
Guidelines on Analyst Conflicts of Interest

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GUIDELINES ON ANALYST CONFLICTS OF INTEREST EFFECTIVE APRIL 1, 2005

The SFC's Guidelines to Address Analyst Conflicts of Interest (the "Guidelines") came into effect on April 1, 2005. These impose strict requirements on investment banks and broker/dealers in relation to reducing and disclosing analysts' conflicts of interest. The full text of the Guidelines and a set of related "Frequently Asked Questions and Answers" are available on the SFC's website at www.hksfc.org.hk. The purpose of this note is to summarise the principal features of the Guidelines.

1. INTRODUCTION

The Guidelines are set out at Paragraph 16 of the Code of Conduct for Persons Licensed or Registered with the Securities and Futures Commission and accordingly apply only to corporations licensed and authorized institutions registered under Part V Securities and Futures Ordinance (the "SFO"). They do not regulate the conduct of journalists or media organisations.

The Guidelines are based on the principles of the International Organisation of Securities Commissions ("IOSCO") and cover the 9 key areas identified in IOSCO's Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest which are:

- Analyst trading and financial interests
- Firm financial interests and business relationships
- Analysts' reporting lines and compensation
- Firm compliance systems and senior management responsibility
- Outside influence
- Clarity, specificity and prominence of disclosure
- Integrity and ethical behaviour
- Investor education.

2. REGULATORY BACKGROUND

In the same way as any other person carrying on business in a regulated activity in Hong Kong, analysts employed by securities firms are required to be licensed by the Securities and Futures Commission (the "SFC") and are subject to the SFC's relevant codes and guidelines.

The SFC's Code of Conduct governs the business conduct of licensed or registered persons, including conflicts of interest. It requires licensed corporations and registered institutions and their representatives (including analysts) to act honestly, fairly and in the best interests of clients. They should try to avoid conflicts of interest, and exercise due care and diligence when providing advice. Where licensed corporations, registered institutions or their representatives have material interests in transactions which give rise to actual or potential conflicts of interest, they should refrain from advising or dealing in relation to the transaction unless the material interest or conflict has been disclosed to the client and they have taken all reasonable steps to ensure fair treatment of the client.

Licensed corporations and registered institutions are also required to establish corporate policies and procedures in accordance with the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC. These require the

effective segregation of the sales and dealing functions from the research function where the possibility of potential conflicts of interest exist. Where practicable, the research and corporate finance functions should be segregated to ensure the objectivity of the research function. These guidelines further require that compliance procedures should be in place to govern the preparation, approval and dissemination of research reports. The guidelines further recommend that staff members should be required to disclose (at least semi-annually) details of their transactions in relation to products in which the firm deals or on which it advises.

Analysts and other licensed persons breaching these Codes are subject to disciplinary action by the SFC. The disciplinary sanctions which the SFC may impose include suspension or revocation of licence, public or private reprimand and a prohibition order against undertaking regulated activities. A monetary fine may also be imposed either alone or in addition to other sanctions.

Analysts are also subject to the SFO's provisions relating to market misconduct. Dealings in insider information and market manipulation attract both criminal and civil sanctions under the SFO. In addition, Sections 298 and 300 of the SFO respectively provide for the criminal offences of disclosure of false or misleading information to induce transactions and employment of fraudulent or deceptive devices in securities or futures contract transactions. In terms of civil liability, Section 277 SFO provides for civil liability in respect of disclosure of false or misleading information to induce transactions and Section 391 provides for civil liability where a person makes a communication to the public (or a group comprising members of the public including shareholders of a listed corporation) concerning securities or futures contracts which is false or misleading in a material particular.

Analysts who receive a bribe in return for issuing favourable reports also contravene the Prevention of Bribery Ordinance, administered by the ICAC.

3. SCOPE AND APPLICATION OF THE GUIDELINES

The Guidelines cover investment research on:

- i. securities that are shares listed on the SEHK, or warrants or options on such shares which are listed or traded on the SEHK ("securities") and
- ii. investment research that has an influence on securities.

They do not cover research on fixed income securities, foreign exchange or collective investment schemes.

Definition of "Analyst" (Paragraph 16.2(a)).

An analyst is defined for the purposes of the Guidelines as "any individual within a firm who prepares and/or publishes investment research or the substance of investment research". The term covers independent, buy-side and sell-side analysts.

The following are however excluded from the scope of the Guidelines:

- i. a person giving advice or comments wholly incidental to his dealing or broking function;

- ii. investment research conducted solely for the firm's and its group companies' internal consumption and not for distribution to clients;
- iii. personal (one-to-one) investment advice; and
- iv. research on macro-economic or strategic issues.

