Consultation Paper on the Proposed Guidelines for Market Soundings

The Law Society's Submissions

The Securities and Futures Commission (the "SFC") on 11 October 2023 issued a consultation paper on "Proposed Guidelines for Market Sounding" ("Consultation Paper").

In response, the Law Society provides the following submissions. The same abbreviations and definitions appearing in the Consultation Paper are used in this submission.

GENERAL COMMENTS

The Law Society appreciates SFC's effort in the proposed draft Guidelines for Market Soundings set out in the Appendix to the Consultation Paper.

That said, the proposals in the Consultation Paper appear to be inconsistent with those corresponding regulatory provisions in other major global financial centres (such as Australia, the EU, the UK and the US). We express concerns. We also note that the current proposals duplicate and potentially are in conflict with the existing provisions of the Hong Kong Securities and Futures Ordinance (Cap. 571) ("SFO") governing insider dealing. At the moment, we are not convinced of the legality of setting up a separate regulatory regime without seeking a direct amendment to the insider dealing provisions contained in the SFO to address the issues raised in the Consultation Paper.

RESPONSES TO THE CONSULTATION QUESTIONS

Q1. Do you agree with the scope of application of the Proposed Guidelines? If not, please explain.

Law Society's response:

We have reservations regarding the scope of application and the proposed definition of "market sounding" put forward in the Consultation Paper. Our concerns include: -

(A) Departure of regulatory standards between Hong Kong and other financial centres

The proposed definition of "market soundings" in the Consultation Paper includes communication of all non-public information, whether such information is price sensitive or not. This is a *very broad definition.*

The comparable regulatory provisions in Australia, the EU, the UK and the US governing market sounding indicate, whether expressly or impliedly, that there is an imperative consideration as to whether such non-public information communicated is "price sensitive" or "material"[1]. Many leading jurisdictions and global financial corporations have also adopted this definition by way of common global industry practice.

The courts of Hong Kong take significant references to judicial cases from other common law jurisdictions. The potential deviation of Hong Kong regulations from the approach taken by other leading financial institutions could prejudice the Hong Kong courts and legal professionals in advising on securities laws for a case scenario in Hong Kong, when they are unable to take reference from similar cases overseas. This is highly undesirable and it could work against the policy aim on development of financial regulations of Hong Kong and the global harmonisation of regulations, which were highlighted by SFC's CEO in her earlier speech this month[2].

[1] The usual terminology used in the industry is MNPI – ie. material non-public information.

[2] https://events.bizzabo.com/BloombergGRF2023/home

(B) Conflict with the current SFO provisions under Part XIII and Part XIV of the SFO

Sections 245 to 249 and 285 to 294 of the SFO govern insider dealing. Over the years, with the publication of many judgements and SFC guidance materials, the legal and compliance professionals in the industry have established policies and procedures addressing the handling and processing of "inside information". These policies and procedures have been tested by investigations and disciplinary actions by the SFC Enforcement Department. Following from the above, an industry standard and practice have evolved and been developed regarding "insider dealing" which are well understood and accepted by market participants, the Court and legal practitioners.

The Consultation Paper appears to contemplate the implementation of a parallel regime to the existing "inside information" regime. If this is the case, this likely would create additional administrative burden on intermediaries. From a regulatory oversight perspective, it also raises questions about the necessity of parallel monitoring under two regimes simultaneously.

Notably, if a change in the current market standard is warranted, the SFC can seek a revision of Part XIII and XIV of the SFO, in order to replace the current legislation with more refined new requirements, instead of issuing an additional guideline establishing a new and parallel regime that is in conflict with the existing market standard under sections 249 and 289.

(C) Ambiguity of the "carve outs" contained in Section 1.3 of the Proposed Guidelines, Burden of proof of the "carve outs"

Section 1.3 of the Proposed Guidelines provides for certain carve-outs to "market soundings".

