# Aspects Of The Securities And Futures Ordinance

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**ASPECTS OF THE SECURITIES AND FUTURES ORDINANCE**

Good morning ladies and gentleman. I am going to talk about some areas of the SFO of particular interest, namely:

- Part XV on Disclosure of Interests in shares of Hong Kong listed companies;
- Parts XIII and XIV which establish new dual civil and criminal regimes in respect of market misconduct;
- Part IV which regulates offers of investment; and
- Stabilisation under the Securities and Futures (Price Stabilising) Rules.

## I. THE SECURITIES AND FUTURES ORDINANCE PART XV – DISCLOSURE OF INTERESTS (Overhead 2)

### INTRODUCTION (Overhead 3)

The Securities and Futures Ordinance ('SFO') which came into force on 1 April 2003 has broadened considerably the previous regime governing the disclosure of interests in the shares and debentures of Hong Kong listed companies with a view to enhancing transparency in the Hong Kong market.

### A. DISCLOSURE BY SUBSTANTIAL SHAREHOLDERS (Overhead 4)

As under the previous regime, the SFO requires disclosure when a person acquires or ceases to have a notifiable interest and when there is a change in the percentage *level* (ie. the figure rounded down to the next whole number) of his interest.

### THE NEW FEATURES

### 1. REDUCTION OF SUBSTANTIAL SHAREHOLDING THRESHOLD (Overhead 5)

The SFO reduces the threshold for disclosure from 10% to 5% of a Hong Kong listed company's issued voting share capital. Where there are more than one class of listed shares, the percentage of each class is taken separately.

Section 310(1) requires notification to be made on the occurrence of the relevant events set out in Section 313 which can be summarised as follows:

(i) when a person first becomes interested in 5% or more of the shares of a listed company (ie. when he first acquires a notifiable interest) (Section 313(1)(a));

(ii) when a person's interest drops below 5% (ie. he ceases to have a notifiable interest) (Section 313(1)(b));

(iii) when there is an increase or decrease in the percentage *level* (ie. the figure rounded down to the next whole number) of a person's holding above 5% (eg. his interest increases from 6.8% to 7.1% – so the percentage *level* increases from 6% to 7%) (Section 313(1)(c));

(iv) when a person has a notifiable interest (ie. 5%) and the nature of his interest in the shares changes (eg. on exercise of an option) (Section 313(1)(d));

(v) when a person has a notifiable interest and he comes to have, or ceases to have, a short position of more than 1% (eg. he is already interested in 6.5% of the shares of a listed company and takes a short position of 1.7%) (Sections 313(4)(a) and (b)); and

(vi) when a person has a notifiable interest and there is an increase or decrease in the percentage *level* of his short position (eg. he is already interested in 6.8% of the shares of a listed company and increases his short position from 1.7% to 2.2%) (Section 313(4)(c)).

## 2. SHORTENING OF NOTIFICATION PERIOD (Overhead 5)

2.1 The SFO shortens the notification period for notification of relevant events from 5 days to 3 business days after the date of the relevant event. If a person is not aware of the relevant event when it occurs, the 3 day limit runs from the date on which he is aware of its occurrence (ie. the date on which he is aware of the facts which constitute the relevant event (eg. a buy-back of shares) and not the date he realises he has a notifiable interest). A '**business day**' is defined to mean a day other than a public holiday or a day on which a gale or black rain storm warning is in force. It therefore includes Saturdays but not Sundays.

Notices should be filed with the Stock Exchange and the relevant listed company at the same time or one immediately following the other (Section 324(2)). The previous requirement for notice to be given to the Stock Exchange first has been removed.

2.2 ***Initial Notifications***

An 'Initial Notification' does not refer to a notice given on initially crossing the 5% threshold. Instead it refers to a notice required to be given in the following circumstances:

(i) where a person has 5% or more of the shares of a company which is being listed (Section 310(2)(a));

(ii) where a person has 5% or more of shares of a class which is being listed or given full voting rights (Section 310(2)(b));

(iii) if a person had a notifiable interest when the SFO came into effect which had not already been disclosed under the previous regime; and

(iv) if a person has a notifiable interest on either the 5% threshold or 1% threshold for short positions being reduced (Section 310(3)).

Under Section 325(2) the time limit for Initial Notifications only is 10 business days after the relevant event or, if later, the date on which the person concerned is aware of the relevant event (ie. is aware of the facts which constitute the event).

Interests discloseable on the commencement of the SFO were required to be filed on or before 14 April 2003. Any interest already disclosed under the previous regime was not required to be notified on commencement of the SFO.

## 3. DISCLOSURE OF INTERESTS IN EQUITY DERIVATIVES ) (Overhead 6)

Under the previous regime, the disclosure requirements applied only to physically settled derivatives. The SFO extends the disclosure obligations of substantial shareholders to interests in the **unissued** shares of listed companies which, if issued, would carry the right to vote and also to **cash settled** derivatives. Hence, interests in the 'underlying shares' of all equity derivatives (whether issued or unissued) are discloseable, including interests in options, subscription warrants, convertible bonds, ADRs and stock futures.

A holder, writer or issuer of equity derivatives will be taken to have a long position in the underlying shares and must add these to his other interests in determining his disclosure obligations if:

(i) he has a right to take the underlying shares;

(ii) he has an obligation to take the underlying shares; or

(iii) he has a right to receive money or to avoid or reduce a loss, if the price of the underlying shares increases,

before or on a certain date or within a certain period (whether the right or obligation is conditional or absolute) (Section 322(8)).

## 4. DISCLOSURE OF SHORT POSITIONS (Overhead 7)

The SFO extends the disclosure obligations of substantial shareholders to cover 'short positions'. Under Section 308 a person is regarded as having a short position in shares if he:

(i) holds, writes or issues financial instruments under which:

(a) he can require another person to take the underlying shares;

(b) he is obliged to deliver the underlying shares; or

(c) he has a right to receive money or to avoid or reduce a loss if the price of the underlying shares declines,

before or on a certain date or within a certain period (whether the right or obligation is conditional or absolute); or

(ii) he borrows shares under a securities borrowing and lending agreement.

Hence the writing of a call option, holding of a put option and stock borrowings will be discloseable.

**(Overhead 8)**

Note however that:

- a person (not being a director) with a short position will only be required to disclose it if he already has a 5% interest in a class of a listed company's voting share capital ie. he must be a substantial shareholder before he has a duty to disclose a short position (Section 313(4));
- the short position must be at least 1%;
- as with long positions, a change in the short position will only require disclosure if it results in the short position crossing a percentage level or in the person ceasing to have a short position of at least 1% (Sections 313(4)(b) and (c)).
- Short positions cannot be netted off against long positions and the percentage figures for short and long positions must be calculated and notified separately.

***Options***

The SFC Outline confirms that the SFC takes the view that when a listed company allots shares or issues an instrument under which it agrees to allot shares, or grants an option over its **own** shares, it is not taking a position in its own shares, short or long, but is simply issuing or agreeing to issue the shares. Hence there is no disclosure obligation for the company. Likewise, since the listed company is not taken to have a short position, a controller of the company will not be deemed to have a short position under the deeming provisions of the SFO and no disclosure is required. This view would appear to be at odds with a strict interpretation of the legislation and its wide definition of the term

'short position'. It therefore seems likely that this view has been adopted more on the basis of the spirit of the legislation whose focus is primarily on the disclosure of positions held in other listed companies.

The holder of an option or other right to receive shares will however acquire a long position in the shares which must be disclosed.

Where a company grants an option over the shares of another listed company, then it is taking a short position which must be disclosed if the former company already holds a 5% interest and the short position amounts to 1% or more.

Note also that where a listed company grants an option over its own shares or debentures to a chief executive or director of that company, it is required to record details of the grant in its register of the interests of directors and chief executives.

## 5. HOW MANY SHARES IS A PERSON TAKEN TO BE INTERESTED IN IN THE CASE OF EQUITY DERIVATIVES?

Holders, writers and issuers of equity derivatives are taken to be interested in, or have a short position in, the number of shares to be delivered, or by reference to which the amount payable is derived or (in the case of stock futures only) the relevant contract multiplier (Section 322(12)).

## 6. CALCULATION OF A PERSON'S INTEREST (Overhead 9)

***Long Positions***

The percentage figure of an interest in shares should be determined using the following formula:

$$\frac{\text{nominal value of shares in which a person is interested }^{*}}{\text{nominal value of the issued shares of the listed company of the same class}} \times 100$$

* Note that this will include all issued shares and shares underlying equity derivatives whether issued or unissued.

***Short Positions***

To calculate whether a short position constitutes 1% or more, a similar formula can be used:

$$\frac{\text{nominal value of shares in which a person has a short position }^{*}}{\text{nominal value of the issued shares of the listed company of the same class}} \times 100$$

* Note that this will include all issued shares and shares underlying equity derivatives whether issued or unissued.

The forms require the percentage *figure* to be rounded to 2 decimal places. To find the *percentage level* of the interest the percentage *figure* is rounded down to the next whole number.

The date for calculating the relevant percentage is the date of occurrence of the relevant event and the number of shares in which a person is interested and the total number of issued shares should be determined on that day.

## 7. NOTIFICATION OF CHANGES IN THE NATURE OF INTERESTS (Overhead 10)

Any change in the nature of an interest already notified is required to be disclosed under Section 313(d). The situations in which there is considered to be such a change are extensive and include a change in the nature of a person's title to shares, any of the person's interest whether legal or equitable or any of the person's interest in the underlying shares of equity derivatives on the exercise of rights thereunder (whether by or against him).

Common situations requiring notification of a change in interest will include:

(i) the exercise of rights (by or against a person) under options and other derivatives;

(ii) the lending of shares under a securities borrowing and lending agreement (unless the Securities Borrowing and Lending Exemption applies); and

(iii) the giving of shares as security to another person.

There is not considered to be a change in the nature of an interest under Section 313(13) and Section 5 of the Securities and Futures (Disclosure of Interests – Exclusions) Regulation:

(i) where a purchaser takes delivery of shares, if he has previously disclosed his equitable interest arising on contracting to buy the shares;

(ii) where a vendor of shares enters into a contract for sale, if the sale is required to be completed within 4 days on which the Stock Exchange is open for business;

(iii) where there is a change in the terms on which rights under equity derivatives may be exercised which results from a change in the number of underlying shares in issue;

(iv) on the exercise of rights to subscribe for or on delivery of shares under a rights issue;

(v) where a 'qualified lender' comes to have a security interest in a person's shares; and

(vi) where the person is a holding company and the transfer is of shares from one wholly owned subsidiary to another.

## 8. WHAT CONSTITUTES AN INTEREST IN SHARES

The definition of an 'interest in shares' is extremely broad and includes the following situations:

(i) If a person's name is listed in the register of members maintained by a listed company.

(ii) If the shares are held for a person by another person such as his stockbroker, a custodian, a trustee or a nominee (eg. in the Central Clearing and Settlement System ('CCASS') or with HKSCC Nominees Limited, the CCASS depository).

(iii) If a person is deemed by Part XV to be interested in the shares.

(iv) If a person enters into a contract (for example if he holds, writes or issues financial instruments including equity derivatives) that give him a right to shares, or to a payment in the event of a change in the price of shares.

