THE LAW SOCIETY OF HONG KONG 香港律師會

Securities and Futures Ordinance – Part XV

This paper sets out the views of the Hong Kong Law Society's Securities Law Committee and Company Law Committee on the provisions of Part XV of the Securities and Futures Ordinance. These provisions relate to disclosure of interests in the securities of listed companies by substantial shareholders and directors.

For present purposes our comments have been presented at an issue level and we have not included a detailed technical analysis on each issue raised.

1. Time of notification

The time of notification is currently 3 business days. While this is broadly in line with international standards, in practice, the 3 business day time limit is difficult to comply with – in particular for shareholders which need to aggregate interests arising across different product lines, different services, different legal entities and different jurisdictions.

A related issue is the question of whether or not Saturdays should be counted as a business day for the purposes of the 3 business day requirement. While Saturdays have traditionally been considered a business day in Hong Kong, in practice, most relevant businesses will only operate reduced hours (equivalent to less than half those of a week day) in Hong Kong. Other jurisdictions will not treat Saturdays as a business day at all. The Committees are of the view that Saturdays (like public holidays) should not be counted as a business day for the purposes of the 3 business day requirement.

2. Trade date and settlement date

For reporting purposes, disclosure implications are treated as arising:

(i) in respect of a purchase of relevant securities, on the trade date; and

(ii) in respect of a sale of securities, either:

  (a) if the sale is required to be completed within 4 trading days on the Stock Exchange, on the settlement date; or

  (b) if the sale is required to be completed within 5 or more trading days after the date of the contract, on the trade date (i.e. date of the contract), and a second notice on the settlement date (i.e. date of delivery of shares by the seller).

The use of a single date for each purchase or sale avoids a technical requirement for multiple disclosure obligations arising on each transaction. This approach is helpful for shareholders

with relatively unsophisticated positions not arising under some of the more convoluted deeming provisions of Part XV. However, for other shareholders this approach causes practical difficulties. Shareholders with more sophisticated interests and those which require cross product and cross business line aggregation will often need to rely on their trading platform systems to provide the necessary data for the purpose of calculating whether, and if so what, disclosure obligations arise. We understand that, in practice, having a different basis for treatment of purchase transactions and sale transactions imposes an (in our view) unnecessary administrative burden. The Committees recommend that only one of the settlement date or the trade date be used for both sales and purchases (subject in general terms to the existing principles set out in Part XV.

3. Accuracy of the HKEx website

The Committees have concerns regarding the accuracy of the public register maintained by HKEx. Specifically:

(i) the Committees are of the view that there should be a set of clear procedures for the reporting of errors so that errors can be rectified by HKEx as quickly as possible and that incorrect information should not be retained on the register;

(ii) the information contained on the register is presented in a manner which some find to be misleading. In particular, it is often unclear if and when a substantial shareholder has ceased to hold a substantial shareholding. The Committees are of the view that, while the register should maintain historic records, a clear distinction between current and historic records should be made in the way in which the register is presented. Possibly separate folders could be used.

The Committees are of the view that it is important that the integrity and usefulness of the public register should not be comprised by inaccurate information and should be presented in as clear a manner as possible.

4. Availability of electronic filing

At present it is not possible to disclose both long and short positions in the same electronic filing (even where both positions arise under the same transaction or a group of related transactions). It is necessary to do manual filings and submit by facsimile.

The Committees are of the view that efficiency would be enhanced if it were possible to do all filings electronically (as well as manually).

We understand that some market participants are reluctant to make electronic filings due to concerns about the reliability of the delivery channel. The Committees are of the view that it would encourage more electronic filing if a receipt was generated automatically on submission. The receipt should record, amongst other things, the date and time of the filing and the reference number in case the person making the filing needs to follow up on the status of the filing with the HKEx.

5. Disclosure requirements in relation to offerings

The additional and specific disclosure requirements in relation to offerings are excessive and add little to the transparency which is the principle objective of imposing the requirements. More specifically, the requirement to make specific filings for each company in a group

(rather than the use of "box 22" filings) imposes an administrative burden which, in our view, generates little, if any, benefit to the market. The Committees recommend that the group exemption for wholly-owned group companies be reviewed and, if possible, expanded and simplified.