We note that some descriptions or language in the provisions are ambiguous and open to different interpretations. Section 1.3(b) of the Proposed Guidelines provides exemption to transactions "*commensurate with ordinary day-to-day trade execution*". In the absence of an objective quantifier of what constitutes "ordinary" trade execution, it is a challenge

for a sell-side firm (usually the in-house Legal and Compliance Department) to determine whether or not the carve-out applies.

Also, section 1.3(b) of the Proposed Guidelines is drafted in a way that potentially provides a defence to Section 1.2 of the Proposed Guidelines. Typically, in the experience of practitioners in private practice and in-house counsels, the SFC Enforcement Department will usually interpret such provisions as "legal defences". This carries a reverse burden of proof (i.e. the burden of proof to demonstrate that a set of circumstances does not exist rests with the licensed corporation). A licensed corporation would unfairly be made to carry the burden of proof in evidence to prove its innocence, upon an ambiguous definition as pointed out in the foregoing paragraph. We would strongly suggest the SFC to take reference to the similar provisions in other jurisdictions and to provide more clarity on the operation of these sections.

(D) Practical and economic concern

Hong Kong often plays the role of the Asian hub or headquarters for mid/back office function in global financial institutions. This is frequently the case for the compliance control room function, which means a lot of job opportunities in Hong Kong

A practical concern is that if the Hong Kong regulation regarding market soundings substantially deviates from the position adopted in other key Asian financial centres (i.e. Singapore, Japan), this might result in Hong Kong being considered as a market "outlier" and their internal policies on market soundings to be marked "global (ex Hong Kong)". In the long run, this may result in Hong Kong playing less of a global/regional consolidated supervisory role in terms of control room/regulation of information flow function, as other regional financial centres gain in importance and stature.

Q2. *Do you consider the definition of "market soundings" to be clear and appropriate? If not, please explain.*

Law Society's response:

Please refer to our response to Question 1.

Q3. *Do you have any comments on the examples of factors to consider when determining the level of certainty of the corresponding potential transaction materialising in connection with a market sounding?*

Law Society's response:

We note that the term "*express an interest… in proceeding with a possible transaction*" in the footnote under Section 1.2 of the Proposed Guideline is arguably too broad and impractical.

Clients of a licensed corporation regularly communicate with the corporation to express their view on the market and investment strategy, and ask for global stock market updates in the foregoing days/weeks. Very often market participants express interest in a number of stocks that falls within their investment parameters (especially true and frequent for themed funds). Such communications are part of the general market daily dynamics, and most of the time do not necessarily amount to a deal (eg. block trade) even when an initial interest on a specific stock had been expressly mentioned.

We suggest that the footnote with the three sample factors be simplified to whether a mandate/engagement has been entered between a corporation and the client, which is more objective and clear.

Q4. *Do you agree that a Market Sounding Intermediary has a duty to maintain the strictures of confidentiality of non-public information passed or received during market soundings? If not, please explain.*

Law Society's response:

With reference to our response in Question 1 above, there is an existing standard established market practice under Part XIII and XIV of the SFO in which most licensed corporations already ascribe to. We note that most licensed corporations and their legal and compliance advisors have little issue with the current standard on confidentiality upon insider information.

We believe that most licensed corporations and their legal and compliance advisors are against the idea of having a new and duplicated monitoring regime

that may be in conflict with the existing regime under Part XIII and XIV of the SFO.

Q5. *Do you agree that, from the standpoint of the Code of Conduct, a Market Sounding Intermediary should not trade on or use any non-public information passed or received during market soundings for its own or others' benefit or financial advantage? If not, please explain.*

Law Society's response:

Please refer to our response in Question 1.

Q6. *Do you have any comments on the Core Principles in the Proposed Guidelines as outlined above?*

Law Society's response:

In respect of Core Principles 2 to 5, with reference to our responses to Question 1 to Question 5 above, the ambiguity in the proposed scope and definition of "market soundings" render it difficult for a licensed corporation to implement a set of practical policy and control procedures, and to develop a set of review procedures.