Definition of "Firm" (Paragraph 6.2(d))

"Firm" is defined as any corporation licensed or authorized institution registered under Part V SFO and any of its group companies that carries on business in Hong Kong in investment banking, proprietary trading or market making, or agency broking, in relation to securities.

4. FIRM COMPLIANCE SYSTEMS (Paragraph 16.7)

The Guidelines require firms to establish, maintain and enforce written policies and control procedures to eliminate, avoid or manage actual and potential analyst conflicts of interest. These policies and procedures should be drawn up having regard to a firm's particular structure and business model and the experience and investment profile of its clients.

5. ANALYST TRADING

Analyst Integrity (Paragraph 16.11)

Analysts are required to have a reasonable basis for their analyses and recommendations. Terms used in making recommendations should be defined and such definitions should be used consistently.

Firms to Establish Dealing Policies for Analysts (Paragraph 16.4(a))

Firms are required to establish and maintain written policies and control procedures governing analysts' personal trading activities.

Limitations on Analysts' Dealings (Paragraph 16.4(b))

Analysts and their associates are prohibited from trading in the securities of a listed corporation reviewed by the analyst:

- i. in a manner contrary to the analyst's outstanding recommendation; or
- ii. within 30 days before and 3 business days after the issue of investment research on the listed corporation.

There are exceptions allowing:

- i. analysts and their associates to trade during the blackout period in special circumstances outlined in the firm's policy and pre-approved by the relevant legal or compliance function; and

- ii. analysts to issue research within 30 days after he or his associate has traded securities of a listed corporation on the occurrence of a major, publicly known event that would affect the price of the relevant securities.

The Guidelines adopt a much narrower definition of “associates” than the definition which applies generally for the purposes of the SFO. In the Guidelines, “associates” are defined as:

- i. the analyst’s spouse or natural or adopted child or step-child under 18;
- ii. the trustee of a trust of which the analyst, his spouse, child or step-child under 18, is a beneficiary or discretionary object; and
- iii. any other person accustomed or obliged to act in accordance with the analyst’s directions or instructions.

6. ANALYSTS’ FINANCIAL INTERESTS AND RELEVANT RELATIONSHIPS (Paragraphs 16.4 (c) and (d))

An analyst’s research report must disclose if the analyst or any of his associates is an officer of, or has any financial interest in, the listed corporation reviewed by the analyst.

The term “officers” has the same meaning as in the SFO, that is “a director, manager, or secretary of, or any other person involved in the management of a corporation” (Part 1 of Schedule 1 to the SFO).

“Financial interest” is defined in the Guidelines as any commonly known financial interest, such as investment in the securities of a listed corporation or a financial accommodation arrangement between the listed corporation and the firm or analyst. Excluded from the definition are commercial lending conducted at arm’s length and investments in collective investment schemes notwithstanding that the scheme has investments in a listed corporation’s securities.

7. ANALYST REPORTING LINES, COMPENSATION AND PARTICIPATION IN OTHER FUNCTIONS (Paragraph 16.6)

The Guidelines prohibit:

- i. analysts reporting to the investment banking function;
- ii. linking analysts' compensation to any specific investment banking transaction;
- iii. the pre-approval of analyst reports or recommendations by the investment banking function except in circumstances overseen by the compliance or legal function where the investment banking function reviews a research report for factual accuracy prior to publication; and
- iv. analysts participating in business activities designed to solicit investment banking business, such as sales pitches and deal roadshows.

Company Visits in the Course of Investment Research

There is no restriction on analysts making company visits in the course of their research. Firms and analysts should however ensure that there are measures in place to shield analysts from improper influences which may affect the objectivity of their work.

8. FIRMS' FINANCIAL INTERESTS AND RELEVANT RELATIONSHIPS (Paragraph 16.5)

Disclosure Requirements

Firms are required to disclose the following in their research reports:

- i. **Financial Interests** - where the firm has financial interests which amount in aggregate to 1% or more of the market capitalisation of a listed corporation whose securities have been reviewed by the firm;
- ii. **Market Making Activities** - where the firm makes a market in securities of the listed corporation;
- iii. **Relevant Relationships** - where an individual employed by or associated with the firm is an officer of the listed corporation; and
- iv. **Relevant Business Relationships** - where a firm has an investment banking relationship with the listed corporation. Any compensation or mandate for investment banking services within the preceding 12 months is taken to constitute an investment banking relationship.