(v) If a person holds shares as security.

(vi) If a person is entitled to exercise rights attaching to the shares or control their exercise eg. voting rights.

***Buying and Selling Shares***

A buyer of shares acquires an interest in shares at the time when he contracts to buy and therefore is required to give notification within 3 business days of the contract. No further notice is required when the buyer takes delivery of the shares.

A seller of shares will normally only cease to have an interest when he actually transfers the shares to the buyer and is therefore required to notify the cessation of his interest within 3 business days after the settlement date (ie. the date of the actual transfer). If the contract for sale of the shares provides for settlement within 4 days on which the Stock Exchange is open for business, notification by the seller is not required on the entering into of the contract.

If in fact a seller ceases to be interested in the shares on the date of the contract for sale (eg. due to the operation of the clearing system), then notice should be filed within 3 business days of the contract for sale.

If a contract for sale specifies a settlement date which is 5 or more days on which the Stock Exchange is open for business after the date of the contract, then 2 notices are required: first, a notice of change in nature of the interest which must be filed within 3 business days of the contract and second, a notice of cessation of interest to be filed within 3 business days of delivery of the shares.

## 9. DEEMED INTERESTS (Overhead 11)

There are a number of circumstances where the interests and derivative interests (including short positions) of others in a listed company's shares must be added to a person's own interest in calculating the number of shares in which they are interested.

### 9.1 *Family and Controlled Company Interests (Section 316)*

As under the previous legislation the interests of a person's spouse and children under 18 are attributable to him.

Also, as previously, a person will be deemed to be interested in the interests of any company which he 'controls' (ie. a company of which he controls, either directly or indirectly, one third or more of the voting power at general meetings or if the company or its directors are accustomed to act in accordance with that person's directions).

### 9.2 *Limited Liability Partnerships*

The SFC Outline confirms that the SFC regards a limited liability partnership as a company for the purposes of Part XV. Hence interests in shares held by a limited liability partnership should be disclosed by the general partner as interests in shares of a controlled corporation (rather than as joint interests of each partner).

### 9.3 *Trusts*

The interests of a trust of which a person is a trustee must also be aggregated with his own interests (with the exception of a trust of which he is a bare trustee (ie. his only powers or duties are to transfer the underlying shares according to the directions of the beneficial owner – see [paragraph 12.7] below).

A beneficiary of a trust must include the interests of the trust in calculating his own interest (Section 322(4)(a)). The interest of a beneficiary under a discretionary trust is however disregarded (Section 323(1)(a)(iii) provided that he is not also a director of the relevant listed company or a 'founder' of the trust (see below).

***New Provisions in the SFO (Overhead 12)***

### 9.4 *'Founders' of Discretionary Trusts*

The SFO has introduced new provisions so that the interests of a 'discretionary trust' will be attributed to the 'founder' of such trust (Section 322(4)(b)). The term 'founder' is very widely defined and essentially will catch anyone who has procured the creation of the trust and (i) whose consent is a condition of a trustee's exercise of his discretion or (ii) in accordance with whose wishes a trustee is accustomed or expected to act (whether, in either case, legally enforceable or not).

### 9.5 *Concert Party Agreements (Section 317)*

The SFO broadens the previous provisions relating to concert party agreements. In essence, those provisions apply where two or more persons agree to acquire shares in a target company and the agreement dictates the manner in which any one or more of the parties may exercise the rights attached to those shares or dispose of them. Each party to the agreement must include the interests of all other

parties to the agreement in determining whether they together hold 5% or more of the listed company. If so, each party will be considered to be a substantial shareholder whose interests must be disclosed.

Under the SFO those provisions are extended to any arrangement whereby a 'controlling person' or director of a listed company makes a loan to a person on the understanding that the money will be used to acquire interests in shares in that company and shares are in fact acquired. A 'controlling person' for these purposes is any person who, either alone or with associates, controls at least 30% of the voting power at general meetings, can nominate any of its directors or veto or modify any resolution of a general meeting.

The effect of extending the provisions to the borrower and controlling shareholder is to create an irrebutable presumption that the loan or funding will be provided pursuant to an agreement dictating how the borrower may deal with his shares.

There is an exemption where a 'controlling person' or director makes the loan in the ordinary course of his business as a 'qualified lender' (as defined below).

## 10. DISCLOSURE OBLIGATIONS ARISING FROM SHARE REPURCHASES AND PLACEMENTS

Disclosure obligations may also arise from actions taken by others. For example, if a listed company buys back shares thereby reducing the number of shares in issue, an increase in the percentage level of the interests of the remaining shareholders will be discloseable.

Conversely, in the case of a placement and top-up, where new shares are issued to a major shareholder to replace the shares he has placed with a third party, the number of shares in issue increases. The consequent reduction in the percentage level of the interests of the other shareholders will then be discloseable.

In both cases, the 3 business day time limit for disclosure runs only from the date the person concerned became aware of the facts that led to the change in the level of his interest ie. the date on which he became aware that the number of issued shares had reduced/increased.

## 11. CESSATION OF INTERESTS

A person is regarded as having ceased to be interested in shares if:

(i) he delivers them to another person (or to his order) pursuant to a contract for sale, in fulfilment of his obligations under a call option, or on exercising his rights under a put option;

(ii) his right to subscribe for or call for the delivery of shares lapses or he assigns such right to another;

(iii) his obligation to take shares lapses or he assigns that obligation to another;

(iv) he receives an amount from another person, or avoids or reduces a loss, on the assignment or settlement of any cash settled equity derivatives.

## 12. EXEMPTIONS (Overhead 13)

There are a number of exemptions and interests which may be disregarded. These are very detailed, hence the following is limited to a brief outline only of the principal exemptions and disregards.

### 12.1 *Basket Derivatives (Overhead 14)*

Basket derivatives over the shares of at least 5 companies listed on a 'specified' stock exchange are disregarded provided that no one share accounts for over 30% of the value of the total basket. The percentage figure is calculated at the time of issue of the derivatives.

**12.2** ***De Minimis Change Exemption on Change in Long or Short Positions (Sections 313(7) and (9)) (Overhead 15)***

The exemption applies so that an increase or decrease in a person's holding or short position which results in his interest crossing over a percentage level above 5% (in the case of a holding) or 1% (in the case of a short position) will not be discloseable if:

(i) the percentage *level* of his interest is the same as, or less than, the percentage *level* of his interest stated in the 'Last Notification' given by him; and

(ii) the difference between the percentage *figure* of his interest disclosed in his 'Last Notification' and the percentage *figure* of his interest at all times after such notification, is less than 0.5%.

'Percentage *level*' in (i) above means the percentage figure rounded down (if not a whole number) to the next whole number. 'Percentage *figure*' in (ii) above, however, means the actual (unrounded) percentage figure.

The 'Last Notification' must, in the case of a holding, be a notice given under Section 313(1)(c), that is notice of a change in the percentage level of a person's interest above 5%. Hence a notification given on commencement of the SFO, on first crossing the 5% threshold or of a change in the nature of an interest will not qualify as a 'Last Notification'. In the case of a short position, the 'Last Notification' must be a notice under Section 313(4)(c), that is notice of a change in the percentage level of a person's short position above 1%.

This exemption will not therefore apply if the percentage level of a person's interest has increased since his Last Notification or if at any time after such notification his percentage interest differed by 0.5% or more from the percentage figure of his interest stated in that notification.

**12.3** ***De Minimis Change Exemption on Change in the Nature of Interests (Section 313(8))***

There is no duty of disclosure where:

(i) the 'percentage level' (ie. the rounded down figure as explained above) of a person's unchanged interest (ie. disregarding the part in which his interest has changed) is the same as the percentage level of his interest in the last notice (this notice is not restricted to notices of change in the percentage level of an interest) given by him; or

(ii) the percentage level of a person's unchanged interest has crossed over a percentage level if:

  (a) the percentage level of his unchanged interest is the same as or less than the percentage level of his interest given in the 'Last Notification' by him (ie. a notice under Section 313(c) of a change in the level of a person's interest above 5%); and

  (b) the difference between the percentage figure (ie. the actual unrounded figure as noted above) of his unchanged interest and the percentage figure disclosed in the Last Notification has been less than 0.5% at all times since the giving of that notification.

**12.4** ***Exempt Security Interests (Section 323(6)) (Overhead 16))***

An interest in shares is not required to be disclosed if it qualifies as an 'exempt security interest' ie. if it is held by a 'qualified lender by way of security only' for a transaction entered into in the ordinary course of his business (Section 323(6)). Further, the creation of the security interest in favour of a 'qualified lender' will not result in a change in the nature of the holder's interest in those shares (Section 313(13)).

A 'qualified lender' is defined under Section 308 to include an authorised financial institution, an authorised insurance company, an exchange participant of a recognised exchange company and an intermediary licensed to deal in securities or margin financing. The term also now includes overseas institutions authorised to carry on business as a bank, insurance company or activities which, in the

opinion of the SFC, are equivalent to the regulated activities of intermediaries in countries recognised by the SFC.

As to when a qualified lender is taken to hold an interest in shares 'by way of security only', a distinction is drawn between the creation of a security interest in, and a transfer of title to, shares. If a person has a right to return equivalent shares and may deal with the shares transferred to him as if they are his own in the meantime, this is a transfer of title and not the creation of a security interest.

Under Section 323(7) an interest will no longer qualify as an 'exempt security interest' if the qualified lender becomes entitled to exercise voting rights of the relevant shares due to default by the person who gave the security, and shows an intention or takes any step to exercise or control the exercise of those voting rights. Similarly, an interest will cease to be an 'exempt security interest' if the power of sale becomes exercisable and the qualified lender or its agent offers for sale all or any of the shares. In either case, the qualified lender is regarded as having acquired an interest in the shares and is obliged to disclose his interest.

### 12.5 *Wholly Owned Group Exemption (Section 313(10)) (Overhead 17)*

A wholly owned subsidiary is not required to notify an interest *in certain circumstances* if its ultimate holding company has given notice of its interest in the relevant shares. The certain circumstances in which wholly owned subsidiaries are exempted are those where the disclosure obligation arises under Sections 313(1) or (4). Significantly, the wholly owned group exemption is <u>not</u> available on the making of an 'Initial Notification' under Sections 310(2) and (3) (ie. notice given when the SFO came into force, when an interest is held in shares in a company which is being listed or when a notifiable interest is acquired on a reduction of the 5% threshold or 1% theshold for short positions is reduced (see paragraph 2.2 above). Hence, if a wholly owned subsidiary holds an interest of 5% or more in the shares of another company at the time that other company becomes listed, it cannot rely on the wholly owned group exemption: instead both the wholly owned subsidiary and its holding company will be obliged to separately disclose the interest in the shares held by the subsidiary.

Further, transactions between wholly owned subsidiaries of the same group do not give rise to a duty of disclosure since the number of shares in which the ultimate parent is interested or has a short position and the nature of its interest remains the same. Hence transfers of shares of a listed company, the grant and taking of options over such shares and the issue of warrants between wholly owned subsidiaries of the same group do not give rise to a duty of disclosure.

