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Submission to the SFC consultation on the Draft Guidelines on Disclosure of Inside Information

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CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published by the SFC.

Introduction

This document is submitted to the Securities and Futures Commission (SFC) in response to its Consultation Paper on the Draft Guidelines on Disclosure of Inside Information published in March 2010. In this submission, we will discuss the issues raised in the Consultation Paper and raise our opinions. We have also separately filed a submission to the "Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations" released by the Financial Services and the Treasury Bureau (FSTB), which was attached as an appendix in this submission for reference.

Background to the Guidelines

The objective of the guidelines is to provide assistance to listed corporations to comply with the proposed legislation of the disclosure of price-sensitive information, which is defined as information that can materially affect its securities' prices, proposed by the FSTB.

General comments

In general, the guidelines proposed are able to provide guidance to corporations in disclosing their information to fulfill their obligations under the proposed legislations by the FSTB. Therefore, we agree to most of the proposed guidelines. Nevertheless, there are several points that we would like to seek clarification or reconsideration by the SFC.

Rethinking proposed legal framework

Highlighted in paragraph 2, the proposed guidelines cannot be relied upon as an authoritative legal opinion. The issue is whether the SFC guidelines should be codified as subsidiary legislation, which can be done in pursuant to Section 397(P) SFO. Guidelines with statutory backing may result in greater certainty and higher deterrence against breaching.

Currently, Section 399(6) SFO provides that

> *"A failure on the part of any person to comply with the provisions set out in any code or guideline published under this section that apply to him shall not by itself render him liable to any judicial or other proceedings, but in any proceedings under this Ordinance before any court the code or guideline shall be admissible in evidence, and if any provision set out in the code or guideline appears to the court to be relevant to any question arising in the proceedings it shall be taken into account in determining that question."*

As violation of the guidelines does not necessarily cause the person to be liable and will only be considered as evidence in the Market Misconduct Tribunal (MMT), codifying the guidelines provides greater certainty and deterrence. Although legislation implies lower flexibility for any alterations, the high importance of the matter of disclosing inside information means serious consideration to codifying the SFC guidelines shall be given.

SFC's consultation service

It is mentioned in paragraph 10 of the proposed guidelines that the SFC will provide consultation service for 12 months from one month before the commencement date to assist corporations in understanding how to comply with the obligations laid out in the proposed guidelines. Nevertheless, the proposal also stressed that the SFC will not judge whether the price of a corporation's listed securities will be materially affected by certain information of the corporation, and thus whether the particular piece of information is inside information to be disclosed.

Nevertheless, it is often difficult for corporations to determine for themselves whether certain information should be disclosed given the lack of previous cases, and it is very likely that the advice provided by the SFC in the consultation service would be far from concrete as the SFC will not determine the nature of the piece of information for the listed corporations.

However, as the proposals are to prevent breach from happening, it is appropriate for the SFC to provide more constructive and concrete advice and thus provide consultation regarding both the information itself and the Safe Harbours to the corporations.

It should also be noted that the advice should be customized to different corporations instead of standardized, and should be "without prejudice" and cannot be used as an evidence in MMT in respect of liability.

We also suggest that the consultation may be considered when the MMT decides on remedies, where the penalty for the corporation concerned, which has been held liable, may be mitigated when the SFC has been consulted previously.

Safe Harbours permitting corporations to withhold disclosure of inside information

We largely agree with the Safe Harbours proposed in paragraph 47 of the proposed SFC guidelines, as they are able to take into account some exceptions. Nevertheless, regarding several Safe Harbours, we believe that further clarification is needed.

<u>Incomplete proposal or negotiation</u>

Although few examples are listed in the drafted guidelines to illustrate cases of "incomplete proposal or negotiation" (paragraph 55), it is ambiguous and thus difficult for both listed corporations and the SFC to determine what stage the proposal or the negotiation shall be in to be mature enough to disclose the inside information.

We understand it may be difficult to describe exhaustively in the SFC guidelines in what situations the listed corporation enjoys a waiver due to incomplete proposal or negotiation, but it may be appropriate for the SFC to respond, assessing on a case-by-case basis, to the queries from the listed corporations concerning immature stage of proposals and negotiations with more concrete advice on whether waivers will be granted.