6. Double counting

There are some circumstances in which multiple disclosures are required by a group of companies. For example if a group provides a full range of services to a managed fund which is a substantial shareholder of a listed company, it is possible that in respect of a single holding of securities:

(i) the fund (if a separate legal entity) will have a discloseable interest;

(ii) the fund manager will have a discloseable interest;

(iii) if the group provides prime broking services, the prime broker will have a disclosure interest; and

(iv) if the group provides custodial services, then the custodian may have a discloseable interest (in practice not all custodians have a sufficiently narrow mandate to take advantage of the "exempt custodian interest" provisions - see paragraph 13 below).

While there is a provision in the SFO for an exemption from double counting and reporting obligations where disclosure is made by a parent company on a consolidated basis, in practice the provisions are drafted in such a way that not all groups will be able to take advantage of them. The Committees recommend that the provisions of Part XV which are intended to eliminate the need for multiple reporting/double counting be reviewed and, if possible, expanded and simplified.

7. Usefulness of information provided

For the purposes of this comment a distinction needs to be made between substantial shareholders who hold a genuine substantial/controlling/majority shareholding and those who hold a less genuine shareholding or deemed shareholding by virtue of the aggregation of a number of disparate interests or deemed interests (typically large institutions will be required to aggregate a number of unrelated interests or deemed interests arising under different business activities).

While information about dealings by genuine substantial shareholders and directors is often commented on (e.g. in press articles), there is seldom public comment on disclosures relating to (sometimes frequent) small changes in position or changes in specified particulars made by institutional investors. As far as we are aware, there is no evidence that the market has found such disclosures (or the detailed information contained in the disclosure notices) useful.

The Committees are of the view that the size of the *de minimis* exemption available to substantial shareholders in respect of both long and short positions could be increased without impairing the quality or usefulness of the information provided to the market. Increasing the *de minimis* exemption for substantial shareholders would materially reduce the compliance burden faced by many shareholders who actively trade their position, and/or who

are required to regularly file disclosure notices because of the nature of their business activities.

8. Inconsistent consolidation/ring-fencing

Certain interests held by different group companies can be ring-fenced from other group interests such that (at least) two independent pools of interests in relevant share capital are created which, for disclosure purposes, need not be aggregated. In particular, independent fund management activities.

However, there are at least two respects in which the current approach results in unequal treatment of market participants:

(i) ring-fencing under these provisions is limited to business entities which operate through separate legal entities - it is not available where the relevant business entities are divisions within a single legal entity (even where internal segregation of the business entities is strictly enforced through, for example, Chinese walls);

(ii) ring-fencing under these provisions is only available when the relevant entities are established in a limited number of approved jurisdictions. There are a number of jurisdictions which are not approved which, in the view of the Committees, should be. These include Japan and Singapore.

The Committees are of the view that the above issues:

(a) create an uneven playing field - imposing additional compliance burdens on some entities but not on others for reasons unrelated to their respective interests in relevant securities; and

(b) impact on the usefulness of the disclosures made generally by effectively requiring some entities to file disclosure notices in circumstances where entities which use a different business structure or are domiciled in different jurisdictions do not have to file disclosure notices.

The Committees are of the view that the information provided to the market in these circumstances can only be said to represent a partial, and, consequently, a possibly misleading, picture of the interests of (in particular) institutional investors in the securities of listed companies.

9. Complex derivatives

The treatment of certain derivatives under Part XV remains unclear (although adopting a position that where the number of underlying shares in which a person is interested is uncertain, no disclosure obligation arises is extremely helpful.)

Of particular concern are some of the more complex products. For example, a "call put combo" which contains both put and call elements where only one side of the contract can ever be executed may result in different treatment depending on the form of the documentation used.

In some cases the disclosure treatment depends on the form of the documentation used. If a single document is used then it may (depending on particular terms) be possible to avoid

having any discloseable interest by drafting the contract appropriately. However, if the more traditional approach of using separate documents for each side of a trade involving both put and call elements is used then multiple disclosure obligations are likely to arise.

The Committees are of the view that it is illogical that disclosure obligations should depend on the form of documentation used and it would be constructive to consider the extent to which some netting of positions in paired trades could be allowed for the purposes of determining disclosable interests. Alternatively, clarification of the treatment of such products regardless of the form of document would be desirable.