A duty of disclosure will arise if any relevant subsidiary ceases to be wholly owned, even if only 1% of its shares are sold to a third party.

### 12.6 *Bonus and Rights Issue Exemption (Overhead 18)*

When there is a rights issue shareholders become interested in the unissued shares covered by the issue. In calculating their percentage interest the following formula should be used (Section 314(2)):

$$\frac{\text{nominal value of shares (including unissued shares) in which the shareholder is interested}}{\text{nominal value of shares of the listed company of the same class in issue} + \text{nominal value of shares to be issued on completion of the bonus/rights issue}^{*}} \times 100$$

* This is the only situation where the denominator is increased to take account of unissued shares.

Shareholders of listed companies who take up rights under qualifying bonus and rights issues (and whose percentage interest therefore remains unchanged) are not required to make any disclosure whereas shareholders who do not take up their rights (and whose percentage interest therefore changes) will have to make disclosure.

If a shareholder sells his rights, both he and the buyer must make disclosure if their interests cross a percentage level.

A rights issue is defined to include the offer by a listed company of its shares to holders of its issued shares at a certain date (other than to shareholders whose address is in a place where such an offer is not allowed under local law) in proportion to the number of shares held by them at that date. A rights issue does not however cover an offer or issue of shares in lieu of a cash dividend.

The underwriter of the rights issue will acquire an interest in all rights shares that he agrees to take up if they are not taken up by shareholders. The underwriter will then need to file notice of cessation of his interest in the number of rights shares taken up by shareholders on completion of the rights issue.

### 12.7 *Investment Managers, Custodians and Trustees (Overhead 19)*

The exemption previously available to local SFC registered investment managers and trust companies is removed. The following exemptions may however be relied on:

*Bare Trustee Exemption*

A narrow exemption is retained for bare trustees ie. a trustee who is only entitled to deal with the interest in accordance with the instructions of the beneficiary.

*Exempt Custodian Interest (Section 323(3))*

The interests of corporate custodians carrying on a business of holding securities in custody for others need not be disclosed provided that the custodian has no authority to exercise discretion in dealing in the shares or exercising the rights attached to those shares.

### 12.8 *Disaggregated Group Interests (Section 316(5)) (Overhead 20)*

More importantly, the SFO removes the obligation of a holding company to aggregate the interests of controlled companies (see paragraph 9.1 above) who are investment managers, custodians or trustees whose interest in the shares arises solely from their obligation or entitlement to invest in, manage, deal in or hold interests in those shares on behalf of customers in their ordinary course of business as such. For the exemption to apply the controlled company must exercise any rights to vote in respect of the shares and any power to invest in, manage, deal in or hold the shares, independently of its controlling company and any 'related corporations' (ie. companies within the same group or under the same majority control (Section 3 of Schedule 1)).

This exemption is available for the fund management industry only. It does not entitle family members whose interests in the shares of 'family controlled' listed companies are held by trustees to disaggregate such interests. A trustee of a trust does not have 'customers' and will probably not be 'carrying on a business' as an investment manager, custodian or trustee. The terms 'investment manager' and 'trustee' are specifically defined in Section 316(7).

### 12.9 *Securities Borrowing and Lending Exemption(Overhead 21)*

The Securities and Futures (Disclosure of Interests – Securities Borrowing and Lending) Rules ('SBL Rules') simplify the regime for disclosure of securities borrowing and lending for substantial shareholders (other than substantial shareholders who are also directors), 'approved lending agents' and 'regulated persons'.

*Substantial Shareholders*

Substantial Shareholders are exempted from disclosing changes in the nature of their interest arising on the lending and return of shares provided that they lend shares through an 'approved lending agent' (see below) who holds the shares as their agent for the sole purpose of lending shares and the shares are lent using a specified form of agreement. In essence, this is an agreement providing for the borrower to provide collateral exceeding the value of the shares lent. The value of the collateral is marked to market and the lender can require return of the shares at any time.

*Approved Lending Agents*

Companies approved by the SFC as 'Approved Lending Agents' ('ALAs') holding 5% or more of the shares of a listed company will only be required to disclose changes in the percentage level of its 'lending pool' of shares in that listed company. Hence if shares are added to or removed from the lending pool, a disclosure obligation will arise. ALA's are exempted from any disclosure requirements arising when shares are lent from or returned to their lending pool.

*Regulated Persons*

Interests in shares borrowed by 'regulated persons' (ie. companies licensed to deal in securities and overseas brokers in recognised jurisdictions), that merely act as a conduit (ie. they borrow and on-lend the shares within 5 business days) are disregarded. On the return of shares to the regulated person, it may either return them to the ultimate lender or lend them to another borrower. Provided this is done within 5 business days, the regulated person's interest is disregarded. Regulated persons can still rely on this exemption if it transfers shares to a related company provided that the related company on-lends the shares within 5 business days after they were acquired by the regulated person.

Both ALAs and regulated persons are required to keep records of their transactions in the shares.

### 12.10 *Collective Investment Schemes (Section 323(1)(c)) (Overhead 22)*

The interests of holders, trustees and custodians of collective investment schemes authorised by the SFC, certain pension and provident funds schemes and qualified overseas schemes are not required to be disclosed.

A 'qualified overseas scheme' means a collective investment scheme, pension scheme or provident fund scheme established in a country recognised by the SFC. It will not include a scheme which is not run as a business, has less than 100 holders or where less than 50 persons hold 75% or more of the interests in it (Section 323(5)).

### 12.11 *Intermediary Exemption (Section 323(1)(i)) (Overhead 23)*

The SFO provides an exemption for an intermediary (eg. a dealer or broker) licensed or registered for dealing in securities who acquires interests in shares as agent for his client. The exemption only applies if (i) the interest is acquired for (and from) someone who is not a related company of the intermediary and (ii) the interest is held by the intermediary for not more than 3 business days.

A similar exemption applies to intermediaries whose interests arise under exchange traded stock futures or stock options contracts.

### 12.12 *Further Exemptions*

(i) Dual listings: a company may apply to the SFC for exemption from the provisions of Part XV if it is listed on an overseas exchange and certain other criteria are met.

(ii) Structured products: the issuer of structured products may apply to the SFC for an exemption from Part XV. The main conditions to be satisfied are that the company's shares are not listed in Hong Kong, it does not intend to raise publicly traded equity capital in Hong Kong and only the structured products will be listed in Hong Kong. It is the substantial shareholders and directors of the issuer of the structured products who are able to claim the exemption. The issuer and holders of the equity derivatives must still include interests in the underlying shares of those derivatives in determining their disclosure obligations.

## 13. INFORMATION TO BE DISCLOSED

The SFO removes the previous requirement for substantial shareholders to disclose particulars of registered shareholders and changes in those particulars. Instead, it introduces more structured

notification forms to facilitate disclosure. Among the details to be disclosed by a substantial shareholder are the following:

1. In the case of corporate substantial shareholders, the name and address of any person in accordance with whose directions it, or its directors are accustomed or obliged to act, except where it is listed in Hong Kong or on a specified stock exchange or is the wholly owned subsidiary of any such listed company.

2. In the case of subsequent disclosures of long positions in shares disclosure is required of the highest price and average price per share paid or received in an on-exchange transaction. In off-exchange transactions the highest and average consideration per share and nature of the consideration must be disclosed. If no price or consideration has been paid or received, this should be stated. Transactions in equity derivatives do not require details of price or consideration.

3. In the case of equity derivatives, details as to whether they are listed or unlisted, cash or physically settled, and details of the underlying shares.

## 14. FORMS TO BE USED

There are 6 separate forms to be used for notification of interests under the SFO. These are:

- Form 1 – Individual Substantial Shareholder Notice
- Form 2 – Corporate Substantial Shareholder Notice
- Form 3A – Director's/Chief Executive's Notice of Interests in Shares of a Listed Company
- Form 3B – Director's/Chief Executive's Notice of Interests in Shares of Associated Corporation
- Form 3C – Director's/Chief Executive's Notice of Interests in Debentures of Listed Company
- Form 3D – Director's/Chief Executive's Notice of Interests in Debentures of Associated Company

**Directors who are also Substantial Shareholders must use Form 3A instead of Form 1 to disclose interests in shares of a listed company of which they are directors.**

If an event gives rise to separate disclosure obligations in each capacity (as director and substantial shareholder), both obligations can be fulfilled by filing Form 3A. For example, if a person has a 5.9% interest in the shares of a listed company and acquires a further 0.2%, he must file a notice as a director (who must disclose all transactions) and as a substantial shareholder because his interest has crossed a percentage level.

## 15. PENALTIES FOR FAILURE TO DISCLOSE (Overhead 24)

Failure to make disclosure within the time limits required by the SFO or the making of a statement which is false or misleading in any material particular constitutes a criminal offence carrying a maximum fine of $100,000 or maximum prison sentence of 2 years for each offence. Members and officers of a company can also be personally liable for the offences of a company. The Financial Secretary may further impose restrictions on the transfer of the shares of any person convicted of an offence.

## B. DIRECTORS AND CHIEF EXECUTIVES

### 1. DISCLOSEABLE INTERESTS (Overhead 25)

As under the previous regime the disclosure requirements for directors and chief executives ('directors') of a listed company are broader than for substantial shareholders requiring disclosure of interests in **any** shares (not just voting shares) or debentures of the listed company of which they are a director and any associated company. Also as previously, there is no disclosure threshold so that all interests must be disclosed however small.

The principal changes introduced by the SFO are to extend directors' disclosure obligations in respect of interests in equity derivatives, short positions and changes in the nature of interests in shares and debentures.

#### 1.1 *Definition of Associated Company*

An associated company is defined to include holding companies and subsidiaries of the listed company, fellow subsidiaries of the listed company's holding companies and any company in which the listed company has an interest of more than 20% of the nominal value of the issued shares of any class (Section 308).

A company will be a subsidiary of another if the other company controls the composition of its board of directors, controls half the voting power at general meetings, holds more than half of its issued share capital (excluding any part carrying no right to participate beyond a specified amount on a distribution of profits or capital) or is a subsidiary of a company which is the other company's subsidiary. This definition thus makes each company in a chain of companies a subsidiary of the ultimate holding company (Section 2 of Schedule 1).

### 2. WHEN IS NOTIFICATION REQUIRED?

#### 2.1 *Notifications – Shortening of Notification Period*

Section 341 requires that a director of a listed company must disclose any of the following 'relevant events':

(i) when he becomes interested in the shares or debentures of a listed company or any associated company;

(ii) when he ceases to be interested in such shares or debentures;

(iii) when he enters into a contract to sell any such shares or debentures;

(iv) when he assigns any right granted to him by the listed company to subscribe for shares or debentures of the listed company;

(v) when an associated company grants him rights to subscribe for shares or debentures of that associated company, or if he exercises or assigns such rights;

(vi) when the nature of his interest in the shares or debentures of the listed company or any associated company changes; and

(vii) when he comes to have or ceases to have a short position in the shares of a listed company or any associated company.

As for substantial shareholders, the notification period is reduced to 3 business days.