Trade secret

Both the drafted SFC guidelines and the proposed legislation by the FSTB did not define clearly the vague term "trade secret" according to paragraph 57. It is highly probable that the waiver concerning "trade secret" may be abused by claiming all inside information to be trade secret, and thus it is desirable to make the term more precise.

It can also be inferred from the guidelines that blanket immunity is granted to all information regarded as trade secret, meaning that the SFC will cease to treat the so-called "trade secrets" of different nature differently. On the other hand, it may be advisable to follow the differentiation made in the regulations in the United Kingdom, where information regarding product development and intellectual property needs not be disclosed while important information that affects major projects should be.

Compromising market transparency solely for the sake of protecting trade secret seems undesirable. The UK provision can thus be a better alternative to the proposed Safe Harbour.

Disclosure waived by the SFC

It is mentioned that corporations may submit applications with explanations for exempting from disclosing certain inside information. We suggest that there should be guidelines on how the SFC exercises its discretion on granting waivers and how corporations can appeal for exemptions.

Timing of disclosure

The drafted guidelines stated that a listen corporation shall disclose the inside information as soon as practicable once it becomes aware of it, which we agree with this proposal.

However, referring to paragraph 41 of the drafted guidelines, it determines when the company has come to the knowledge of a piece of inside information by introducing the concept of constructive knowledge. It defines that a company have knowledge of the inside information once an officer actually knows or "ought to have" known the information in the course of performing his functions. We can contrast the proposal with the existing disclosure rules by referring to the Guideline on Disclosure of Price-sensitive Information issued by the Hong Kong Stock Exchange in January 2002,

> *"The guiding principle is that information which is expected to be price-sensitive should be announced promptly after it becomes known to a director or senior management of the issuer and/or is the subject of a decision by the directors or senior management of the issuer."*

The current rule provides that a corporation will not be considered to have possessed the knowledge of the inside information unless its senior managers or directors know it. However, in the drafted guidelines an "officer" is defined as a director, manager or secretary of, or any other person involved in the management of, the corporation. We find that it may impose a heavy burden on the listed corporation, because although it

may be reasonable to expect the corporation to disclose the information if the senior management comes to know it, it may be too strict if we expect the corporation to be able to disclose the information when only the middle management is aware of it. As a result, we suggest that companies should not be fixed with constructive knowledge unless the senior management or the directors ought to have known the inside information.

Judicial consequences of disclosure of inside information cases

Although it is mentioned that breach of the proposed SFC guidelines does not result in any legal consequences, it is understood that the SFC will sometimes bring cases to the MMT when breach of the SFO (i.e. the proposed legislation) happens. It is therefore suggested that the SFC clarifies under what circumstances it will bring the cases that involve breach of the drafted SFC guidelines on disclosing inside information to the MMT.

Conclusion

We agree that the proposed guidelines are able to provide authoritative assistance to corporations in disclosing their inside information and deal with exceptions through the Safe Harbours. With further explanation about the legal framework, the consultation service, the Safe Harbours, the timing for disclosure, and the judicial consequences, the guidelines will become clearer to practitioners and listed companies in Hong Kong.

Appendix

Submission to the FTSB Consultation: The Disclosure of Price-sensitive Information

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CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published by the Financial Services and Treasury Bureau.

Introduction

This document is submitted to the Financial Services and Treasury Bureau (FSTB) in response to its Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations published in March. In this paper we will discuss the issues raised by the FSTB in the Consultation Paper. We have also filed another submission to the Securities and Futures Commission, attached in this document as an appendix for the sake of completeness.

Background of the proposed codification

The objective of the proposed legislation is to foster transparency by providing that all Listed Companies should disclose information that can materially affect their securities' prices (Price-sensitive Information, "PSI"). On the other hand, the proposal has to cater for the legitimate interest of the Listed Companies. In particular, the rules ought to be sufficiently certain and should not impose too heavy a burden on the companies. Otherwise, the officials of the companies may release too much irrelevant information so as to ensure that they comply with the rules, and the public can be confused, defeating the underlying purpose of this legislation. The proposal should strike a balance between these competing interests.

