Appendix

Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations (the "Consultation Paper")

While we are supportive of measures to further promote a culture of disclosure among Hong Kong listed companies, we have a number of serious concerns in relation to the specific proposals, as set out in this Appendix .

Of the disclosure obligations originally proposed for statutory codification[1], we consider the disclosure of price sensitive or inside information, being incapable of precise definition, to be the least well suited. The definition is necessarily broad and a decision as to whether a matter falls within its scope invariably involves a judgement call on the part of the company's board. The difficulty of the analysis coupled with the severity of the proposed sanctions, would put directors in an extremely unenviable position.

The primary difficulty in determining whether particular information is discloseable is that directors are required to determine, beforehand, whether the information would be likely to materially affect the price of the company's shares if generally known to persons likely to invest in the company's shares. As noted in the draft SFC Guidelines on Disclosure of Information ("SFC Guidelines"), the test is a hypothetical one and determining whether it is satisfied "has necessarily to be an assessment"[2]. As enforcement agencies, however, the SFC and MMT will have the luxury of hindsight and the knowledge that non-disclosed information in fact had a material affect on the share price obviously makes it harder for the directors to justify a decision made in good faith that it was unlikely to do so. With the need to second-guess investors' response to disclosure of any particular piece of information, there will inevitably be situations where directors simply get it wrong notwithstanding considered analysis of the information and the taking of professional advice. This gives rise to our primary concern, that the current proposals give insufficient protection to directors who make an honest and reasonable mistake.

For these reasons, we consider it essential that there is a complete defence from liability for listed companies, their directors and officers if they have acted honestly, reasonably and in good faith in the performance of their duties. Timely disclosure of price-sensitive information will be achieved not only by regulation and punitive deterrents but through the continued ability of Hong Kong listed companies to attract competent and responsible directors able to ensure compliance. The onerous nature of directors' responsibilities and harsh penalties proposed by the Consultation Paper are however likely to deter many suitable candidates from taking up company directorships, thus potentially undermining rather than enhancing the ability of listed companies, particularly SMEs, to meet their disclosure obligations.

It is considered that the severe penalties proposed could only be justified if "inside information" were defined by way of an exhaustive list of specific matters so that there could be certainty for those responsible for disclosure. However, that approach runs the

[1] SFC Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules of January 2005.
[2] At paragraph 23 of the SFC draft Guidelines on Disclosure of Information.

risk that important information will not be disclosed as it would be impossible to conceive of every situation that investors would consider important for all companies. It would also be difficult to keep the definition up-to-date with financial innovation and changing market conditions.

The more serious cases of non-disclosure warranting more severe penalties than those available to the Stock Exchange ("SEHK"), should in any event already be covered by existing provisions of the Securities and Futures Ordinance ("SFO"). Section 384 SFO imposes criminal liability if any public disclosure under the Hong Kong Listing Rules contains information which is false or misleading in a material particular, if there is knowledge or recklessness as to whether that is the case. The SFC has also recently prosecuted non-disclosure of price sensitive information under the Listing Rules under Section 214 SFO. In March 2010, directors of Wardley International Holdings Ltd. were disqualified for five years from being directors or otherwise involved in the management of a company for failing to ensure disclosure of material information to the company's shareholders.[3] Given the number of statutory provisions already imposing liability for false or misleading disclosure and the ability to impose penalties for non-disclosure under Section 214 SFO, we see little need for an additional statutory offence.

The temptation for listed companies and their advisers will be to err on the side of caution and disclose which could result in a large amount of superfluous disclosure. The strategy is also not without risk: the premature disclosure of incomplete or indefinite matters risks creating a false market and could well constitute an offence under the market misconduct regime of the SFO.

We note the intention that the Listing Rules' existing general obligation of disclosure will be amended to dovetail with the statutory provisions following a further public consultation to be conducted by me SEHK[4]. We believe that the proposed statutory codification would be best considered in conjunction with the proposed amendments to the Listing Rules. It is considered that the disclosure obligation under the Listing Rules and the SFO will need to be identical to avoid creating two overlapping but different regimes administered by two separate regulators. If there are matters which Listing Rules 13.09(1) and 17.10 and the notes thereto currently require to be disclosed which may not constitute inside information, these would be best dealt with elsewhere in the Listing Rules. With respect to the draft SFC Guidelines, it is not clear whether these are intended to replace or merely supplement the detailed guidelines already published by Hong Kong Exchanges and Clearing Limited in its Guide on Disclosure of Price Sensitive Information. We believe that compliance with, and enforcement of, the proposed statutory obligation will be best facilitated by the adoption of one set of rules with one comprehensive set of guidance. Anything that creates confusion as to the continuing disclosure obligations of listed companies risks damaging the reputation of the Hong Kong market.