#### 2.2 *Initial Notifications*

An 'Initial Notification' is required in the following circumstances:

(i) where a director has a notifiable interest at the time the company becomes listed (Section 341(2)(a));

(ii) where a director had a notifiable interest when the SFO came into effect (Section 341(2)(b));

(iii) where a director has a notifiable interest at the time he becomes a director of a listed company (Section 341(2)(c)); and

(iv) where a director of a listed company has a notifiable interest in the shares of another company at the time that company becomes an associated company of the listed company (Section 341(2)(d)).

The period for notification in the case of an Initial Notification is 10 business days.

**3. INTERESTS IN SHARES UNDER EQUITY DERIVATIVES**

As for substantial shareholders, the SFO extends the disclosure obligations of directors to interests in equity derivatives which are not physically settled (ie. interests in unissued shares such as options and interests under cash settled derivatives). For directors this includes interests in the shares of the listed company and its associated companies.

The circumstances in which a person will be taken to have a long position in the underlying shares of equity derivatives and the method of calculating the number of shares in which he is interested are the same as for substantial shareholders.

**4. SHORT POSITIONS**

Directors must disclose all short positions under equity derivatives. A person will be taken to have a short position in the same situations as for substantial shareholders (see paragraph 4 under Substantial Shareholders) and the method of calculating the number of shares in which he is interested is the same. Similarly, the SFO does not permit the netting off of long and short positions and requires each to be disclosed separately.

**5. CHANGES IN THE NATURE OF AN INTEREST (Overhead 26)**

Directors are further required to disclose any change in the nature of an interest which has previously been disclosed. The situations in which there will be such a change are wide and include a change in a person's title to shares or debentures, any of his legal or equitable interest in shares or debentures and any interest in the underlying shares of equity derivatives on the exercise (by or against him) under such derivatives.

The exercise of rights under options and other derivatives and the giving of shares as security (other than to a qualified lender) will, among other things, require notification of a change in nature of a director's interest.

There are only 3 circumstances under Section 341(5) in which there is taken to be no change in the nature of a director's interest:

(i) on the delivery of shares or debentures to him, if he has previously notified his acquisition of an equitable interest;

(ii) where there is a change in the terms on which underlying shares are held due to a change in the number of underlying shares; and

(iii) where a qualified lender comes to have a security interest in the shares or debentures.

Hence, in contrast to the position for substantial shareholders, there will be a notifiable change in the nature of a director's interest in shares on his exercise of rights to subscribe for and on delivery of shares under a rights issue.

## 6. DEEMED INTERESTS

A director is taken to be interested in the interests of his spouse and minor children (not being themselves directors of the listed company), any company which he controls (ie. a company of which he controls the exercise of one third of more of the voting power at general meetings or whose directors are accustomed or obliged to act in accordance with his directions or instructions) and trusts. As under the previous disclosure regime, a director must also disclose his interest under a discretionary trust.

The provisions relating to cessation of interests are the same as for substantial shareholders.

## 7. EXEMPTIONS (Overhead 26)

The exemptions available to directors are limited to those in respect of basket derivatives, bare trustees and collective investment schemes, all as discussed above.

In particular, the exemptions available to substantial shareholders in respect of de minimis changes, lending shares under the SBL Rules and bonus and rights issues are not available to directors.

## 8. PENALTIES FOR FAILURE TO DISCLOSE

Failure to make disclosure within the required time frame or the making of false or misleading statements constitute a criminal offence liable to the same fines and periods of imprisonment as for substantial shareholders (Section 351).

## C. REGISTRATION OF THE INTERESTS AND SHORT POSITIONS OF SUBSTANTIAL SHAREHOLDERS, CHIEF EXECUTIVES AND DIRECTORS (Overhead 27)

As under the previous legislation, listed companies are required to maintain registers of interests and short positions disclosed to them (Sections 336 and 352). These registers may be the same as the registers required by the previous legislation, adapted to include the additional information required to be disclosed by Part XV. Details must be entered on the register within 3 business days following the day of receipt of information by the listed company and the index must be updated within 10 business days of a name being entered on the register. In addition, the register must disclose details of any party holding shares pursuant to a concert party agreement (see paragraph 9.5 above).

If the register is not kept at the company's registered office, a listed company must inform the Registrar of Companies of its whereabouts using the prescribed form of notice now available on the SFC website. Directors and chief executives who are also substantial shareholders will give notice of their interests using Form 3A. The information given in these notices must be registered on both the register of interests and short positions of directors and chief executives and also the register of interests of substantial shareholders.

In addition, under Section 352(3) a listed company is required to record certain information when it grants to a director or chief executive a right to subscribe for shares or debentures of the company. The information required to be recorded against the person's name is as follows: the date on which the right is granted; the period during which, or the time at which, it is exercisable; the consideration for the grant (or if none, that fact); and a description of the shares or debentures involved, the number of shares or the amount of debentures and the price to be paid (or consideration to be given, if not in money). When any such right is exercised by a director or chief executive, the listed company is required to record specified information about that exercise in the register (Section 352(4)). The time limit for recording information relating to the grant and exercise of such rights is 3 business days from the date the obligation to record arises.

Further, under Section 352(4) when any such right is exercised by a director or chief executive, the listed company must record the following information against his name in the register:

(a) the fact of the exercise (identifying the right);
(b) the number of shares or amount of debentures in respect of which it has been exercised; and
(c) if -

(i) they were registered in his name, that fact; or

(ii) they were not registered in his name, the name or names in which they were registered and the number of shares or amount of debentures registered in each name, if applicable.

The time limits for the listed company to record the above information in the register are 3 business days after the date of the grant of the right to subscribe for shares or debentures and 3 business days after the exercise of any such right.

## D. INVESTIGATIONS OF SHAREHOLDERS BY LISTED COMPANIES (Overhead 28)

Under Section 329 a listed company has the power to investigate the identity of holders of interests and short positions in its shares and also the ownership of equity derivatives where the underlying shares of such derivatives are shares in that listed company. As under the previous legislation, a listed company may be required to exercise its powers of investigation on the request of members.

The listed company is then under a duty to inform the Stock Exchange, the SFC and, in the case of authorised financial institutions only, the Hong Kong Monetary Authority of any information received. This notification must be given before the end of the business day after the day on which the duty arises. The listed company must prepare a report of the information received pursuant to any such investigation and make that report available at its registered office within 10 business days of the end of the investigation and must deliver a copy of the report to the SFC and the Stock Exchange. Information received following an investigation must also be recorded in its register of interests and short positions.

## II. THE SECURITIES AND FUTURES ORDINANCE PARTS XIII AND XIV MARKET MISCONDUCT (Overhead 29)

### 1. INTRODUCTION (Overhead 30)

The SFO establishes dual civil and criminal regimes (under Parts XIII and XIV respectively) in respect of all types of market misconduct. The new market misconduct provisions represent a considerable extension of the previous law on market manipulation and disclosure of false or misleading information concerning securities and futures. While some of the new provisions have evolved from legislation replaced by the SFO, the new law is modelled largely on Australian law.

### 2. KEY FEATURES (Overhead 31)

'Market misconduct' as regulated under Parts XIII and XIV comprises 6 offences:

- insider dealing
- false trading
- price rigging
- disclosure of information about prohibited transactions
- disclosure of false or misleading information inducing transactions
- stock market manipulation.

Parts XIII and XIV contain virtually identical civil and criminal provisions in relation to the above.

**(Overhead 32)**

In addition, Part XIV creates 3 new criminal offences:

- use of fraudulent or deceptive devices in transactions in securities, futures contracts or leveraged foreign exchange trading

- disclosure of false or misleading information inducing others to enter leveraged foreign exchange contracts

- falsely representing dealings in futures contracts on behalf of others.

**(Overhead 33)**

The most significant changes effected by the SFO are that:

(i) the civil regime under Part XIII has been considerably extended so that the remit of the Market Misconduct Tribunal ('MMT') (which replaces the Insider Dealing Tribunal ('IDT') extends to all types of market misconduct and not just insider dealing as was the case under the previous legislation;

(ii) the criminal regime under Part XIV has been expanded to cover all forms of market misconduct (previously insider dealing was subject only to civil proceedings) and 3 new offences created by Part XIV;

(iii) the range of sanctions which the MMT can impose is wider than those available to the IDT;

(iv) the maximum criminal sanctions have been increased and harmonised;

(v) the SFO creates a right of civil action in favour of a person who has suffered financial loss to seek compensation from the perpetrator of market misconduct; and

(vi) the SFO imposes a duty on officers of a corporation to take reasonable measures to ensure that the corporation does not contravene the market misconduct provisions.

## 3. INSIDER DEALING (Overhead 34)

### WHAT IS INSIDER DEALING?

In broad terms insider dealing takes place where a person buys or sells shares in a listed company when he has insider information – that is, knowledge of certain facts about that company which the public does not have and which, if known to the public, would have an impact on the price of that company's shares.

Sections 270 and 291 of the SFO set out seven occasions on which insider dealing in relation to a listed corporation occurs **(Overhead 35)**. They are as follows:

(a) **Person with insider information deals in shares of a corporation with which he is connected – Sections 270(1)(a) and 291(1)(a)**

Insider dealing in relation to a listed corporation occurs when a person connected with the corporation has information which he knows is relevant information in relation to that corporation and:

- deals in the corporation's listed securities or their derivatives or in those of a related corporation; or

- counsels or procures another person to deal in such listed securities or derivatives, knowing or having reasonable cause to believe that the other person will deal in them.

(b) **Take-over offer – bidder deals in shares of target – Sections 270(1)(b) and 291(2)**

Insider dealing in relation to a listed corporation also occurs when a person who is contemplating or has contemplated making a take-over offer for the corporation and knows that the information that the offer is contemplated or is no longer contemplated is relevant information:

- deals in the corporation's listed securities or their derivatives or in those of a related corporation otherwise than for the purpose of the take-over; or

- counsels or procures another person to deal in such listed securities or derivatives otherwise than for the purpose of the take-over.

This provision is designed to stop, for instance, a director of a company which is about to launch a take-over bid from telling his friends to buy shares in the intended target in order to make a profit when the price of those shares inevitably rises. It does not stop the director of the bidder from buying shares in the target (or indeed counselling or procuring others to do so) in a "dawn raid" where the sole purpose of such purchases is to facilitate the take-over itself.

The provision is also designed to catch, say, a director of the bidder who sells short in the target when he knows (but the public does not) that the bidder is not going to increase its offer price at the end of the initial offer period but instead is to let the offer lapse.

(c) **Person connected with a corporation leaks insider information about that corporation – Sections 270(1)(c) and 291(3)**

Insider dealing in relation to a listed corporation also occurs when a person connected with a listed corporation has information which he knows is relevant information in relation to the corporation and discloses the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will use the information to deal, or counsel or procure another person to deal, in the corporation's listed securities or their derivatives or in those of a related corporation.

The sub-section is designed to cover the person who deliberately leaks confidential information with a view to someone (whether it be the person to whom he has leaked the information or some other person) using that information to make a favourable deal on the Exchange.

(d) **Bidder leaks take-over information – Sections 270(1)(d) and 291(4)**

Insider dealing also occurs when a person who is contemplating or has contemplated making a take-over offer for a listed corporation and knows that the information that the offer is contemplated or no longer contemplated is relevant information discloses the information, directly or indirectly, to another person knowing or having reasonable cause to believe that the other person will use the information to deal, or to counsel or procure another person to deal in the corporation's listed securities or their derivatives or in those of a related corporation.