Rethinking the proposed legal framework

The first issue is whether the SFC guidelines should also be codified as a piece of subsidiary legislation. This can be done in pursuant to Section 397(P) of the Securities and Futures Ordinance ("SFO"). As aforesaid, the need of certainty is of paramount importance. A statutory backing can reduce the litigation risk and give more certainty to the regime. This is especially so when a breach of the legislation may lead to civil liabilities. It is not uncommon for the Securities and Futures Commission ("SFC") to promulgate rules in the form of subsidiary legislations. The Securities and Futures (Disclosure of Interests – Securities Borrowing and Lending) Rules (Cap. 571X) may serve as an example.

Currently, Section 399(6) SFO provides that:

"A failure on the part of any person to comply with the provisions set out in any code or guideline published under this section that apply to him shall not by itself render him liable to any judicial or other proceedings, but in any proceedings under this Ordinance before any court the code or guideline shall be admissible in

evidence, and if any provision set out in the code or guideline appears to the court to be relevant to any question arising in the proceedings it shall be taken into account in determining that question."

It seems that the guidelines may not be conclusive evidence in the Market Misconduct Tribunal ("MMT") hearing, since a breach of the guidelines will not by itself make the person or company liable. Subsidiary legislation, in contrast, will provide certainty to the scheme.

On the other hand, in an ever-changing business world, flexibility is also an important consideration, so that the rules can keep abreast of the latest changes in the market. We understand that enacting a piece of subsidiary legislation will reduce flexibility, as any amendment to the legislation has to be gazetted, and is subject to the approval of the Legislative Council. In this respect, issuing guidelines seems to be advantageous. Nevertheless, given the importance of this legislation, and the significance of its effect, it can be argued that any changes to the rules must be scrutinized by the Legislative Council, and hence codification is also in the interest of the public. In any event, we urge the FSTB and the SFC to explain the rationale behind the use of guidelines.

Please find below our submissions on several issues arising from the Consultation Paper.

Question 1(a): Definition of PSI

The proposed legislation utilizes the concept of "relevant information" in the context of insider dealing. "Relevant information" is defined as the following in S.245 SFO:

"relevant information" (有關消息), in relation to a corporation, means specific information about-
(a) the corporation;
(b) a shareholder or officer of the corporation; or
(c) the listed securities of the corporation or their derivatives,
which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but which would if it were generally known to them be likely to materially affect the price of the listed securities.

We agree with the proposal. The proposed definition introduces a single test: whether the information is likely to cause material price change. According to case laws,

PSI consists of three elements. Firstly, the information has to be specific. Secondly, it has to be material. Lastly, the information should not be generally known. In relation to materiality, the touchstone is whether the information is capable of affecting the mind of a reasonable investor.

Thus, the definition is investor-oriented. The Listed Companies have to evaluate the information from the investors' point-of-view. The legislation therefore can afford greater protection to the investors. From the companies' perspective, the new definition seems to be clearer: all the criteria in the listing rules are subsumed into one single test, namely whether the information may affect the price. Moreover, there are sufficient case laws on this point, and the concept of "relevant information" is now fully understood, since it has been introduced in the context of insider dealing for 20 years. The companies can have a good grasp of the PSI concept. We therefore agree with the proposal.

Question 1 (b): Timing of disclosure

Under the proposal, once the company is aware of the information, the information has to be disclosed as soon as practicable. We agree that the companies should disclose such information as soon as practicable.