Other Restrictions

The Guidelines contain the following additional restrictions:

- i. **Improper Dealing** - a firm should not improperly deal or trade ahead in the securities of a listed corporation covered by its investment research;
- ii. **Firms not to Provide Assurances** - firms should not, with a view to commencing or influencing a business relationship with a listed corporation, provide any promise or assurance of a favourable review or a change of coverage or rating in its investment research;
- iii. **Quiet Periods** - a firm that acts as a manager, sponsor or underwriter of a public offering is prohibited from issuing investment research with respect to the relevant listed corporation for:
 - a. in the case of IPOs, 40 days after the day of pricing; and
 - b. in the case of a secondary offering, 10 days after the day of pricing.

The day of pricing means the day when the specific price of the offering is determined. There are 2 exceptions to the quiet period prohibition:

- a. for firms that have been issuing investment research on the listed corporation with reasonable regularity in their normal course of business; and

- b. where a major, publicly known event occurs that would affect the price of the relevant securities.

Pre-deal Research

The question of whether "pre-deal research" (ie. investment research issued before the public offering of securities that are covered in the research) should be allowed which was raised in the March Consultation Paper will be examined in a separate consultation in the context of the regulatory framework for public offers.

9. OUTSIDE INFLUENCE (Paragraph 16.8)

Where a listed corporation or other third party provides or agrees to provide any compensation or other benefits in connection with investment research, this fact must be disclosed in the research report.

10. ANALYST APPEARANCES IN THE MASS MEDIA (Paragraphs 16.9(a) and (b))

With the exception of the disclosure requirements (which are simplified as described below), all provisions of the Guidelines including the trading blackout periods apply to an analyst who makes an appearance in the mass media. Making an appearance includes appearing in broadcasting programmes and writing articles, reports or comments in the print media.

Analyst Disclosure Requirements for Mass Media Appearances

Simplified disclosure requirements apply to analysts who analyse or comment on securities in the mass media. An analyst need only disclose:

- i. his name;
- ii. the fact (but not the details) that he is licensed; and
- iii. the fact (but not the details) that he and/or his associate (but not his firm) has a financial interest in the listed corporation.

These disclosures must be made at the time the analyses or comments are provided.

Where unsolicited questions regarding specific securities are raised with an analyst by the audience during a media appearance, the analyst may respond and give analyses and comments, notwithstanding that he and/or his associate(s) may have traded those securities during the preceding 30 days. The analyst is however required to make the disclosures referred to above before commenting on the securities.

Analysts should disclose their real names (and not pseudo names) when publishing their analyses or commentaries in the mass media.

11. FIRMS' APPEARANCES IN THE MASS MEDIA (Paragraph 16.9(c))

A firm that communicates its investment research through the mass media, such as disseminating its research reports in whole or in part in a sponsored programme, must comply

with the Guidelines and, in particular, make full disclosures as required by Paragraphs 16.4, 16.5 and 16.8.

12. REQUIREMENTS FOR DISCLOSURE (Paragraph 16.10)

Disclosures are required to be clear, concise, specific, given adequate prominence and released in a timely and fair manner. The method of disclosure should be commensurate with the medium through which the investment research, or analyst's advice or comments, is being delivered. The required disclosures are limited to the fact of the matter and need not give details of the amount or its nature.

Disclosure Responsibility

Provided that analysts and firms make the disclosures required by the Guidelines, they will not be held responsible if their investment research or recommendation is published or otherwise reproduced in whole or in part by the mass media without the relevant disclosures.

13. FINANCIAL JOURNALISM

The SFO has made it clear that persons who publish research or recommendations in the media do not fall within the SFC's licensing regime if they do not conduct regulated activities. The definition of "advising on securities" in Schedule 5 to the SFO does not include a person giving advice or issuing analyses or reports on securities through a newspaper, magazine, book or other publication which is made generally available to the public or through a television or radio broadcast for reception by the public, whether on subscription or otherwise. However, while such commentators are not required to be licensed and therefore need not comply with the Code of Conduct, they are subject to the SFO's provisions relating to market misconduct, including the criminal offences under Sections 298 and 300 of the SFO and to the imposition of civil liability under Section 277 SFO (as described under paragraph 2 above). Section 279 SFO further requires every officer of a corporation to take all reasonable measures to ensure that proper safeguards exist to prevent the corporation perpetrating any market misconduct.

While the mass media is not subject to the Guidelines' requirements, it is encouraged by the SFC to disclose the source (ie. name of the firm and date of issuance of the original research report) of extracts or summaries of research reports published.

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The purpose of this note is to summarise the principal features of the SFC's Guidelines on Analyst Conflicts of Interest. Specific legal advice should be sought in relation to any particular situation.