We are also concerned at the suggestion that criminal sanctions could be imposed in the future for breach of the statutory obligations[5]. For the reasons set out in this letter, the imposition of criminal liability would be entirely inappropriate. As noted in the

[3] SFC Enforcement News "First director disqualification over timely disclosure of information", 17 March 2010

[4] Paragraph 3.4 of the Consultation Paper.

[5] At paragraph 2.29 of the Consultation Paper

Consultation Paper, the EU does not require member states to impose criminal liability and breach of the comparable provisions of the UK Financial Services and Markets Act attracts civil liability only (fines or censure).

Question 1(a): Do you agree with the proposal to adopt the existing definition of "relevant information" from the insider dealing regime under the SFO to define PSI?

As highlighted above, decisions on disclosure of price sensitive information involve difficult and subjective judgements. The amount of case law in jurisdictions adopting similar concepts of inside information pays testament to the ambiguity of the definition. Particular difficulty surrounds the hypothetical test of whether the information "would be likely" to "materially" affect the price of listed securities. What may seem obvious in hindsight is unlikely to have been so at the time the relevant matter occurred.

The draft SFC Guidelines do not address the degree of likelihood which would be required. They also refer to determining how the "general investor" would behave if in possession of relevant information without giving any guidance as to who would be a "general investor". These guidelines are considerably less clear than the guidance given in the Financial Services and Markets Act 2000 and the Disclosure and Transparency Rules ("DTR") and consideration should be given to more precise guidance, particularly on the meaning of "inside information", and ensuring that the companies will be able to rely on such guidance to justify their decisions in any MMT proceedings. For example, DTR 2.2.4(1) sets out the following explicit "reasonable investor" test: "In determining the likely price significance of the information an issuer should assess whether the information in question would be likely to be used by a reasonable investor as part of the basis of his investment decisions and would therefore be likely to have a significant effect on the price of the issuer's financial instruments." It should be noted that in the decision of the Irish Supreme Court in Fyffes Plc v DCC Plc [2007] IESC 36, the "reasonable investor test" was rejected because it was not provided for in the relevant statute or EU directive.

Question 1(b): Do you agree that a listed corporation should be obliged to disclose to the public as soon as practicable any "inside information" that has come to its knowledge, and that it should be regarded to have knowledge of the inside information if a director or an officer has come into possession of that information in the course of the performance of his duties?

The obligation should be to disclose such information as soon as *reasonably* practicable, which is the current requirement under Listing Rules 13.09(1) and 17.10. Paragraph 34 of the draft SFC Guidelines states that the proposed requirement to disclose information "as soon as practicable' means that the issuer should "immediately take all necessary steps that are reasonable in the circumstances" to make the disclosure. It should be made clear that such reasonable necessary steps will allow directors to ascertain relevant facts and take professional advice, where necessary, in order to reach a decision.

We agree with the proposal that information in the actual possession of the directors and officers of a company acquired in the performance of their duties should be attributed to

the company. It does not however agree with the actual wording in the draft Section 101B(2)[6] which additionally attributes information that "ought reasonably to have come into possession" of such directors and officers. A disclosure obligation in respect of information which company officers ought to have known (but did not in fact know) takes companies' disclosure obligations one step too far and should therefore be deleted. This would also be in line with the insider dealing offence[7] which requires actual knowledge that information is inside information.

It is considered that the term "officer" should be restricted to members of an issuer's senior management, i.e. those to whom the board has directly delegated management responsibilities. The current SFO definition which catches a manager or secretary of a company or any other person involved in its management is too wide. In the United Kingdom, a "person discharging managerial responsibilities" is defined in the DTR as either a director of an issuer or a senior executive who: (i) has regular access to inside information relating, directly or indirectly, to the issuer; and (ii) has power to make managerial decisions affecting the future development and business prospects of the issuer[8]. The Group would favour narrowing the category of officers whose knowledge is attributed to the issuer in a similar way to that adopted by the F.S.A.