Separately, there is some confusion on how some "derivative on a derivative" transactions should be treated (e.g. an option on a convertible) where the derivative doees not expressly refer to shares in its pricing/valuation. It appears that such “secondary” derivatives do not have "underlying shares" (and they clearly do not if they are cash settled), but clarifying this area would be helpful. The Committees are of the view that it would be helpful to clarify the treatment of such transactions.

10. Disclosure notices

There are circumstances where it is not clear which code on the disclosure notice should be used. This typically arises where a disclosure obligation arises for multiple events. For example, if a change in a substantial shareholding triggers a disclosure obligation and the change arises from several distinct events (e.g. a combinations of acquisitions, disposals and other events such as stock borrowing and lending transactions) then it is unclear whether (for example) Code 103 or 104 should be used in Box 17. At present only one code can be inserted. While there may be some circumstances in which separate forms can be used, this will not be practicable in all circumstances (e.g. because some of events will be *de minimis*) and, in some circumstances, the use of multiple forms for each individual event will often be nonsensical where, individually, each event is itself *de minimis*.

In addition, a number of people have commented that:

(a) the forms are not particularly easy to understand or complete;

(b) the prescribed codes for notification of a change in the nature of an interest are not particularly helpful, as there are only 3 codes in the forms for changes in the nature of interests, so almost all changes will need to be disclosed as “Miscellaneous – other”.

11. Legal status of the SFC's Outline of Part XV

The Committees are of the view that the SFC Outline of Part XV is an extremely useful guide to the SFC's interpretation of the provisions of Part XV and is of great assistance. Many people rely on it extensively in assessing their position and interpreting the substantive provisions of Part XV.

However, given the complexity of Part XV it is possible that discrepancies between Part XV and the contents of the guide exist. An example regarding short positions under section 310 is given below.

It would be helpful if the SFC would state publicly its position where a discrepancy between the SFC's outline and Part XV exists which results in an incorrect disclosure notice being filed (or no disclosure notice being filed at all). The Committees are of the view that it would

be unreasonable for a prosecution or other disciplinary act to be taken in circumstances where a breach of statute is at least partially attributable to reliance (where appropriate and in good faith) on a publication by the market regulator.

12. Fax numbers

The fax numbers for listed companies are not always easy to find (especially for PRC companies). This can cause delay in making filings. The Committees recommend requiring HKEx to obtain and maintain a list of fax numbers for listed companies which can be used for disclosure purposes.

13. Exempt custodian interests (Section 323(1)(b))

The current requirements for an interest held by a custodian to be an exempt custodian interest include that the custodian have no authority to exercise discretion in relation to either dealing in interests in relevant share capital or exercising any voting rights attached thereto.

In practice many custodians will take custodial interests on terms which do include a residual power to deal and exercise voting rights (either in general or in limited circumstances). Even if not expressly provided in a custodial agreement a custodian will, as a matter of law, have a legal right to vote by virtue of being a registered shareholder and that right to vote will only be excluded as between the custodian and the beneficiary to the extent that it is expressly or impliedly excluded by the terms of the custodian's appointment. In addition, as a matter of law a custodian will have a lien on securities held in custody. As a specific example a custodian who acts as a security trustee will not benefit from the exemption.

The Committees are of the view that the exemption for custodian interests as presently drafted is overly narrow, that few custodians will be able to take advantage of the exemption and that consideration should be given to widening the exemption to allow a wider and more representative range of custodian interests to be treated as exempt.

