SUBMISSIONS ON PROPOSED CHANGES TO THE LISTING RULES "BLACKOUT PERIOD"

The Law Society would like to take this opportunity to elaborate on its submission on Question 18.4 in the *Combined Consultation Paper on Proposed Changes to the Listing Rules* ("*Combined Consultation*"). As stated in our earlier submissions, we strongly disagree with the Exchange's proposal to extend the "blackout period" to commence from the financial year/period end date and end on the date of publication of results.

(a) Unreasonable length of blackout

For Main Board issuers, under the proposed formulation, assuming the issuer uses the maximum time allowed for preparing its annual and half-yearly results, the blackout period constitutes a total of seven months in the year (five months for accounting periods ending on or after 31 December 2010). This is unacceptably long. The blackout period needs to balance the interests of directors and investors and a proposal that prohibits directors in their capacity as investors from dealing for more than half of the year is too long.

For companies producing quarterly results, assuming that 45 days are used for preparing the quarterly results after the end of each quarter, an additional 60 days (reduced from 90 days because of a one-month overlap) are blacked out, making a total of nine months in the year (eight months for accounting periods ending on or after 31 December 2010) in which directors and their associates may not deal in their shares.

Generally under the Listing Rules, quarterly reporting is not required for Main Board issuers, only recommended. For A and H share dual-listed issuers, however, quarterly results are mandatory and therefore, directors of such companies would find themselves not being able to trade for close to three quarters of a financial year.

For GEM issuers, there is a three-month preparation time for annual results and 45 days each for half-yearly and quarterly results (quarterly results being mandatory for GEM companies). The GEM blackout period amounted to a total of seven and a half months in the year. Although shorter than the Main Board blackout, this again renders directors' shares illiquid for an unreasonable length of time.

Under the new rule, Hong Kong will have the longest blackout period amongst the top financial markets in the world. It is doubtful why this is necessary or desirable, given there is no indication that Hong Kong suffers from an undue volume of insider dealing or related market abuse.

(b) Rationale

Insider dealing

The Exchange stated in paragraph 18.12 of the *Combined Consultation* that the purposes of the Model Code are to buttress the Securities and Futures Ordinance (SFO) provisions against abusing price-sensitive information, and to promote investor confidence by removing or mitigating suspicion of abuse. Paragraphs 4 and 5 of the Model Code reiterate the statutory prohibitions against insider dealing and market manipulation, and the general requirement for directors to refrain from dealing while in possession of price-sensitive information.

In this context the Model Code blackout period operates as a blanket prohibition (regardless of what information is in the dealer's possession at the time of dealing). It would not be appropriate to extend the blackout indiscriminately to cover all kinds of cases while the regulatory interest lies only in the prevention of SFO insider dealing cases.

In any event, the kind of insider dealing likely to cause regulatory concerns in the Hong Kong market tends to take place more on the back of information about specific transactions and exceptional corporate activities than on financial results. The committee does not see any reason to target periodical financial reporting as a particular risk area.

Lengthening the blackout period to an unreasonable extent does not contribute significantly to enhancing Hong Kong's insider dealing regime. If the regulators intend to step up the insider dealing regulations, amendments to the SFO would be the more appropriate way to achieve this.

Directors' knowledge

In principle, directors in a company are particularly informed investors and could potentially abuse their position. This state of affairs is inevitable under our company laws and regulations. There are already clear and tough rules on insider dealing to catch egregious cases and the proposed extension of the blackout period will be an overkill.

The new blackout period also suffers from artificiality. In reality, management will be aware of the financial results of the company for some time before the financial period-end. In theory, there is no reason for the blackout to commence on the period-end date rather than, say, one month earlier. The Law Society cannot find a satisfactory justification for the proposed length of extension.

Directors as long-term investors

The Exchange's proposition that, as a matter of regulatory philosophy, management should be long-term investors in a listed company is at least highly debatable. If there is a need to address the issue, it may be more appropriate to do so by law reform. The committee submits that, whilst re-considering the blackout rule, the Exchange should not be unduly influenced by a wish to promote directors' long-term commitment as shareholders.

