Comments on the Consultation Paper on Review of Disclosure of Interests Regime under Part XV of the SFO

1. Section 2.1

The Law Society is very strongly of the view that the proposals to require disclosure of additional information by substantial shareholders and lenders to substantial shareholders set out in the consultation paper are:

(i) inappropriate; and

(ii) not in the interests of the market or market participants generally.

There are also practical difficulties in implementing the proposals in this area.

Disclosure of pledges generally

The Consultation Paper states that "Recently, forced sales or speculation about controlling shareholders defaulting on margin calls have caused the share price of certain companies to fall or accelerated previous falls as margin calls were triggered." and "There are arguments that disclosures of security interests could forewarn the market of such possible cases."

The Committee is of the view that speculation about the possibility of a substantial shareholder's shares being sold is not a "problem" that requires a solution. Speculation about what substantial shareholders may or may not do (either on the buy side or the sell side) is an inherent and fundamental part of any free securities market. We fail to see any reason why a security interest should be treated as a special case. In any event even if such speculation is viewed as being a "problem", requiring disclosure of pledges and advance notice (see below) of intention to enforce security interests is a "solution" that is likely to create more problems than it will solve.

The alleged purpose of requiring disclosure of pledges is to "…provide investors with a signal about which companies might have certain risks associated with share pledges. Investors might then act in time to protect their investment or to decide whether to invest in a company or not." This additional information is likely to increase speculation about possible forced sales at times when either the market as a whole or the shares of the individual company concerned are falling in price (as may happen for reasons unrelated to the share pledge). Such speculation raises a genuine risk that the acts of speculators (e.g. sales and short sales) will have the effect of pushing the share price lower, increasing the risk of a margin call being made. The Law Society agrees with the observation that disclosure of security interests of themselves does not tell investors about the risk of default.

Put differently, such disclosure increases the potential for (i) unfounded speculation in the share price (arguably, a false market) and (ii) the risk of a margin call being imposed on the substantial

shareholder. At the same time, the proposal fails to provide additional useful information to the market unless a lot of information is provided in addition to the fact that shares have been pledged (see below for the Committee's comments on this issue). It is inappropriate for Hong Kong's regulatory regime to create such speculative risks.

2. Disclosure of additional information

Disclosure of information about pledges of shares can be approached in two ways:

(i) by placing the obligation on the pledgor (i.e. the substantial shareholder) to provide additional disclosure; and

(ii) by removing the exemption currently given to qualified lenders.

It would be inappropriate for the exemption currently available to qualified lenders to be removed. As qualified lenders will often provide credit facilities to more than one shareholder in a listed company secured over the shares of that listed company, any removal of the exemption would require aggregation not only of the qualified lender's interest in securities held as collateral, but also any other interests or deemed interests which they may have. In effect, aggregation will reduce, if not completely destroy, the rational for requiring such disclosure in the first place. Requiring a break down in such aggregated interests would be unduly burdensome and generate a mass of potentially confusing information.

The Law Society is of the view that placing an additional burden of disclosure on the substantial shareholder, would not be particularly helpful (due to the wide range of individual circumstances that could apply) unless considerable details (e.g. the amount secured against the pledged securities) were publicly disclosed. Such disclosure would be an unacceptable erosion of the substantial shareholder's privacy rights. It is only in very rare circumstances that requiring a participant in Hong Kong's financial markets to disclose details of their personal financial position can be justified. Even if such disclosure would address the perceived problem (which is very much doubted), this is not one of them.

In addition, the Law Society agrees with the observation in the Consultation Paper that requiring substantial shareholders to make disclosure of security interests granted over their shares may result in a "significant number" of security interests being disclosed but "would still not provide the market with information on the likelihood or impact of default".

One of the perceived problems with forced sales of a substantial shareholder's shares in a listed company is that it results in a large number of shares being sold on market. There is no logical basis for treating a forced sale by a lender as being any different from sales of large blocks of shares generally - for example, where the borrower initiates the sale rather than the lender initiating a forced sale or where a substantial shareholder sells for reasons unrelated to financial pressure from lenders. There is no suggestion that substantial shareholders should be obliged to make public disclosure of all circumstances which could give rise to a sale of a large number of shares.

3. Advance notice

It has been suggested that the current requirement for impending forced sales to be disclosed within three business days be changed to require disclosure of impending forced sales immediately after:

(i) in the case of a lender, it becomes entitled to exercise the security interest and has evidenced an intention to exercise the voting rights or control their exercise or taken any step to do so; and

(ii) in the case of a substantial shareholder, it receives verbal or written indications from the lender of any of the circumstances in (i).

The proposal would also require, not only that disclosure be made immediately, but that the number of shares be disclosed and that the listed company itself make an immediate announcement.