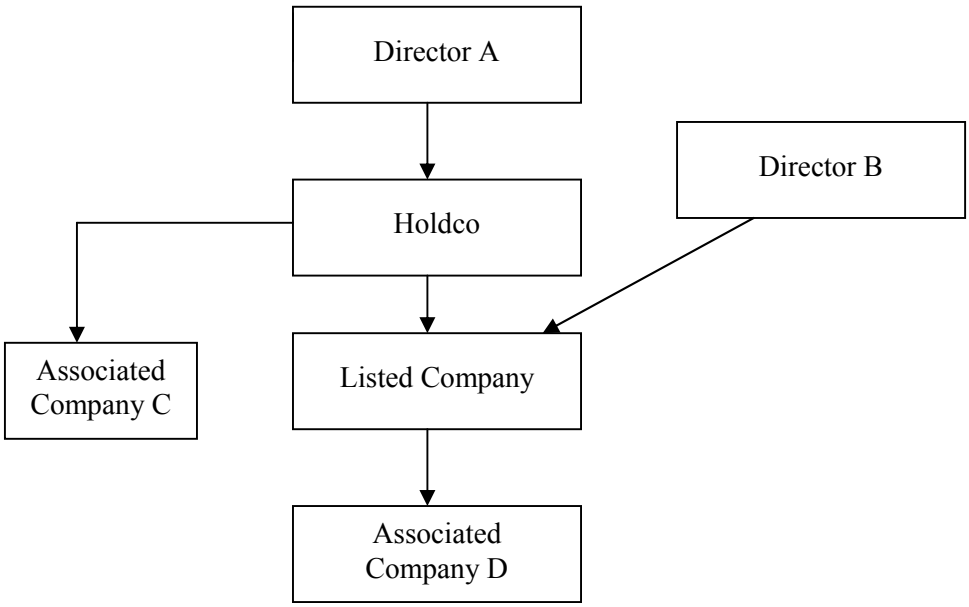
14. Exempt security interests (s. 323(1)(f))

The Committees are of the view that the concept of an exempt security interest is too narrow. Specifically, the exemption does not treat as exempt security interests, securities which are pooled with a common mortgagee, nominee or security trustee which is not itself a qualified lender. In our view such arrangements should be treated as exempt security interests. (The holder of such security interest will invariably be precluded from claiming an exempt custodian interest by reason of the terms of its appointment.)

The Committees are of the view that the exempt security interest provisions should extend to persons who hold securities for the account of, or subject to a security interest in favour of, a qualified lender (acting in the ordinary course of business).

In addition, the position arising where shares are held as security for a syndicated loans where some, but not all, of the lenders are qualified lenders should also benefit from the exemption.

15. Director's disclosure obligations



The SFC outline on disclosure of interests (Paragraphs 3.9.6 and 3.9.7) expressly states that the interests of Director B in Associated Company D can be disregarded for disclosure purposes (on the assumption that Director B has filed a disclosure notice in respect of his/her interest in the listed company). This is a very sensible approach since otherwise Director B will have to file a DI Form whenever the Listed Company incorporates a subsidiary.

However, the SFC has previously advised that a director in the position of Director A would have to file a disclosure notice in respect of his/her deemed interest in Associated Company C (even if a disclosure notice in respect of the director's indirect interest in Holdco has been filed). This should not be the intention of the legislation since this means that Director A will have to file a DI Form whenever Holdco incorporates a subsidiary.

The Committees are of the view that Director A should be subject to the same disclosure obligation in respect of the Associated Company C as Director B in respect of Associated Company D (i.e. none).

16. Trigger for short positions

Although Section 310 does not contain any trigger requiring disclosure of a short position when a company first obtains listing, the Committees understand that it is the SFC's policy to require a substantial shareholder (or director) to disclose its (notifiable) short positions when a company first becomes listed. While the Committees are of the view that the omission in Section 310 was inadvertent, the absence of a requirement to disclose short positions on listing seems to be reasonably clear.

17. Timing of initial disclosure

On listing, initial disclosures must be submitted within 10 business days (s. 325(2)). After listing, disclosure notices must be made within 3 business days of a relevant event occurring (s.325(1)). The Committees are of the view that these requirements can result in anomalies

as to the timing of disclosure obligations arising from post listing trading. The Committees recommend that the 10 business day requirement for initial disclosure should automatically be reduced when a subsequent notification obligation arises before the expiry of the 10 business day period .

18. *De minimis* exemption

There are doubts as to whether or not the *de minimis* exemption achieves its intended purpose (in particular, but not limited to, its application on a change in the nature of a persons' interests). The Committees recommend that the *de minimis* exemption be reviewed and amended to make it easier to follow so that there is greater certainty that it will achieve its intended purpose.