Encouraging quicker and more frequent reporting
One of the perceived benefits of the extended blackout period is more frequent financial reporting. There is an incoherence here as directors of companies that report on a quarterly basis are actually in a worse position in terms of their freedom to deal. Under the new rule, the more frequently a company reports, the more restrictions there are on its liquidity. The proposed new rule flies in the face of one of its stated objectives.

The pros and cons of quarterly reporting warrant further debate for which this submission is not the appropriate forum. In any event, it is submitted that the Exchange should not be unduly influenced by concerns that directors may be withholding information through delayed or infrequent financial reporting to advance their personal gain. This assumes bad faith on the part of directors and is not borne out by evidence as a prevalent problem for the market in general.

(c) Practical problems
Investment structures
It is submitted that the unreasonably long blackout period may severely undermine flexibility of investment structures and affect Hong Kong's position as an international financial centre. Private equity funds and other institutional investors very often appoint a member to the issuer's board and depending on the shareholding arrangements, the board appointee's inability to deal could also render it inappropriate for the appointor to deal. This is central to the investor's exit rights and may affect the desirability of investing in a Hong Kong listed company at all.

In a small market like Hong Kong, high quality persons with a good understanding of financial markets, high corporate governance standards and business acumen are highly sought after by companies. Any rule that discourages such persons from taking up directorships of listed companies will be detrimental to Hong Kong’s position as a sophisticated financial centre.

Takeover defence
As has been highlighted by some commentators, a lengthy blackout period also undermines management/controlling shareholders' ability to use a common defence against hostile takeover bids or manipulative market tactics, namely buying shares in the market and supporting the price. The proposal that in legitimate cases the company may apply to the Exchange for a waiver is unrealistic. This is because manipulative acts are purposely made hard to detect and when it is detected, time will be of key importance. The additional time it takes for the Exchange to digest the facts and come to a conclusion will likely render the defence illusory.

Consequences of dealing
The Exchange has focused on the negative aspects of directors’ dealings. However, on the other side of the equation, given directors’ disclosure of interest requirements, such dealings may help inform the market of director’s views on the company’s prospects. It is submitted that in formulating the policies, the regulators should consider not only abusive cases, but also potential positive aspects of directors’ dealing.

Liquidity
Hong Kong is attempting to position itself as one of the world's premium financial centres. An important element to this is ample market liquidity. Putting severe restrictions on directors' dealings, especially in the current depressed economy, will reduce liquidity and will damage Hong Kong's interest as a whole.

In particular, trading in many family companies is so illiquid that removing a further source of dealing may in practice be counter-productive to investors' protection.

(d) Inconsistency
Assuming the appropriate general mandates have been given, there is nothing in the Listing Rules preventing listed companies from issuing or repurchasing securities during the blackout period, if this is approved by the board.

There is an inherent inconsistency in that, if directors are presumed to be in possession of price-sensitive information during the blackout period and are themselves prevented from dealing, they should not in theory be able to approve dealings by the issuer.

It is submitted that the Exchange is correct in its current practice of not taking the presumption to its logical extreme because it would be too onerous on the part of the issuer and the director. This highlights the importance of striking a balance between good corporate governance and commercial practicality. It would be wholly undesirable to expand the blackout period drastically as currently proposed.

(e) Sufficient time for consultation
The market, especially listed companies, should have been given more time to digest and consider a proposed rule change that has such far-reaching and potentially destabilising impact. Such a rule may lead to directors' resignations and board reorganisations for some companies. Ample time will be required to find suitable candidates to fill the vacancies and re-consider the board structure. It is not appropriate for the Exchange to give the market notice of mere months.

In view of the strong views expressed by market participants, the Law Society believes it is appropriate to reconsider the proposal.

To conclude, Hong Kong, renowned for its free economy, should not be overburdened by unnecessary rules and regulations with speculative benefits. It is through effective governance and high flexibility that the Exchange can become attractive and competitive with other markets of the world. It is submitted that the drawbacks of the Exchange's proposed approach far outweigh its benefits.

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