This applies where a person who is contemplating or has contemplated a take-over offer for another corporation leaks to another person information to the effect that he is contemplating such an offer or is no longer contemplating such an offer with a view to that other person using the information to deal in the target's securities or to counsel or procure another to deal in them.

(e) **Recipient of insider information from a person connected with a corporation deals in shares of that corporation – Sections 271(1)(e) and 291(5)**

Insider dealing in relation to a listed corporation also occurs when a person has information which he knows is relevant information in relation to a listed corporation which he received, directly or indirectly, from a person whom he knows is connected with the corporation and whom he knows or has reasonable cause to believe held the information as a result of being so connected:

- deals in the corporation's listed securities or their derivatives or in those of a related corporation; or

- counsels or procures another person to deal in such listed securities or derivatives.

This catches the recipient of the leaked information who uses it either by dealing himself or by counselling or procuring someone else to deal. (The person who actually leaks the information would be caught by Sections 270(1)(c) and 291(3).)

(f) **Recipient of insider information about a take-over deals in shares of the target – Sections 270(1)(f) and 291(6)**

Insider dealing also occurs when a person has received, directly or indirectly, from a person whom he knows or has reasonable cause to believe is contemplating or no longer contemplating making a take-over offer for the listed corporation, information to that effect which he knows is relevant information in relation to the corporation and:

- deals in the corporation's listed securities or their derivatives or in those of a related corporation; or

- counsels or procures another person to deal in such listed securities or derivatives.

(g) **Person with insider information seeks to facilitate a dealing on an overseas market – Sections 270(2) and 291(7)**

Insider dealing also occurs when a person who knowingly has relevant information in relation to a listed corporation in any of the circumstances set out above (ie. in sub-section 270(1) and sub-sections 291(1)-(6)) and:

- counsels or procures another person to deal in the corporation's listed securities or their derivatives or in those of a related corporation, knowing or having reasonable cause to believe that the other person will deal in such listed securities or derivatives outside Hong Kong on an overseas stock market; or

- discloses the relevant information to another person knowing or having reasonable cause to believe that he or some other person will use the relevant information to deal or counsel or procure another person to deal in the corporation's listed securities or their derivatives or in those of a related corporation outside Hong Kong on an overseas stock market.

**Definitions**

(i) "Securities"

"Securities" is widely defined to mean:

(a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, or which it is reasonably foreseeable will be issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;

(b) rights, options, or interests (whether described as units or otherwise) in, or in respect of, any of the foregoing;

(c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, any of the foregoing;

(d) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities; or

(e) interests, rights or property, whether or not in the form of an instrument, which the Financial Secretary has specified by notice in the Gazette is to be regarded as a 'security'.

(ii) "Listed securities"

Under the SIDO, the insider dealing laws applied only to securities listed on the Hong Kong Stock Exchange at the time of the dealing in question. The SFO extends the definition of 'listed securities' to include:

- issued unlisted securities provided that, at the time of the insider dealing, it is reasonably foreseeable that they will be listed and they are subsequently in fact listed; and

- unissued securities provided that, at the time of the insider dealing, it is reasonably foreseeable that they will be issued and listed and they are subsequently in fact issued and listed.

This is intended to catch 'grey market' dealings prior to a secondary issue of securities. As insider dealing can only occur in relation to a 'listed corporation', insider dealing in an IPO grey market is not covered. The market manipulation provisions may however apply to such trading to the extent that it affects post listing prices and trading.

As previously, securities are treated as listed notwithstanding that dealings in them may have been suspended.

(iii) "Corporation"

The definition of "corporation" includes the large number of companies which are listed in Hong Kong but incorporated abroad.

(iv) "a person connected with a corporation"

A "person connected with a corporation" is someone who is on the inside track who has access to information about a corporation by reason of his relationship with it. He is commonly called an "insider".

Under Sections 247 and 287 of the SFO, an individual is connected with a corporation if:

(a) he is a director or employee of that corporation or a related corporation;

(b) he is a substantial shareholder (ie. has an interest in 5% or more of the issued voting share capital) in the corporation or a related corporation*;

(c) his position may reasonably be expected to give him access to relevant information concerning the corporation by reason of:

(i) a professional or business relationship existing between himself (or his employer or a corporation of which he is a director or a firm of which he is a partner) and that corporation, a related corporation or an officer or substantial shareholder in either corporation; or

(ii) his being a director, employee or partner of a substantial shareholder of the corporation or a related corporation; or

(d) he has access to relevant information by virtue of being connected (within the meaning of (a), (b) or (c) above) with another corporation where that information relates to a transaction (actual or contemplated) involving both corporations or involving one of them and the listed securities of the other or their derivatives, or to the fact that such transaction is no longer contemplated; or

(e) he was connected with the corporation within the meaning of (a), (b), (c) or (d) above at any time within 6 months preceding any relevant dealing.

* Note that the definition of substantial shareholder has been amended to refer to a holder of an interest of 5% (rather than 10% as under the previous legislation) or more of the company's issued voting share capital consistent with the changes to the regime for disclosure of interests.

A corporation is connected with another corporation if any of its directors or employees are so connected. A director is defined to include shadow directors, that is, persons in accordance with whose instructions the directors of the corporation are accustomed or obliged to act.

Under possession of relevant information obtained in a privileged capacity (Sections 248 and 288), any public officer, member or employee of certain bodies who in his capacity as such obtains relevant information about a corporation will be deemed to be connected with that corporation.

(v) "Relevant information"

"Relevant information" in relation to a corporation (commonly termed "insider information") means specific information about:

(a) the corporation;

(b) a shareholder or officer of the corporation; or

(c) the listed securities of the corporation or their derivatives,

which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but which would, if it were generally known to them, be likely to materially affect the price of the listed securities.

The corresponding definition under the SIDO referred only to information 'about the corporation'. The addition of paragraphs (b) and (c) under the SFO clarify that such information includes information about the corporation's officers, shareholders and listed securities. Insider information could therefore include information about changes in a corporation's shareholders or officers and about rights attaching to listed securities and derivatives over those securities.

(vi) "Dealing in securities"

Under Section 249 of the SFO a person deals, whether he acts as principal or agent. Agreeing to deal and buying or selling the right to deal will also be dealings under the SFO.

(vii) "related corporation"

For the purposes of the SFO:

(a) 2 or more corporations are regarded as related corporations of each other if one of them is:-

(i) the holding company of the other;

(ii) a subsidiary of the other;

(iii) a subsidiary of the holding company of the other;

(b) when an individual:

(i) controls the composition of the board of directors of one or more corporations;

(ii) controls more than half of the voting power at general meetings of one or more corporations; or

(iii) holds more than half of the issued share capital (excluding any part which carries no right to participate beyond a specified amount on a distribution of either profits or capital) of one or more corporations,

each of the corporations referred to in paragraphs (i) to (iii), and each of their subsidiaries, are regarded as related corporations of each other.

***Defences***

Under Sections 271 and 292 of the SFO a person will have a defence if he can establish that he is within one of the categories set out below:

(1) the dealing, counselling or procuring was made:

(a) for the sole purpose of acquiring a qualifying shareholder as a director or intending director of a corporation;

(b) in good faith in performance of an underwriting agreement for the listed securities or derivatives in question; or

(c) in good faith as a liquidator, receiver or trustee in bankruptcy.

(2) in the case of a corporation:

(a) there were effective arrangements in place (commonly called a 'chinese wall') to ring-fence any relevant information in the possession of any of its directors and employees; and

(b) each person who took the decision for the corporation to deal, counsel or procure a dealing in the listed securities or derivatives in question did not have the relevant information at that time and had not received advice from those in possession of such information.

(3) the purpose for which a person dealt in or counselled or procured another to deal in the listed securities or their derivatives or disclosed information did not include the purpose of securing or increasing a profit or avoiding or reducing a loss, whether for himself or another, by using the relevant information.

(4) the person dealt or counselled or procured another to deal in a corporation's listed securities or their derivatives:

(a) as agent;

(b) he did not select or advise on the selection of such listed securities or derivatives; and

(c) he did not know that the person for whom he acted was connected with that corporation or had the relevant information.

The third requirement at (c) above was introduced by the SFO.

(5) the dealing was off-market in Hong Kong and:

(a) where a person dealt in listed securities or their derivatives, he and the other party entered into the dealing directly with each other and at the time of the dealing, the other party knew, or ought reasonably to have known, of the relevant information; or

(b) where a person counselled or procured another person to deal in listed securities or their derivatives, he counselled or procured the other party to enter into the dealing directly with him and at that time the other party knew, or ought reasonably to have known, of the relevant information.

The requirement that the transaction has to be proved to be entered into directly on a principal-to-principal basis before the defence can be relied on was introduced by the SFO.

(6) the person dealt in listed securities or their derivatives but did not counsel or procure the other party to deal and at the time of the dealing the other party knew, or ought reasonably to have known, that he was a person connected with the corporation.

This defence was in the previous legislation and operates on the assumption that people who transact with someone they know or should know is a company insider, should be on notice that the other party may be insider dealing and so make adequate inquiries with the insider before dealing with them and maybe negotiate terms as to the disclosure of insider information.

(7) the person counselled or procured another to deal in listed securities or their derivatives and establishes that:

(a) the other person did not counsel or procure the other party to the dealing to deal in the listed securities or derivatives; and

(b) at the time he counselled or procured the other person to deal, the other party to the dealing knew, or ought reasonably to have known, that the other person was a person connected with the corporation.

This is a new defence added by the SFO. In essence, it gives a defence to a person who counsels or procures a person to deal in the same circumstances as a defence is available to a person who deals under (6) above. It is really a logical extension of the existing defence under paragraph (6). It would, for example, protect a merchant bank who introduced a prospective purchaser to a substantial shareholder of a listed corporation who the bank thought might want to tender to divest their shareholding and advised the shareholder on the sale.

(8) the person dealt or counselled or procured another to deal in a corporation's listed securities or their derivatives and:

(a) he acted in connection with any dealing which was under consideration or was the subject of negotiation, or in the course of series of such dealings and with a view to facilitating the accomplishment of the dealing or the series of dealing; and

(b) the relevant information was market information arising directly out of his involvement in the dealing or the series of dealings.

'Market Information' is defined to include facts such as -

- that there has or is to be (or that there has not been or is not to be) a dealing in listed securities or their derivatives or that any such dealing is under consideration or negotiation;

- the quantity and price (or price range) of the listed securities or their derivatives; and

- the identity of the persons involved.

This defence was introduced by the SFO. It gives a defence to a person who trades with knowledge of his own trading intentions or activities and also to those who simply execute or facilitate a trade on his behalf. The new defence caters for the situation in which a person, whose trading activities might be price-sensitive information (eg. a substantial shareholder and therefore a connected person, increases his stake in a listed company). Without such an explicit defence a person dealing with 'insider' information about their own trading activities is technically insider dealing even though the Hong Kong authorities did not taken action against such conduct under the previous legislation.