Nonetheless, ascertaining when the companies know the information is not without difficulties. The proposed legislation introduces the concept of constructive knowledge. The companies have knowledge of the PSI once an officer actually knows or "ought to have" known the PSI in the course of performing his functions. The proposal can be contrasted with the existing disclosure rules. According to paragraph 10 of the Guide on Disclosure of Price-sensitive Information, issued by the Hong Kong Stock Exchange in January 2002,

> *The guiding principle is that information which is expected to be price-sensitive should be announced promptly after it becomes known to a director or senior management of the issuer and/or is the subject of a decision by the directors or senior management of the issuer.*

Under the current regime, the company will not be deemed to have knowledge unless its senior members or directors know the piece of information in question. However, under the proposed rules, the company will be deemed to have knowledge of the information as long as an "officer" knows the information. "Officer" is defined in SFO Sch.1 as:

> *"officer" (高級人員)-*

(a) in relation to a corporation, means a director, manager or secretary of, or any other person involved in the management of, the corporation; or
(b) in relation to an unincorporated body, means any member of the governing body of the unincorporated body

This imposes a heavy burden on the listed company. While it may be reasonable to expect the company to disclose information that the directors are aware of, it will be too strict if we expect the company to disclose a piece of information when a middle-level manager is aware of it. Therefore, we suggest that the company should not be fixed with constructive knowledge unless the senior management or the directors ought to have known the PSI.

Question 1 (c): manner of disclosure

We agree that the information should be disclosed in an "equal, timely and effective" manner. We agree that the companies can comply with such requirement by disseminating the information through the current electronic publication system (HKEx-EPS).

Question 2 (a)(c): The 4 safe harbors

Disclosure prohibited by HK law

We agree with the proposal. The companies need not disclose the information if the disclosure is prohibited by local legislation

Negotiation

We agree that information in relation to the on-going negotiation needs not be disclosed. It should be emphasized that the companies ought to disclose such information if the relevant information is leaked. This is in line with the UK and the EU position.

Trade secret

The proposed legislation and the drafted SFC guidelines contain no definition of the term "trade secret'. Given that the concept of "trade secret" is potentially vague, we suggest that the legislation or the guidelines should define the term with greater precision.

Under the proposal, blanket immunity is granted. On the Contrary, in the United Kingdom, information in respect of product development and intellectual property needs

not be disclosed, while important information that affect major projects should be disclosed.

We suggest that the proposed legislation requires a balance between the importance of protecting the trade secret and fostering transparency in the market. It seems unwise to grant a blanket safe harbor. There may be cases where the advantages of disclosure will outweigh the possible harm to the companies. Therefore, we suggest that this safe harbor should be qualified by conditions similar to that of the UK provision

Liquidity support

Similarly, under the proposal blanket immunity is granted. The Consultation paper cited the UK position as an example. Nevertheless, it should be emphasized that before the Northern Rock crisis, companies in the United Kingdom are still obliged to announce their underlying financial problems, even if they are in serious financial difficulties. It was only after the Northern Rock crisis did the Financial Services Authority (FSA) began to re-consider this rule. The FSA eventually amend this rule in December 2008. Thus, it must be emphasized that establishing this safe harbor is rather uncommon before the Financial Tsunami.

We agreed that when a company is in dire financial difficulties, a delay in disclosure may be desirable, especially when the very existence of the company is under jeopardy. Nevertheless, it is unwise to grant blanket immunity. This safe harbor creates a weird scenario: when the news is so bad that disclosure will seriously affect the price of the company's security, the company, ironically, needs not disclose the information. Obviously, this safe harbor can frustrate the entire purpose of the proposed legislation.

The better approach is to authorize the SFC to grant waiver on a case-by-case basis. Again, the SFC should also be empowered to attach condition to the waiver.

There should be guidelines on how the SFC exercises its discretion and an appeal procedure should be established.

The legislation should clarify that the companies must disclose the information as soon as their financial problems are relieved.

Question 2 (b)(d): SFC's empowerment

We agree that the SFC should be empowered to grant conditional waiver in

relation to possible breach of legislation or court order in other jurisdiction. There should be proper guidelines and an appeal procedure in this regard, and the application must be dealt with in timely basis.

We agree that the SFC should be empowered to create new safe harbors if it is in the public interest to do so, and suggest that the SFC should consult the relevant stakeholders regularly.

Question 3 (a): Jurisdiction

We agree with the proposal that the MMT is the proper forum, given that the MMT specializes in this area and is experienced in dealing with cases involving "relevant information".