In respect of Core Principle 6 (together with its footnote), which requires (i) the compulsory use of office-provided communication channels at all times and at all stages of a market sounding, and (ii) that the existing practice of Hong Kong brokers and European sell-side firms (under MAR) to take contemporaneous notes immediately following an unrecorded call is not permitted in the SFC's new proposal, the Law Society has grave concerns on this as set out in the following:-

(A) **The international nature of the Hong Kong securities and debt market**

Hong Kong is an international city. Many clients of a licensed corporations are located outside of Hong Kong. These clients include many large fund houses based in Europe, the Middle East, the Americas, as well as various sovereign funds and family offices around the world, spreading across various key international time zones.

These investors participate in Hong Kong market soundings on a daily basis, be it IPO, debt issues or block trades. Salespersons of licensed corporations in Hong Kong communicate with them as much as they can during Hong Kong office hours to perform initial sounding, but very often these clients call back to respond to soundings (subsequent to initial sounding) beyond normal Hong Kong office hours, when the salespersons are not in the office, e.g. at home, in restaurants, on planes. The salesperson may not have an office-provided communication channel available to them outside the office.

To disallow the taking of a subsequent contemporaneous record would make the participation of these international investors difficult.

(B) Shortage in widely available technology in the market

Contrary to the SFC's observation in its soft consultation, the technology to voice record a mobile phone conversation and to automatically save/archive on a licensed corporation's system is not yet widely available in the industry. A majority of the existing licensed corporations, even the large and medium size global firms, currently do not have such mobile conversation recording technology in place.

If the proposal is made mandatory, the market may see a number of medium or smaller size sell-side corporations ceasing to participate in market soundings or even leaving Hong Kong. It is crucial to have these medium and small licensed corporations to participate in the Hong Kong IPO market as their orders traditionally form at least 20% of a typical Hong Kong IPO transaction, in terms of size and number of orders.

(C) Alignment with secondary market order taking

Under paragraph 3.9 of the current SFC Code of Conduct (at its footnote), in respect of secondary market orders received by a salespersons of a licensed corporation, if the order comes in a situation where the salesperson does not have immediate access to an office-provided channel (eg. outside office hours or during a work trip), the salesperson can first communicate with the client on the order and then make a contemporaneous note in the firm's system to record the order.

We strongly suggest the SFC adopt the same regulation in respect of communication under the Proposed Guidelines.

From a practical point of view, it is very difficult for a salesperson to distinguish whether the client is calling in respect of a market sounding deal or a secondary market deal. If there are two sets of regulations governing client calls, it is likely to be difficult for a licensed corporation to implement procedures across all product types in all departments.

(D) **Alignment with international practice**

As noted by the SFC in the Consultation Paper, the EU allows market sounding communication in unrecorded calls followed by minutes/notes to be made (note: same for Australia). We strongly suggest the SFC to ensure that the regulator regime for market sounding in Hong Kong is, so far as reasonably practicable, made consistent with regulatory requirements in Europe and Australia. A deviation of the Hong Kong regulatory regime from international practices may have a detrimental effect on Hong Kong as a jurisdiction, as identified in our response to Question 1 above (under 1A).

Q7. *Are there any other areas which you think the Core Principles in the Proposed Guidelines should cover? If so, please provide examples.*

Law Society's response:

We do not have any comment on this.

Q8. *Do you agree with the proposal for Disclosing Persons to adopt the use of a standardised script? If not, please explain.*

Law Society's response:

In respect of the first attempt at market sounding, we have no objection to the mandatory use of a standardized script across all salespersons within a licensed entity. This standardized script can outline the minimum points for a salesperson to cover. We note that this is indeed the current market practice in Hong Kong and most major financial centres.

In respect of the subsequent communications between a salesperson and his/her client following the salespersons reading the standardised script (in the same call

or the next call with the client), before the client accepts wallcrossing, a certain level of flexibility should be permitted in order to allow the salesperson to address any questions the client may ask/ any content specifically applicable to the licensed corporation – without the need to seek specific SFC approval.