(9) the dealing in question was subject to the rules of a recognised clearing house and was entered into by the clearing house with a clearing participant for the purposes of the clearing and settlement of a market transaction.

Sections 272 and 293 provide a further defence where a trustee or personal representative dealt in or counselled or procured a dealing in listed securities or their derivatives on advice obtained in good faith from an appropriate person who did not appear to him to be a person who would have been involved in insider dealing if he himself had dealt in the listed securities or their derivatives.

Sections 273 and 294 provide a defence where a person dealt in listed securities or their derivatives in the exercise of a right to subscribe for or otherwise acquire such securities or their derivatives which was granted to him or was derived from securities held by him at a time when he was not aware of any relevant information.

**OTHER FORMS OF MARKET MISCONDUCT**

**1. FALSE TRADING (Sections 274 and 295) (Overhead 36)**

In summary, false trading prohibits:

(i) intentionally or recklessly creating (or doing anything likely to create) a false or misleading appearance of active trading in, or as to the market for, or price of, securities or futures; and

(ii) transactions (which need not be in securities or futures) entered into with the intention that, or being reckless as to whether, they create or maintain an artificial price for securities or futures.

It is not necessary for the transaction or transactions concerned to be in securities or futures. These provisions therefore prohibit a range of conduct that occurs off a market that affects prices on a securities or futures market, most importantly cross-market manipulation (ie. conduct in one market which has a manipulative effect in another market) and cornering (ie. monopolising or restricting supply of an asset so as to manipulate its price).

A person who engages in an on-market 'wash sale' or 'matched order' is presumed to have intended, or been reckless as to whether, his conduct creates or is likely to create a false or misleading appearance of active trading, the market for, or price of, the securities under the first leg of the offence (S274(5) and S295(5)). He will have a defence if he can establish that the purposes for which he engaged in the transaction did not include the purpose of creating such a false or misleading appearance (S274(6) and S295(7)). The presumption applies only to 'on-market' wash sales and matched orders – that is they are recorded on the relevant exchange or ATS or have to be reported to the exchange or ATS operator under the rules governing the exchange or ATS. For off-market wash sales and matched orders, the prosecution will need to prove the mental element.

'Wash sales' are trades in which a person buys or sells securities without there being a change of beneficial ownership (Sections 274(5)(a) and 295(5)(a)).

A 'matched order' is where a person offers to sell or buy securities at a price that is substantially the same as the price at which he has made or proposes to make, or he knows an associate of his has made or proposes to make, an offer to buy or sell the same or substantially the same number of securities (Sections 274(5)(b) and (c) and 295(5)(b) and (c)).

## 5. PRICE RIGGING (Sections 275 and 296) (Overhead 37)

Price rigging prohibits:

(i) engaging in wash sales which affect the price of securities (unless the defendant can show that his purposes did not include the purpose of creating a false or misleading appearance as to the price of securities); and

(ii) engaging in a fictitious or artificial transaction intending that, or being reckless as to whether, it will affect the price of securities or futures.

A person will have a defence in relation to (i) above if he can establish that the purposes for which the securities were sold or purchased did not include the purpose of creating a false or misleading appearance with respect to the price of securities (Sections 275(4) and 296(5)).

## 6. STOCK MARKET MANIPULATION (Sections 278 and 299) (Overhead 38)

These provisions relate only to securities.

They prohibit engaging in transactions in securities of a corporation that affect the price of any securities, intending to induce investment decisions relating to the securities of the corporation or to those of a related corporation.

## 7. DISCLOSURE OF INFORMATION ABOUT PROHIBITED TRANSACTIONS (Sections 276 and 297) (Overhead 39)

This offence prohibits a person from disclosing information that the price of securities or futures traded on an exchange or through an automated trading system ('ATS') in Hong Kong will be affected by a transaction in contravention of the market misconduct provisions or Part XIV, if he or his associate entered into the transaction or will benefit from the disclosure. Defences are available to those who innocently report market misconduct and its effect on prices and innocently receive a benefit for such conduct (eg. journalists and research analysts).

These provisions build upon the previous law in Section 135(5) of the SO and Section 62(2) of the CTO. Their aim is to prevent persons involved in market misconduct, their associates or those they have recruited for reward from spreading information about the effect that market misconduct is going to have on the price of a security or futures contract. Those involved in market misconduct may seek to increase their profits by spreading such rumours hoping that ordinary investors will be encouraged to buy or sell, so pushing the price of the securities or futures further in the direction that those involved in the market misconduct intend.

## 8. DISCLOSURE OF FALSE OR MISLEADING INFORMATION INDUCING TRANSACTIONS (Sections 277 and 298) (Overhead 40)

This offence prohibits the disclosure of information about securities or futures which is materially false or misleading that is likely to induce investment decisions or affect prices in Hong Kong, if the defendant knows that, or is reckless or, *for civil liability only*, negligent as to whether, the information is materially false or misleading.

Defences are available for those who unwittingly disseminate false or misleading information in the course of their business, which involves disseminating information received from others and who are not in a position to check the accuracy of that information. In summary these defences are for:

(a) persons operating a 'conduit' style business of issuing or reproducing information supplied by others, such as publishers and printers;

(b) persons whose business involves electronically providing access to third party information, where the information is wholly devised by another person, for example those operating internet websites providing access to third party information; and

(c) broadcasters of information devised wholly by another.

These defences may only be relied upon if the person did not know that the information was materially false or misleading at the time of disclosure. They are narrowly drafted and will only be available in very specific circumstances. In particular, they are only available where the information has been devised entirely by someone else and the defendant and his officers and employees did not in any way modify or exercise control over the information. In the case of paragraph (b), it must also be made clear that those re-transmitting the information have not devised it, and do not take responsibility for or endorse its accuracy.

These provisions have significant implications for issuers of securities (whether listed or unlisted) and their advisers. While it must be the case that the information is likely to have an effect (ie. induce a dealing in, or affect the price of, securities or futures contracts) in Hong Kong, the disclosure of information may occur anywhere. Further, it is not necessary for the information disclosed to in fact have such an effect. It is sufficient if the information is *likely* to have that effect. Given that negligence as to whether the information is materially false or misleading is sufficient to establish civil liability (and recklessness may establish criminal liability), these provisions are of considerable significance for roadshows, research analysts and the imparting of information to potential investors generally.

## 9. SCOPE OF OFFENCES (Overhead 41)

The new regime is far-reaching. In the case of the market manipulation offences (ie. false trading, price rigging and stock market manipulation) the offences cover both conduct in Hong Kong or elsewhere which affects securities (or futures) traded on an exchange or through an ATS in Hong Kong and conduct in Hong Kong which has the same effect on securities (or futures) traded on an overseas market. Where the conduct affects an overseas market, the prosecution must prove that the conduct is also unlawful in the country in which the market is situated.

## 10. ADDITIONAL OFFENCES

Division 4 of Part XIV creates 3 new offences. These are not within the definition of market misconduct and are therefore not liable to proceedings before the MMT and are instead subject only to criminal proceedings.

**USE OF FRAUDULENT OR DECEPTIVE DEVICES IN TRANSACTIONS IN SECURITIES, FUTURES CONTRACTS OR LEVERAGED FOREIGN EXCHANGE TRADING (Section 300)**

This offence provides that a person shall not, directly or indirectly, in a transaction involving securities, futures contracts or leveraged foreign exchange trading:

(a) employ any device, scheme or artifice with intent to defraud or deceive; or

(b) engage in any act, practice or course of business which is fraudulent or deceptive, or would operate as a fraud or deception.

**DISCLOSURE OF FALSE OR MISLEADING INFORMATION INDUCING OTHERS TO ENTER LEVERAGED FOREIGN EXCHANGE CONTRACTS (Section 301)**

A person shall not, in Hong Kong or elsewhere, disclose, circulate or disseminate, or authorise or be concerned in the disclosure, circulation or dissemination of, information that is likely to induce another person to enter into a leveraged foreign exchange contract in Hong Kong, if:

(a) the information is false or misleading as to a material fact or through the omission of a material fact; and

(b) the person knows that, or is reckless as to whether, the information is false or misleading as to a material fact or through the omission of a material fact.

This prohibits the same conduct in relation to leveraged foreign exchange contracts as is outlawed in respect of securities and futures transactions under Section 298. Section 301 also provides the same narrowly drafted defences as that section for those who passively disseminate information received from others such as printers, internet website operators and broadcasters.

**FALSELY REPRESENTING DEALINGS IN FUTURES CONTRACTS ON BEHALF OF OTHERS (Section 302)**

A person shall not represent to another person that he has on behalf of the other person dealt in, or facilitated or arranged for any dealing in, a futures contract traded on an exchange or through an ATS in Hong Kong (or a contract or other instrument substantially resembling a futures contract in accordance with the rules of a futures market outside Hong Kong), if he has not in fact done so and he knows that, or is reckless as to whether, he has not done so.

## EFFECTS OF MARKET MISCONDUCT (Overhead 42)

## 11. THE MARKET MISCONDUCT TRIBUNAL ('MMT') (Overhead 42)

The MMT, which replaces the IDT, is chaired by a judge assisted by two members and a presenting officer appointed by the Secretary for Justice conducts proceedings. Like the IDT it is inquisitorial and is entitled to direct that the SFC carry out further investigations and report its findings to the MMT.

There are detailed provisions in the SFO governing the composition of and procedures to be followed by the MMT.

***Proceedings of the MMT***

The Financial Secretary may under Section 252 institute proceedings before the MMT in respect of any suspected market misconduct following a report by the SFC or a referral from the Secretary for Justice by giving notice in writing to the MMT setting out the terms of reference for the proceedings.

The main purpose of proceedings is to determine:

(a) whether any market misconduct has taken place;

(b) the identity of every person involved in the market misconduct; and

(c) the amount of any profit gained or loss avoided as a result of the market misconduct.

The MMT may identify a person as having engaged in market misconduct if:

(a) he has perpetrated any market misconduct;

(b) the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or

(c) another person engaged in market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.

The MMT makes its findings on the civil standard of proof. It needs therefore to be satisfied that a person has engaged in market misconduct on the balance of probabilities (rather than beyond reasonable doubt which is the criminal standard of proof). However, like the IDT, the MMT has powers to receive any evidence, whether or not such evidence would be admissible in civil or criminal proceedings. It also has wide powers to compel the giving of evidence and to prevent the publication of information about the evidence the MMT receives. Significantly, a person is not excused from complying with a requirement of the MMT to give evidence on the ground that to do so might incriminate him (Section 253(4)) and such compelled self-incriminatory evidence may be considered by the MMT.