The effect of these proposals is to give the market advance notice of a lender's intention to enforce its security interest. The Law Society is very strongly of the view that this proposal should not be adopted for the following reasons:

(i) the proposal places the interests of other shareholders in the listed company ahead of the interests of (a) the substantial shareholder, (b) the security holder and (c) (potentially) the other creditors of the substantial shareholder. There is no rational basis for giving precedence to one group of stakeholders in a listed company over other interests. Put differently, it is neither fair nor reasonable to require some stakeholders to effectively subordinate their interests to those of other shareholders;

(ii) advance notice of the possibility that a large block of shares may be force sold is likely to result in (i) increased selling by other shareholders and (ii) a reduction in buying interest. Together these consequences have considerable potential to reduce the price of the shares concerned - in effect panic selling would very well be triggered by the implementation of the proposal. The effect of panic selling is difficult to quantify but, as a general observation, would be expected to be more severe in shares which are comparatively illiquid;

(iii) panic selling in advance of a lender enforcing security has the potential for several adverse consequences:

  (a) making it more likely that the security will be enforced - either by reason of a decline in the share price or in anticipation of a decline in the share price;

  (b) lenders will recognise the above risks and react by tightening lending criteria and being less flexible in enforcing security interests;

  (c) if the price of the pledged shares falls sufficiently low (e.g. to a level where the proceeds of sale will be insufficient to discharge the secured indebtedness), lenders may elect to refrain from selling until the share price has improved, effectively creating a overhang depressing the price of the shares concerned for some time and to the detriment of all the company's other shareholders.

Put differently, the disclosure of interests regime is a regime that requires persons on whom a disclosure obligation falls to make disclosure after the event giving rise to a disclosure obligation has occurred. By requiring what amounts to advance disclosure of security interests being enforced, the proposal significantly changes the basis on which certain market participants are treated (to their detriment). The Law Society is only aware of two other instances where advance notice of a person's intentions must be given to the market:

(i) a controlling shareholder of a listed company in the 12 months following listing under the Listing Rules; and

(ii) an offeror (or persons acting in concert with the offeror) during an offer period under the Takeovers Code.

The above instances of advance disclosure being required are limited to very particular circumstances and therefore do not qualify as a precedent for imposing similar requirements in other circumstances.

4. Interests in "associated corporations" at holding company level

In paragraph 15 of the Law Society's submission stated that a director should not be required to disclose interest in an "associated corporation" (being an "associated corporation" at the holding company level) if such interest is held entirely through the holding company, and the director's interest in the holding company has already been disclosed. Otherwise, this would lead to the ridiculous result that, whenever the holding company incorporates a subsidiary (which may have nothing to do with the listed issuer), a disclosure obligation arises.

The response of Securities and Futures Commission ("SFC") (Section 4.8(c) of the Consultation Paper) is that, since such a subsidiary will be a "sister" company of the listed issuer, the SFC would like to have information about it because:-

> *"Part XV is also intended to provide information for greater transparency of connected party transactions. As such, we consider disclosures of deemed interests of a director in such "sister" companies appropriate."*

It seems that the approach of the SFC in dealing with this issue is: (i) contrary to its overall approach to the Part XV of the Securities and Futures Ordinance ("SFO") (ii) cannot serve its own stated purpose, and (iii) impose unreasonable burden on a director who chooses to hold his interest in a listed company through a corporate entity which also holds his other investment interests.

According to the SFC, the purpose of the disclosure requirement of Part XV of the SFO and its predecessor, the Securities (Disclosure of Interests) Ordinance ("SDIO") has always been, inter alia, to improve transparency in the Hong Kong market by improving the extent of information available on **price, securities dealings and person having interests in shares** (see page 4 of the Consultation Paper under the heading of "Reasons for Review"). The SFC's approach to connected transaction has always been that this is a matter for the Listing Rules. This is in fact emphasised by the SFC in the following statement in its response in section 5.2 (in relation to definition of "substantial shareholder") of the Consultation Paper:-

> *"As this is a Listing Rules issue, we passed this comment to the Exchange. The Listing Rules have traditionally focused on identifying conflicts of interests and connected party transactions, while Part XV focuses on market transparency and providing investors with information to enable them to make investment decisions. Accordingly it may be that the 2 regimes have different emphases."*

Further, if the intention of the requirement is to identify connected persons, this approach alone (i.e. without substantive amendments to the SFO) could hardly do the job. A substantial shareholder is not subject to such requirement which is only applicable to director and, if the associated corporation is held by the director directly (i.e. not through the holding company), it would fall outside the disclosure regime.

The result of such an interpretation is that whenever a majority shareholder director chooses to hold his interest in a listed company through a holding company (which incidentally also holds his other investment interests), he has to make disclosure whenever the holding company acquires or establishes a subsidiary which may have nothing to do with the listed issuer. This could not have been the intention of the legislation; and the obligation imposed by this approach is not only unduly burdensome but also, for the reasons given above, irrelevant.

(b) **Enforcement policies**

In response to requests for clarification of enforcement policies (the Law Society's request is set out in paragraphs 28 and 29 of our earlier submission), the SFC simply stated that *"the Enforcement Division of the SFC does not initiate prosecution action in every case, and follows clear guidelines on action to be taken against those who have breached the provisions of Part XV"*.

Such a response is not sufficient to address the concerns of market participants. The SFC should publish the "clear guidelines" cited in its response in the interest of transparency which the SFC sets out to promote.

5. International standards and competitiveness

The Law Society is also of the view that the proposals are out of step with other developed markets. In a world where several financial markets are increasingly competing for new listings, imposing additional burdens on substantial shareholders and lenders alike will not enhance Hong Kong's attractiveness as a place in which to seek a listing.

The Law Society of Hong Kong
Securities Law Committee
Companies and Financial Law Committee
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