There would also need to a defence from liability for a company to cover the situation where a director or officer is "on a frolic of his own", for example where an officer deliberately fails to disclose a matter to the board. This could take the form of a defence for the listed company and the other directors where a director or other officer is in breach of a duty owed to the company or in circumstances where reasonable steps have been taken to ensure compliance with the disclosure obligation.

The proposed Section 101B(3) which deems the disclosure of false or misleading information to be non disclosure of "inside information", and thus an offence under proposed Section 101B(1), should be deleted. The disclosure of false or misleading information in public disclosures under the Listing Rules is already a criminal offence under Section 384 SFO. If the information is likely to affect the issuer's share price, the disclosure of that information may also amount to a criminal or civil offence under Sections 277 and 298 of the SFO, respectively.

Question 1(c): Do you agree with the proposal that the disclosure must be made in a manner that can provide for equal, timely and effective access by the public to the information disclosed?

Yes.

Question 2(a): Do you agree to the provision of the four proposed safe harbours?

Yes, subject to the comments in the response to Question 2(c) below.

Question 2(b): Do you agree that the SFC should be empowered to grant waivers, and to attach conditions thereto?

[6] At page 30 of the Consultation Paper.
[7] At Section 270 SFO.
[8] FSA Handbook: Glossary definition of "person discharging managerial responsibilities".

Yes. We believe that the SFC should have much wider powers to grant waivers. The SFC's ability to waive the disclosure obligation is restricted under the proposals to situations where disclosure is prohibited by a foreign law or court order. It is suggested that the power to grant waivers, with or without conditions, should exist in any circumstances in which it is considered appropriate.

Question 2(c): Do you think that the legislation should provide for additional safe harbours? If so, what are these additional safe harbours?

As mentioned above, it will be crucial that listed companies, their directors and officers do not risk liability for decisions taken honestly, reasonably and in good faith. The proposed Section 101G(2) will make a director or officer liable for a company's breach if:

a. the breach was the result of an intentional, reckless or negligent act or omission on his part; or

b. he failed to take all reasonable measures to prevent the breach.

We are concerned at the breadth of paragraph (b) above. If the failure to take all reasonable measures involved negligence on the part of the director or officer, it should already be caught under paragraph (a) as a negligent act or omission. Paragraph (b) therefore seems to involve behaviour which is not negligent. It is our view that directors and officers should not be liable in the absence of intent, recklessness or negligence on the part of the individual and that paragraph (b) should therefore be deleted.

With respect to safe harbours, we further consider that:

i. there should be a specific safe harbour for a decision that information does not constitute "inside information" which is made by a company's directors acting honestly, reasonably and in good faith in the performance of their fiduciary duties;

ii. the safe harbour for information concerning "an incomplete proposal or negotiation" should not be subject to the condition that the outcome may be prejudiced if the information is prematurely disclosed;

iii. the above safe harbour should be extended to expressly cover negotiations in relation to litigation, hedging activities and fair value accounting issues under review;

iv. a safe harbour should be provided for information that comprises matters of supposition or is insufficiently definite to warrant disclosure; and

v. a safe harbour should exist for information generated for the internal management purposes of the company.

The proposed safe harbours at paragraphs (iv) and (v) are taken from the Australian Securities Exchange Listing Rules (Rule 3.1A.3).

Question 2(d): Do you think that the SFC should be empowered to prescribe further safe harbours in the form of rules under the SFO?

Yes.

Question 3(a): Do you agree to extend the jurisdiction of the MMT to handle breaches of the statutory disclosure requirements?

Yes.

Question 3(b): Do you agree with the proposed range of civil remedies as set out in paragraphs 2.31, 2.35 and 2.36?

No. The proposed maximum fine of HK$8 million, only HK$2 million less than the maximum fine which can be imposed for a criminal offence under the SFO's market misconduct regime, is excessive for civil liability. The proposed HK$8 million fine is therefore at best, only marginally below the level requiring the adoption of a criminal standard of proof and rendering inadmissible compelled self-incriminating evidence. It should also be noted that the MMT has no fining power in the case of civil market misconduct offences under Section 257 SFO. While the MMT may order the payment of an amount up to the amount of any profit made or loss avoided, it has no fining power if there has been no financial benefit to the perpetrator of market misconduct. We see no reason why the MMT should have greater fining powers under the proposals than under Section 257 SFO.[*Note: proportionality is dealt with at paragraph 2.33 on page 16 of the Consultation Paper]* As already mentioned, only directors and members of senior management should face liability and only if they are knowingly, recklessly or negligently involved in the breach.