## 12. ORDERS OF THE MMT (Overhead 43)

At the end of any proceedings, the MMT may under Section 257(1) impose the following sanctions on any person found to have committed market misconduct:

(a) *a disqualification order* – that a person shall not, without the leave of the Court of First Instance, be or continue to be a director, liquidator, or receiver or manager of the property or business, of a listed corporation or any other specified corporation or in any way, whether directly or indirectly, be concerned or take part in the management of a listed corporation or other specified corporation for up to 5 years;

(b) *a cold shoulder order* – that a person shall not, without the leave of the Court of First Instance, in Hong Kong, directly or indirectly, deal in any securities, futures contract or leveraged foreign exchange contract, or an interest in any of them or a collective investment scheme for up to 5 years;

(c) *a cease and desist order* – that the person must not again engage in any specified form of market misconduct;

(d) *a disgorgement order* – that the person pay to the Government an amount up to the amount of any profit gained or loss avoided as a result of the market misconduct;

(e) *Government costs order* – that the person pay to the Government its costs and expenses in relation to the proceedings and any investigation;

(f) *SFC costs order* – that the person pay the SFC's costs and expenses in relation to any investigation; and

(g) *disciplinary referral order* – that any body which may take disciplinary action against the person as one of its members be recommended to take such action against him.

The ability of the IDT to impose high fines (which could be up to 3 times the amount of profit made or loss avoided as a result of insider dealing) has been abandoned in favour of a wider range of civil sanctions. In addition, a disgorgement order may, at the discretion of the MMT, be made subject to compound interest from the date of the occurrence of the market misconduct in question (Section 259). The SFC also has the ability to fine regulated persons [(see 'Disciplinary Proceedings' below)].

When making an order, the MMT may take account of any previous convictions in Hong Kong, any previous findings of market misconduct by the MMT and any previous findings of insider dealing under the S(ID)O (S257(2)).

Cold shoulder orders, cease and desist orders, SFC costs orders and disciplinary referral orders were introduced by the SFO. Failure to comply with a disqualification, cold shoulder or cease and desist order is a criminal offence under sub-sections 257(10) and 258(10) punishable by a maximum fine of $1 million and/or up to 2 years' imprisonment.

In addition, Sections 253(2) and 254(6) prescribe a penalty of a maximum fine of $1 million and a maximum of 2 years' imprisonment for failure to comply with various requirements of the MMT or disrupting its proceedings. The conduct referred to in those sections and in Sections 257(10) and 258(10) is also liable to be punished as contempt under Section 261.

## 13. APPEALS

Any person who is dissatisfied with a finding or determination of the MMT may appeal to the Court of Appeal but only in respect of a point of law or, with the leave of the Court of Appeal, on a question of fact (Section 267).

## 14. CRIMINAL LIABILITY

All forms of market misconduct (including insider dealing) and the new offences created by Part XIV are liable to prosecution as a criminal offence under Part XIV of the SFO. Previously insider dealing was subject only to civil proceedings before the IDT. Some forms of market misconduct were previously criminal offences under the SO and the CTO.

## 15. CRIMINAL PENALTIES (Overhead 44)

The maximum criminal sanctions were increased by the SFO to a maximum of 10 years' imprisonment and fines of up to $10 million. Previously the maximum penalties under the different ordinances were inconsistent. The court may also impose disqualification, cold shoulder and disciplinary referral orders. Failure to comply with a disqualification or cold shoulder order is an offence liable to a maximum fine of $1 million and up to 2 years' imprisonment.

## 16. NO DOUBLE JEOPARDY (Overhead 44)

A person will not be subject to the 'double jeopardy' of both civil proceedings under Part XIII and criminal proceedings under Part XIV for the same conduct. The SFO provides that a person who has been subject to criminal proceedings under Part XIV may not be subject to MMT proceedings if those proceedings are still pending or if no further criminal prosecution could be brought against that person again under Part XIV in respect of the same conduct and vice versa (Sections 283 and 307).

The decision as to whether to take civil or criminal proceedings in relation to suspected market misconduct is made by the Secretary for Justice. The SFC may also institute summary criminal proceedings before a magistrate for less serious market misconduct offences, although the Secretary for Justice is able to intervene in the SFC's conduct of any such proceedings. The decision whether to take criminal or civil proceedings is made in accordance with the Department of Justice's Prosecution Policy which provides two criteria for the institution of criminal proceedings: that there is sufficient evidence for a criminal prosecution and that a criminal prosecution is in the public interest. If these tests are not met, suspected market misconduct will be dealt with through civil proceedings before the MMT.

## 17. CIVIL LIABILITY – PRIVATE RIGHT OF ACTION (Overhead 45)

The SFO creates a private right of civil action in favour of anyone who has suffered financial loss as a result of market misconduct or any offence under Part XIV to seek damages from the person who committed the market misconduct or Part XIV offence. The perpetrator is liable to pay damages, unless it is fair, just and reasonable that he should not (Sections 281 and 305). This is particularly significant in terms of insider dealing: one of the perceived weaknesses of the Securities Insider Dealing Ordinance was that it did not provide for a civil right of action by which a counter party to an insider dealing could be compensated by the insider dealer.

A person will be taken to have committed market misconduct if:

(a) he has perpetrated any market misconduct;

(b) the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or

(c) any other person committed market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.

It is not necessary for there to have been a finding of market misconduct by the MMT or a criminal conviction under Part XIV before bringing civil proceedings. Findings of the MMT are however admissible in the civil proceedings as prima facie evidence that the market misconduct took place or that a person engaged in market misconduct. Further a criminal conviction constitutes conclusive evidence that the person committed the offence. The courts are able to impose injunctions in addition to or in substitution for damages.

## 18. LIABILITY OF OFFICERS OF A CORPORATION (Overhead 46)

### *Duty of Officers*

Section 279 of the SFO imposes a duty on all officers of a corporation to take reasonable measures to ensure that proper safeguards exist to prevent the corporation from acting in a way which would result in the corporation perpetrating any market misconduct. This is an extension of the duty contained in the S(ID)O. Under the SFO the duty applies to all forms of market misconduct and not just insider dealing.

The definition of an 'officer of a corporation' is also broader than under the S(ID)O. It includes a director (including a shadow director and any person occupying the position of a director), manager or secretary of, or any other person involved in the management of, the corporation. The last category (ie. any other person involved in management) was not included in the S(ID)O definition and could, in principle, catch supervisors and anyone else with management responsibilities.

Under Section 258, where a corporation has been identified as having been engaged in market misconduct and the market misconduct is directly or indirectly attributable to a breach by any person as an officer of the corporation of the duty imposed on him by Section 279, the MMT may make one or more of the orders detailed above in respect of that person even if that person has not been identified as having engaged in market misconduct himself. However, a breach of the Section 279 duty will not expose a person to civil suits by third parties unless he has been identified as having engaged in market misconduct.

### *Civil Liability*

As discussed above, the SFO clearly provides that anyone who suffers financial loss as a result of market misconduct or a Part XIV offence has a right of civil action to seek compensation. As already noted, an officer of a corporation which perpetrated market misconduct is taken to have committed market misconduct himself, if the corporation perpetrated the misconduct with his consent or connivance.

***Criminal Liability***

Under Section 390 of the SFO, where it is proved that an offence committed under Part XIV was aided, abetted, counselled, procured or induced by, or committed with the consent or connivance of, or attributable to the recklessness of, any officer of the corporation, or any person purporting to act in any such capacity, that person, as well as the corporation, is guilty of the offence and liable to be punished accordingly.

***Disciplinary Proceedings***

Under Part IX of the SFO, any regulated person who is guilty of misconduct or who, in the opinion of the SFC, is not a fit and proper person to be or to remain the same type of regulated person, is subject to a widened range of disciplinary procedures. 'Misconduct' is defined to include any contravention of the SFO or of the terms of any licence issued or registration made under it. The SFC may revoke or suspend a person's licence in respect of all or any part of the regulated activities for which he is licensed. In addition, or alternatively, the SFC may impose a fine not exceeding the greater of $10 million or 3 times the amount of the profit gained or loss avoided by the regulated person as a result of his misconduct, or such other conduct which led to the SFC's opinion that he is not fit and proper. The SFC may also impose prohibition orders preventing an offending person from, among other things, applying to be registered or licensed under the SFO. Approvals granted to 'responsible officers' may also be suspended or revoked. Persons covered by these provisions include corporations licensed under the SFO, their responsible officers and persons involved in their management. Significantly, authorised financial institutions (now required to be registered with the SFC if carrying out certain regulated activities), their executive officers, persons involved in the management of their regulated business and individuals named in their register as carrying out a regulated activity, are also now subject to the SFC's disciplinary regime.

## III REGULATION OF OFFERS OF INVESTMENTS UNDER PART IV SECURITIES AND FUTURES ORDINANCE (Overhead 47)

### A. INTRODUCTION (Overhead 48)

Part IV of the SFO regulates the offer of investment products to the public in Hong Kong. It covers 3 main areas:

- it builds on the provisions of the repealed Protection of Investors Ordinance (the 'PIO') which prohibited the issue of investment advertisements to the public unless authorised by the SFC;
- it elaborates on the SFC's power to authorise unit trusts and mutual funds previously contained in the Securities Ordinance; and
- it creates civil and criminal liability for fraudulently, recklessly or negligently (for civil liability only) inducing others to invest money.

While the general principles underlying the legislation remain essentially the same, the adoption of certain new definitions, notably the new definition of 'collective investment scheme' which covers mutual funds, unit trusts and other pooled investment arrangements, have widened the range of investment products to which the offering restrictions and offences apply. Other significant changes include a new definition of 'professional investor' for the purposes of the exemption from the prohibition on issue of investment advertisements to the public and a new power for the SFC to withdraw an authorisation already granted.

### B. PROHIBITION ON UNAUTHORISED INVESTMENT ADVERTISEMENTS (Overhead 49)

1.1 Section 103(1) SFO builds on the prohibition in the repealed PIO in providing that it shall be an offence if a person issues, or has in his possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document which to his knowledge is or contains an invitation to the public:

(a) to enter into or offer to enter into:

(i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

(ii) a regulated investment agreement; or

(b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme,

unless the issue is authorised by the SFC.

**NEW TERMINOLOGY (Overhead 50)**

1.2 ***'Regulated Investment Agreement'***

A 'regulated investment agreement' is defined as an agreement, the purpose or effect, or the pretended purpose or effect, of which is to provide, whether conditionally or unconditionally, to any party to the agreement a profit, income or other returns calculated by reference to changes in the value of any property, but does not include an interest in a collective investment scheme.

1.3 ***'Collective Investment Scheme'***

Collective investment scheme is the new term used in the SFO to cover mutual funds, unit

trusts and other pooled investment arrangements. The definition of 'collective investment scheme' is broad bringing a wider range of investment products within the regulatory regime under Part IV. The principal elements of the definition are:

(i) that the scheme constitutes arrangements in respect of any property under which the participants do not have day-to-day control over the management of the property (whether or not they have the right to be consulted or to give directions in respect of the management);

(ii) the property is managed as a whole by or on behalf of the person operating the scheme, or contributions from participants and profits or income are pooled, or both; and

(iii) the purpose or effect, or pretended purpose or effect, of the scheme is to enable participants to receive profits, income or other returns arising from the acquisition, holding, management or disposal of all or part of the scheme's property.

The Financial Secretary is also empowered to prescribe any arrangement or class of arrangements to be collective investment schemes by notice in the Gazette.

1.4 ***New Deeming Provisions (Overhead 51)***

The SFO introduces new deeming provisions whereby:

- any advertisement, invitation or document which consists of or contains information likely to lead, directly or indirectly, to the doing of any act referred to in Section 103(1)(a) or (b) is regarded as an advertisement, invitation or document which is or contains an invitation to do such act; and

- any advertisement, invitation or document which is or contains an invitation directed at, or the contents of which are likely to be accessed or read (whether concurrently or otherwise) by, the public is deemed to be or contain an invitation to the public.

