine up to $8 million on the listed corporation and/or each of the directors respectively;

(b) disqualification of the officer from being a director or otherwise involved in the management of a listed corporation for up to five years;

(c) a "cold shoulder" order on the officer (i.e. the person is deprived of access to market facilities) for up to five years;

(d) a "cease and desist" order on the listed corporation or officer (i.e. an order not to breach the statutory disclosure requirements again);

(e) an order that any body of which the officer is a member be recommended to take disciplinary action against him; and

(f) payment of costs of the civil inquiry and/or the SFC investigation by the listed corporation or officer.

23. Apart from the regulatory fine, the MMT could already impose orders (b) to (f) under the existing SFO. There were alternative suggestions on the maximum level of regulatory fine, ranging from $3 million to unlimited amount. We consider our proposed maximum level of $8 million appropriate and such a ceiling would allow sufficient scope for the MMT to determine the exact amount. The MMT will be required to comply with the principle of proportionality when determining the amount of regulatory fines to be imposed by reference to the facts and circumstances in a particular case.

24. We have also reviewed the existing arrangements under the Listing Rules. We found that one of the remedial measures the Listing Committee may invoke is that under Listing Rule 2A.09 – to "require a breach to be rectified or other remedial action to be taken within a stipulated period…". Based on this, the Listing Committee frequently

makes directions on "Training of Directors"[5], "Internal Control Review"[6] and "Retention of Compliance Adviser"[7]. We consider that these are useful remedial measures for improving corporate governance practice of listed corporations and hence are worthwhile to be introduced into the statutory PSI disclosure regime. **We would therefore empower the MMT to make such orders as is necessary to ensure that the corporation takes appropriate action to prevent a similar breach of the disclosure requirement. Such power includes –**

(a) ordering an officer to undergo training;

(b) ordering a corporation to appoint an independent professional adviser to review its compliance procedure; and

(c) ordering a corporation to appoint an independent professional adviser to advise on compliance matters.

25. To allow for a streamlined process to enforce the statutory PSI disclosure requirement, we proposed in our consultation document to empower the SFC to institute proceedings on such breaches before the MMT, without having to first submit the case to the Financial Secretary for his decision to do so. The majority of the respondents who did not agree with the proposal were from listed corporations, believing that this would lead to a loss of checks and balances.

26. We note that the MMT proceedings have already provided for appropriate checks and balances. The MMT is an independent tribunal. All MMT cases are heard by a high court judge assisted by two members appointed by the Chief Executive[8]. The MMT is able to inquire into the matter and issue orders to obtain further evidence during the proceedings pursuant to the SFO. Any person who is dissatisfied with the MMT's findings may appeal to the Court of Appeal.

---

[5] Requires a director to undergo training on compliance of Listing Rules, director's duties and corporate governance matters for a certain number of hours to be provided by a recognized professional organization satisfactory to the Listing Division.

[6] Requires the listed corporation to retain an independent professional adviser satisfactory to the Listing Committee and/or the Listing Division to conduct a thorough review of and make recommendations to improve the corporation's internal controls including its procedures and compliance systems to ensure compliance with the Listing Rules.

[7] Requires the listed corporation to appoint an independent professional adviser satisfactory to the Listing Division on an ongoing basis for consultation on Listing Rules compliance for a certain period of time.

[8] Or appointed by the Financial Secretary under delegated authority.

27. At present, under the SFO, a decision to refer a case to the Financial Secretary for consideration is made by the SFC (i.e. the full governing body), and such function of the SFC cannot be delegated to any of its director or employee. With direct access, it is still the SFC (not certain SFC director or employee) which will decide whether a case should be referred to the MMT. In addition, most major financial services regulators including those in the UK, United States and Australia are empowered to institute and manage its own civil enforcement work for serious market misconduct where civil remedies exist. Streamlining the referral procedure is consistent with international practice. We believe granting the SFC with direct access to the MMT would help enhance enforcement efficiency.

28. Our consultation proposals also included enabling persons suffering pecuniary loss as a result of others breaching the disclosure requirements to rely on the MMT findings to take civil actions to seek compensation from those having breaches the disclosure requirements. In addition, the SFC may, where appropriate, take action under the existing sections 213 and 214 of the SFO in respect of non-compliance with the statutory disclosure obligation, to apply for injunctive and disqualification orders. These remedies would be retained in our legislative proposals.

Enforcement

29. There was a consensus among the respondents for the SFC to enforce the statutory regime and investigate alleged breaches. As for the existing PSI disclosure requirements under the Listing Rules, the original intention was to dovetail them with the statutory provisions. On review, we believe that the Stock Exchange of Hong Kong Limited ("SEHK") and the Listing Committee should not be put into the position of interpreting / administering the statutory obligation of disclosing PSI. On enactment of the legislative amendments to the SFO, the intention is for **SEHK to delete Listing Rules 13.09(1)(a) and (c) which closely mirror the proposed statutory PSI disclosure obligation** [9] . Amendments to the Listing Rules would be subject to SEHK's public

[9] The residual part of Listing Rule 13.09 and its notes will be retained elsewhere in Chapter 13 of the Listing Rules and will continue to be administered by SEHK . For example, sub-rule (1)(b) is applicable in circumstances where there is an obligation to clarify inaccurate and/or misleading information already in the market. SEHK would still need to address this whether or not issues of price-sensitivity have arisen. Sub-rule (2) requires listed corporations dually listed on Hong Kong and overseas markets to make a disclosure to SEHK at the same time as the information is released to the other markets.

consultation and the SFC's approval in accordance with established procedures.

30. The SFC and SEHK consider that the delineation of duties is likely to be set out by amending the Memorandum of Understanding Governing Listing Matters between the SFC and SEHK, signed on 28 January 2003. They would finalize the details when the statutory PSI regime is enacted.

31. We have uploaded the consultation conclusions on our website at http://www.fstb.gov.hk/fsb/ppr/consult/psi.htm for public viewing.

Way Forward

32. We plan to introduce a bill into the Legislative Council to codify the PSI disclosure requirements in the SFO in the 2010/11 legislative session.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2011