19. "Equitable interests" exemption

The exclusion in s.313(13)(i) could be extended. Currently it only applies where an "equitable" interest has been previously notified, which limits the circumstances in which the exclusion will apply. As for instance, interests in unidentified shares (e.g. pursuant to an on-market transaction) and in unissued shares are not equitable, so completion of an on-market transaction or a subscription do not appear to qualify for this exemption.

20. Definition of "debentures"

The Committees are of the view that this needs to be revised. In the Outline, the SFC takes the view that a debenture means any "financial instrument" which is extremely wide. The Committees take the view that the definition of debentures should be limited to "debt securities" (which meaning shall exclude debentures in private companies).

21. Definition of "Qualified overseas scheme"

The exclusions in this definition are problematic, in that holders will not know whether there is a sufficient number of holders from time to time. The Inland Revenue Department has issued a practice note (No. 20 of June 1998) to the effect that schemes which have been genuinely marketed do not have to reach the specified number of investors. The SFC adopting a similar approach here would help.

22. Exemptions do not apply to short positions

Most of the "disregards" do not apply to short positions. This is not necessarily logical, and can undermine the benefit of the exemptions, and a review of this area would be helpful.

Also on intra–wholly owned group short positions, Section 313(13)(v) needs to be extended to expressly cover these short positions.

23. "Non- aggregation" exemption in s. 316(5)

There are major problems with the "independence" requirement, as many large fund management groups have policies (e.g. market/sector weighting) which all managers must comply with but which, on the strict line taken by the SFC so far, would prevent the managers from counting as operating independently. The Committees are of the view that

there should be greater flexibility for the "non-aggregation" exemption to have to the benefits held out for it by the SFC.

24. Concert party exemption - S. 317(5)(b)

This exemption from the concert party provisions applies only to underwritings of shares. The Committees are of the view that this needs to be extended to interests in shares such as convertibles and warrants (or other equity derivatives).

25. Disclosure of person in accordance with whose directions a company acts

This requirement under s. 326(4) and the corporate disclosure form is too widely described in the Outline of Part XV (paragraph 2.15.2). The Committees are of the view that this needs to be reviewed and amended.

26. Exclusions Regulations –"conditional offer"

This definition should be amended to remove the ambiguity as to whether the offer can also be subject to other conditions than the acceptance condition.

27. Securities lending/borrowing – SBL Rules

Rule 3 should be extended so that persons "up" a corporate chain from a shareholder can also get the benefit of this exemption, which is currently drafted as person-specific and not a general "disregard" (contrast Rules 5 and 7).

28. Enforcement

The SFC has adopted a practice of issuing warning letters relating to suspected breaches without:

(a) allowing the person concerned on opportunity to explain their position first; or

(b) mentioning that a criminal offence will not have taken place where the person concerned has a reasonable excuse for failing to act in accordance with the provisions.

The Committees are of the view that the above represents an approach to enforcement which falls short of the standards of fairness market participants might reasonably expect. In addition, the Committees are also of the view that this approach increases the likelihood that prosecutions will be contested and/or judgments obtained appealed against.

29. Responses to queries

The SFC is currently declining to answer queries relating to Part XV of the SFO. While the Committees understand that the SFC's workload is currently very high, the Committees are concerned about the implications. Given the complexity of these provisions and the uncertainty surrounding the application in certain cases, from both a legal and a market perspective, it is inevitable that persons affected or potentially affected by Part XV and their advisers will need to seek guidance from the market regulator from time to time. Where the market regulator is unable or unwilling to provide clear guidance, market participants will need to proceed on the basis of their own and/or their professional advisers, interpretation of the relevant provisions and certain consequences may follow, including:

(a) the interpretation of the relevant provisions made by a market participant and/or their professional advisers may be different from the views of the SFC;

(b) different market participants and/or their professional advisers may reach different interpretations on relevant issues - resulting in inconsistencies in the application of the disclosure regime and, possibly, misleading disclosures being made (or not made);

(c) market participants may elect to err on the safe side and make disclosure in circumstances where they may not be required to do so - this is costly for both the market participants, the listed companies involved and the HKEx;

(d) it provides a potential defence to allegations that a market participant has breached the SFO.

The Committees recommend that the SFC be willing to provide clear guidance on the application of Part XV of the SFO (and on the application of relevant Hong Kong law and regulations generally).

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