Question 3 (b): Remedies

This part concerns the legal consequences of a failure to disclose.

It seems that as to the individual officer, their obligation is not strict, but only to exercise reasonable care. We agree with this standard. Wholly innocent failure to disclose should not be sanctioned. On the other hand, the companies' obligation is relatively strict.

The company or the officer in question may be liable to damages if it is "fair, just and reasonable" to make them compensate the victims. This confers a wide discretion. We suggest that the legislation can draw an analogy with some tort actions, e.g. provides that "the person in breach may be liable to damages in accordance with the law of negligence".

We agree that a failure to disclose should not be made a criminal offence, although the intention of the company or officer in breach of the disclosure requirement may be relevant in determining the appropriate remedy.

In principle, we agree that the civil remedies proposed should be adopted. With respect to the maximum fine of $8 Million, we suggest that the legislation should not impose a maximum amount. There exists no sound policy reason to set a statutory limit. Otherwise, the companies or the officers may be able to benefit from a breach, although such scenario is rare. Another possible remedy is a disgorgement order if the companies/officers profit from the breach.

Question 3 (c): SFC's direct access to the MMT

The current system is a dual criminal and civil regimes.

As to the civil regime, the case is brought to the MMT by the Financial Secretary. This happens when the Secretary himself detects market misconduct, or when the SFC or the Department of Justice ("DOJ") refers cases to the Secretary.

Simultaneously, the SFC or the Secretary can refer the case to the DOJ. The DOJ may also detect misconduct itself. The DOJ will then decide whether to initiate criminal proceedings at the same time. It should be noted that the standard of proof in civil case is lower.

Under the proposal there will be no criminal proceeding. Thus, we agree with the proposed arrangement in relation to disclosure of PSI, i.e. the SFC can bring the case to the MMT directly. There is no need to refer the case to the DOJ or to report to the Financial Secretary. Nevertheless, the DOJ and the Financial Secretary should still refer cases to the SFC if they detect any possible breach.

In respect of the other market misconduct, we disagree with the proposal. The DOJ must be involved (because the DOJ have to decide whether prosecution should be brought), and it will not be desirable to allow the SFC to access the MMT directly without notifying the DOJ.

Question 4: SFC's Informal consultation

The proposal proposes that the SFC will only provide consultation in relation to the application of safe harbors to the Listed Companies. There will be no consultation as to the definition of PSI and the need of disclosure.

In providing such consultation service, a standardized answer is to be avoided and the SFC should give concrete and specific answers to the companies.

We suggest that the SFC should provide consultation in relation to both PSI and safe harbors to the Listed Companies. Nevertheless, its advice should be "without prejudice" (in relation to liability), and cannot be used as an evidence in MMT in respect of liability.

With respect to the remedy, we suggest that the MMT can take the SFC advice into account when considering the remedy, so that if the SFC has been consulted, the

company may still be liable, but the "penalty" may be mitigated. On the other hand, we understand that this will give companies an incentive to consult the SFC, since this gesture can reduce the severity of the penalty if it turns out that the companies are in breach. A possible solution is to provide that if a company over-uses the consultation service, the fact that it has consulted the SFC will not be taken into account in determining the penalty.

Question 5: SFC and SEHK's division of works

Under the proposal, the Stock Exchange of Hong Kong ("SEHK") will inform the SFC when it detects possible breach. Moreover, the SEHK's listing rules will still apply, so SEHK can also bring disciplinary action based on possible breach, in addition to the MMT proceeding brought by the SFC.

We suggest that there shall be no "double jeopardy" in the sense that a company may face an investigation of SEHK and a trial in the MMT (brought about by the SFC) for the same breach. We suggest that SEHK can still bring disciplinary action simultaneously, but it should be provided in its listing rules that when there is a parallel MMT hearing, the SEHK will treat the judgment of MMT conclusive evidence in respect of liability.

Conclusion

It is hoped that the proposed legislation can further foster transparency in the market on the one hand, and on the other hand ensure that the Listed Corporations' legitimate interest is not hampered. We sincerely hope that the FSTB can refine the proposed legislation after this consultation exercise.

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