Q9. *Do you have any comments on the minimum content and sequence of information set out in the standardised script?*

Law Society's response:

Please refer to our response to Question 8.

Q10. *Do you agree that Disclosing Persons should not provide specific information that may allow the Recipient Person or potential investor to identify the subject security before receiving relevant consent from the Recipient Person or potential investor? If not, please explain.*

Law Society's response:

Please refer to our response to Question 8.

Q11. *Do you agree that Disclosing Persons have an obligation to determine if non-public information disclosed by them during market soundings has been cleansed? If not, please explain.*

Law Society's response:

We do not agree to this suggestion.

On one hand, this proposal potentially presents a material burden on the day-to-day operations of a licensed corporation in that it would require a licenced corporation to constantly monitor the public domain on information being published, just to satisfy a regulatory requirement specifically applying to Hong Kong, but not to other jurisdictions. This adds to the cost of doing a deal in Hong Kong, compared with other more cost-friendly jurisdictions in the same time zone.

On the other hand, some information such as the ultimate beneficial owner of the stock may never go into the public domain even after the deal completes. Hence, the client can practically never be fully "cleansed".

More importantly, this issue has already been sufficiently covered in the current market practice established under Part XIII and XIV of the SFO. The principle is, if a buy-side client has "actual or constructive knowledge" of an inside information and then trades on it, the client may potentially breach the SFO insider dealing provisions. It must be highlighted that, when we consider whether there was "insider dealing", the importance is to see the information received on the buy-side end. It is often the case that one buy-side client receives market sounding information from multiple sell-side firms on the same deal, and sometimes the buy-side client receives deal information directly from the issuer of the securities as well simultaneously. Hence, a sell-side firm can never really "cleanse" a buy-side firm, because a sell-side firm would never know what a buy-side firm knows or not know from its multiple sources, and many times a sell-side firm may know less than the buy-side client.

That said, a sell-side firm can only provide news updates (as opposed to "cleansing") to a buy-side firm from time to time as a courtesy, but not mandatorily. A buy-side firm can "cleanse" itself from restrictions by relying on the information and updates it receives from multiple channels, after exercising its own assessment and judgement upon Part XIII and XIV of the SFO.

Q12. *Do you agree with the proposed periods of record keeping and details of the records to be kept by Disclosing Persons? If not, please explain.*

Law Society's response:

We disagree with the proposed provisions on record keeping, as its presents a discrepancy to existing provisions in the Code of Conduct:-

- for verbal communications, paragraph 3.9(b) of the Code of Conduct on order taking requires only a 6-month retention period

- for written bookbuilding records, paragraph 21.3.9 of the Code of Conduct on Bookbuilding requires a 2-year retention period.

We suggest the SFC to ensure that the market sounding record keeping requirements are made consistent with other existing record keeping requirements in the Code of Conduct. Furthermore, it is confusing to market participants to specifically distinguish records coming from the same sales team when engaging with external record storage service providers.

Also, the requirement to maintain a list of external persons who are in possession of non-public information following market soundings under Section 3.4(e) of the proposed Guidelines needs to be clarified. It is unclear whether this list shall include professionals such as lawyers, accountants, consultants, and/or their respective firms. The flow of information inside a law firm or an accounting firm is outside the reach and knowledge of a licensed corporation, and is mainly governed by insider dealing provisions under the SFO. A licensed corporation shall not be obliged to do something that falls outside the scope of their actual and reasonable knowledge, from a legal perspective.

Q13. *Do you agree that a Recipient Person should designate a properly trained person(s) to receive market soundings? If not, please explain.*

Law Society's response:

On Question 13 and Question 14, we note that this is the first time that the SFC proposes regulations on communications from a buy-side perspective.

We received comments from members who act for or work with the buy-side. We are given the following observations and suggestions: -

(A) The proposal does not line up with the prevailing international standards on definition of "market soundings"

We repeat our comments in our response to Question 1 above, under sub-header (A).