We consider that "disqualification orders" and "cold shoulder orders", which could effectively end a person's career, are inappropriate. In the limited circumstances in which they might be justified, it is more than likely that the individual would face charges under one of the market misconduct offences. Neither the FSA in the UK nor the Australian Securities and Investment Commission ("ASIC") can impose these penalties for breach of the continuous disclosure rules.

A particular shortcoming of the proposed civil sanctions is they do not provide for a timely rectification of the non-disclosure. Cases of suspected non-disclosure will often be able to be dealt with and remedied informally. We consider it essential that the enforcement authority, whether the MMT or SEHK, should be able to issue a private reprimand (as provided for by Rule 2A.09 of the Main Board Listing Rules) to deal with less serious breaches of the disclosure obligation. In the U.K., private warnings may be given by the FSA and in Australia, "infringement notices" have been adopted by ASIC as a remedy for less serious breaches of the statutory continuous disclosure requirements. Features of "infringement notices" are that the issuer can make submissions in a private hearing before the notice is issued; the issuer can choose to remedy the alleged breach without this being taken as an admission of liability; and ASIC can impose fines.

Question 3(c): Do you agree to grant the SFC direct access to the MMT to institute proceedings on breaches of the statutory disclosure requirements?

No. We consider that referral to the Financial Secretary in the first instance provides an important safeguard.

Question 4: Do you agree that the SFC should provide informal consultation for the listed corporations with regard to the statutory disclosure requirements, initially for a 12-month period ?

Given the many years of experience of SEHK in interpreting and giving guidance on the continuous disclosure obligations of the Listing Rules, the Group considers that the consultation process should continue to be provided by SEHK. If consultation were to be provided by the SFC, this would need to be provided for more than the proposed 12-month period. We are concerned in particular by the statement at paragraph 20 of the Consultation Paper that "*The SFC expects that the questions for consultation will generally relate to the application of safe harbours, rather than deciding for a listed corporation whether certain information has to be disclosed".* The consultation process should involve the regulator assisting the issuer in reaching a decision as to whether certain information is discloseable given the particular circumstances of the issuer.

Question 5: Do you think that the administrative and enforcement arrangements proposed by the SFC and SEHK in paragraphs 3.8 to 3.9 are appropriate? Do you have any comments on the respective roles of the SFC and SEHK to further enhance clarity?

While we agree that the proposed statutory disclosure obligations coupled with the ability of the MMT to impose fines would serve to underpin the Listing Rules' disclosure obligations, it nevertheless feels that SEHK's role as the frontline regulator puts it in the best position to deal with these obligations on a day-to-day basis. SEHK's proximity to the market facilitates the pragmatic application of the continuous disclosure obligations with regard to the particular circumstances of individual issuers.

We would suggest borrowing from the Australian model under which the Australian Stock Exchange ("ASX") is primarily responsible for monitoring and enforcing compliance with the listing rules' disclosure requirements whereas ASIC has responsibility for enforcement of the Corporations Act provisions. Other than drawing matters to the attention of the market and suspending a listed company's securities, ASX has no disciplinary powers in respect of companies or their officers. Thus, in cases where ASX believes there has been a serious breach of the disclosure obligations or the Corporations Act, it will refer the matter to ASIC for further investigation under the terms of a Memorandum of Understanding. This is very similar to the current Hong Kong model and suggests that the day-to-day discussions with issuers regarding compliance could be the responsibility of SEHK while enforcement of the statutory provisions could be vested with the SFC.

In conclusion, we sincerely hope that the above points will be taken into consideration in finalising the statutory disclosure obligations, and that this consultation will be effective. It is **imperative** that the disclosure obligations of listed companies are looked at in the context of the existing provisions of the SFO, the Companies Ordinance and the Listing Rules as a whole. We would therefore like to see the issue of SEHK's consultation paper on the proposed amendments to the Listing Rules as soon as possible and would urge that SFO amendments are made simultaneously with, and not in advance of, the Listing Rule amendments. Clarity as to the disclosure obligations and comprehensive guidance on their interpretation provide the best means of ensuring compliance. Hence the importance of putting in place one comprehensive framework governing disclosure of price sensitive information.

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