(B) The proposal does not line up with the prevailing international standards on buy-side specific requirements

For the SFC's reference:-

- Australia and US do not impose training requirements on market sounding.
- For EU and UK, the relevant regulation specifies that the recipient person shall receive training as to how to distinguish whether the information received is MNPI (material non-public information), which is similar to the regime we have in Hong Kong under Part XIII and XIV of the SFO.
- the relevant regulation does not impose compulsory voice recording or record keeping obligation on part of the buy-side information recipients.

We suggest the SFC to align with the regulations of these major international financial centres.

(C) Confusing situation when a buy-side firm has already been sounded out by another sell-side firm

We refer to our response to Question 11 above. Frequently when a sell-side firm attempts to sound out to a buy-side firm, and after the buy-side firm agrees to the market sounding conditions (eg. confidentiality), the buy-side firm realises that it has already received information regarding the same share/debt issue from another sell-side firm. In such a situation, would all the communications from each buy-side firm to the sell-side firm need to follow the new proposed regulation on tracking, training and monitoring and recording? If yes, this can considerably increase the cost and manpower required on the buy-side end in its Hong Kong office.

(D) Non-SFC licensed corporations are not governed

Notably, the SFC Code of Conduct only applies to SFC licensed buy-side corporations, which are mostly holding Type 9 licences.

Buy-side entities, including insurance companies, unlicensed PE funds managers, sovereign funds and family offices are not required to follow these requirements. This presents an unfair competition among the buy-side entities in respect of resources and cost to be devoted to complying with these new provisions.

(E) Easy avoidance by basing a buy-side team outside of Hong Kong

The new proposal appears to be highly susceptible to circumvention, particularly by buy-side entities with various trading desks across different jurisdictions, which is very common. Buy-side entities could potentially avoid being subjected to the SFC's regulation by designating an office/desk *outside* Hong Kong as the recipient person of market sounding information flowing from a Hong Kong sell-side firm. For instance, if a firm has a Singapore office, it could simply designate the Singapore office as the recipient of all market soundings from Hong Kong sell-side firms, thus avoids the application of the SFC's new measures to that market sounding activity. The Singapore desk will not have to spend resources on tracking, training and monitoring and recording.

(F) Lack of clarity

The training requirement is unclear. It does not elaborate on what specific training is necessary for individuals receiving market soundings, and could the information recipients challenge the sell-side disclosing party as to whether the disclosed information are falling into carve-outs?

Q14. *Do you agree with the proposed periods of record keeping and details of the records to be kept by Recipient Persons? If not, please explain.*

Law Society's response:

Please refer to our response to Question 12 on record keeping.

With reference to our response to Question 14 which is on buy-side specifically, notably other comparable jurisdictions (such as Australia and the US) do not impose such a record keeping requirement. For the EU, it is noteworthy that the records kept by the buy-side entities are primarily limited to MNPI arising from market sounding, and as explained in our response to Question 13.

Q15. *Do you think a six-month transition period is appropriate? If not, what would be an appropriate transition period? Please set out your reasons.*

Law Society's response:

A 6-month transition period can be considered as insufficient.

Given the additional Hong Kong-only stringent internal control that licensed corporations will be required to adopt in order to adhere to the new rules under the Proposed Guidelines (eg. assessment of public and non-public information, assessment of carves-outs, tracking, standardised script, 24-hour-7-day market updates and cleansing, name list on internal and external personnel of the disclosing and receiving parties), we suggest that a transition period of at least 15 months would be a more realistic period to enable market participants to properly prepare.

Note: One concern that we have regarding the Proposed Guidelines is that some licensed corporations may simply take the view that, instead of dealing with the cost and practical hassle of adhering to the Proposed Guidelines, a more straightforward solution would simply be to relocate their sell-side function to alternative cost-friendly Asian financial centres, such as Singapore. That would be detrimental to the importance of Hong Kong as a global financial centre.

The Law Society of Hong Kong
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