## 2. SFC AUTHORISATION OF INVESTMENT ADVERTISEMENTS (Overhead 52)

The SFO explicitly empowers the SFC to authorise the issue of an investment advertisement subject to any conditions it considers appropriate (Section 105). Under the previous regime there was some ambiguity as to whether the SFC's power to authorise advertising material permitted it to impose structural and operational requirements on the product itself. The SFO therefore expressly provides that, in authorising any investment advertisement, the SFC may impose such conditions as it considers appropriate, including specifically, conditions on the matter to which the investment advertisement relates.

A new feature of the application procedure is that the applicant must nominate for approval by the SFC an individual to be served with notices and decisions relating to the issue (Section 105(2)).

## 3 EXEMPTIONS (Overhead 53)

3.1 The SFO contains a number of exemptions to the prohibition on unauthorised investment advertisements which are set out in Sections 103(2) and (3). These have for the most part been carried forward from the PIO.

The exemptions fall into 2 main categories:

- exemptions relating to the type of person issuing the investment advertisement (eg. for advertisements issued by intermediaries licensed or registered under the SFO); and

- exemptions relating to certain types of investment advertisement (eg prospectuses complying with the Companies Ordinance and investment advertisements made in respect of the issue of securities whose listing has been approved and where the investment

advertisement complies with the listing rules).

Exemptions are also retained for investment advertisements in respect of securities and interests in a collective investment scheme or regulated investment agreement which:

- are offered only to persons outside Hong Kong; or
- are offered only to 'professionals'.

3.2 The Professional Investor Exemption under the SFO (Overhead 54)

One important change introduced by the SFO is that, with respect to the 'professionals exemption' referred to at paragraph (j) above, it includes a specific definition of 'professional investor' which sets out the categories of persons who will be regarded as 'professionals'. This replaces the more generic wording previously contained in the PIO which applied the exemption to 'persons whose *ordinary business* involves the acquisition, disposal or holding of securities, whether as principal or agent'. The new definition therefore makes for greater certainty as to who is within the definition. The definition which is contained in Schedule 1 to the SFO and the Securities and Futures (Professional Investor) Rules is lengthy and includes:

***(Overhead 55)***

- authorised financial institutions and overseas banks
- authorised insurers (and overseas equivalents)
- authorised collective investment schemes and their operators (and overseas equivalents)
- registered MPF schemes, their constituent funds and approved trustees/service providers and investment managers
- registered occupational retirement schemes (and overseas equivalents)

and

- trust corporations with total assets of HK$40 million
- individuals with a portfolio of HK$8 million
- corporations or partnerships with a portfolio of HK$8 million or total assets of HK$40 million

3.3 The 'Professionals Exemption' under the Companies Ordinance (Overhead 56)

An important point to note is that the corresponding provision of the Companies Ordinance (the 'CO') has not yet been amended in line with the SFO. Section 343(2) which contains the so-called 'professionals exemption' for companies incorporated outside Hong Kong provides that an offer of shares or debentures to 'persons whose *ordinary business* is to buy or sell shares or debentures, whether as principal or agent' shall not be deemed to be an offer to the public triggering the CO prospectus requirements. This definition is narrow as, in practice, many investors (including large corporate investors) who are not buying or selling shares or debentures *in the ordinary course of their business* may not, strictly speaking, be within the definition.

The benefit of the 'professionals exemption' was also effectively made available to Hong Kong incorporated companies by the Companies Ordinance (Exemption of Companies from Compliance with Provisions) Notice 2001 (as amended in 2002 and 2003). That notice exempts Hong Kong incorporated companies and their prospectuses from compliance with the dual language and contents requirements of Section 38(1) CO where the shares or debentures are offered only 'to persons whose ordinary business is to buy or sell shares or debentures, whether as principal or agent'. Offers to 'professionals' are also exempted from the requirements of Section 38(3) (requiring distribution of application forms with prospectuses) and Section 44A2 (the 30-day time limit for allotment of shares and debentures after the issue of a prospectus). Prospectuses issued only to professionals by Hong Kong companies must however be registered with the Registrar of Companies under Section 38D CO whereas prospectuses of overseas companies issued only to professionals are not required to be registered.

*(Overhead 57)*

It is however proposed that the CO be brought into line with the SFO. The CO requires any 'prospectus' to comply with the registration and contents requirements of the CO. The Companies (Amendment) Bill 2003 (the 'CAB') proposes to exclude from the definition of 'prospectus' any document containing an offer to investors falling within the much wider SFO definition of 'professional investors' (Section 27 CAB). This will also mean that prospectuses of Hong Kong incorporated companies making offers only to professionals will no longer be required to be registered with the Registrar of Companies.

3.4 ***Other proposed amendments to the prospectus regime under the Companies Ordinance***

3.4.1 **Other proposed exemptions (Overhead 58)**

The CAB proposes to exclude the offering documentation for 11 further categories of offers from the CO 'prospectus' definition. This will allow such offers to be made by both Hong Kong and overseas incorporated companies without triggering the prospectus regime. The most important of the proposed categories are:

1. Offers to not more than 50 persons.*

2. Offers for which the total consideration payable for the relevant shares or debentures does not exceed $5,000,000.*

3. Offers where the minimum consideration payable by any person is not less than $500,000.*

[4. Offers made in connection with an invitation made in good faith to enter into an underwriting agreement.

5. Offers made in connection with a takeover, merger or share repurchase made in compliance with the relevant SFC codes.

6. Offers in respect of an exchange of shares in the same company which does not result in an increase in the issued share capital of the company or an exchange of debentures of the same company which does not result in an increase in the aggregate principal amount outstanding under the debentures.*

7. Offers made in connection with a collective investment scheme authorised under Section 104 SFO in respect of which the documentation has been been approved under Section 105 SFO.]

* It is proposed that the offer documentation in each of these cases will be required to contain a warning statement that it has not been reviewed or endorsed by any regulatory authority of Hong Kong. Suggested wording will be set out in Part 3 of the new 18th Schedule to the Companies Ordinance.

Although not explicit in the draft legislation, the SFC has stated in writing that offering documentation in relation to an offer targeted at persons outside Hong Kong will be outside the scope of the CO prospectus regime. They have also confirmed that any part of an offer made to persons outside Hong Kong will not be subject to the prospectus regime.

3.4.2 Ability to combine exemptions

A further important change proposed by the CAB is that, with the exception of the 2 exclusions under paragraphs 2 and 3 of section 3.4.1 above, each exclusion will be able to be used in combination with any of the others (Part 4 of the proposed new 17th Schedule to the Companies Ordinance). Accordingly, where an offer is structured into separate parts, provided that each part falls within one of the exclusions, then the whole offer will be excluded. For example, documents making an offer to

professional investors and to not more than 50 other persons would not be regarded as 'prospectuses' under the new CAB proposals. This is a reversal of the current position, the SFC having indicated in the past that the professionals and private placement exemptions cannot be used concurrently, which is also the currently accepted view with respect to the SFO.

The CAB is still being reviewed by the Bills Committee and will not become law until some time in 2004.

3.4.3 New ground for exemption

Another proposal of the CAB is to widen the SFC's existing power to grant an exemption from the prospectus requirements under Sections 38A and 342A of the Companies Ordinance by adding a further ground for exemption: that the exemption will not prejudice the interest of the investing public. It is also proposed that the number of provisions in respect of which the exemption may be granted is increased (Section 3 CAB).

3.4.4 Prospectus provisions extended to prospectuses making offers for sale by overseas companies

The CAB proposes that prospectuses offering shares or debentures 'for sale' (ie. not only those making offers for subscription as is currently the case) by overseas companies will trigger the Companies Ordinance prospectus provisions, as has always been the case for Hong Kong incorporated companies.

3.4.5 Consequential amendments to the SFO

Consequential amendments to the SFO made by the CAB will mean that any document excluded from the CO definition of 'prospectus' (ie. the offering documents for any offer within the safe harbours in the new 17th Schedule to the CO as summarised at paragraph 3.4.1 above) will also be exempted from the prohibition on unauthorised investment advertisements in Section 103(1) SFO by virtue of a new exemption to be added at Section 103(2) SFO.

3.5 ***Private Placements under the SFO (Overhead 58)***

Although this is not technically an exemption, investment advertisements not issued *to the public* should not fall foul of the legislation. It is our view that a private placement to a small group of identified investors (up to a maximum of 20) should not constitute an offer to the public if appropriate precautions are taken. However, this is an untested area under the SFO as yet. In particular, the SFC has given no indication as to the maximum number of placees which can safely be regarded as not constituting an offer *to the public*. Further, whether or not an offer is *to the public* will depend on the circumstances of each case.

As discussed above, the CAB proposes to provide a specific exemption from the Companies Ordinance prospectus provisions for offers to less than 50 persons. This is in line with industry practice which has taken the limit of 50 persons as the benchmark for private placements in relation to the Companies Ordinance.

In view of the current disparity between the SFO and Companies Ordinance definitions of 'professionals' and the uncertainty surrounding the acceptable limit on the number of placees for private placements under the SFO, one option would be to offer to a limited number of persons (making the offer a private placement for the purposes of the Companies Ordinance in view of the restricted definition of 'professionals') and to ensure that all the placees are within the much wider SFO definition of 'professionals' or are overseas investors to take advantage of the specific exemptions under Section 103(3).

4. **PENALTIES FOR BREACH OF SECTION 103(1) SFO (Overhead 59)**

The offence of breaching Section 103(1) carries a maximum fine of $500,000 and up to 3 years' imprisonment. A further fine of $20,000 is payable for each day that the offence continues (Section 103(4)).

5. **DEFENCES**

Sections 103(5) to (9) contain a number of defences to the Section 103(1) offence.

Section 103(5) provides defences for investment advertisements issued or held in possession for the purposes of issue as or on behalf of:

- intermediaries licensed or registered for Type 1, Type 4 or Type 6 regulated activity (whether as principal or agent) in respect of securities;

- intermediaries licensed or registered for Type 2 or Type 5 regulated activity (whether as principal or agent) in respect of futures contracts;

- authorised financial institutions (whether as principal or agent) or intermediaries licensed for Type 3 regulated activity (whether as principal or agent) in respect of leveraged foreign exchange contracts.

These defences do not however apply to investment advertisements in respect of interests in unauthorised collective investment schemes (Section 103(11)).

Section 103(6) contains corresponding defences for investment advertisements issued or held in possession for the purposes of issue *to* intermediaries licensed or registered for the same types of regulated activities (or their representatives carrying on the relevant regulated activity for the intermediary) and authorised financial institutions in respect of the same types of investments.

Defences are also available to conduits and live broadcasters who issue any prohibited material in the ordinary course of their business provided that they have no right to control or modify the content of the material (Sections 103(7) and (8)).

It is also a defence if the person can show that he took all reasonable steps and exercised all due diligence to avoid commission of the offence (Section 103(9)).

## C. AUTHORISATION OF COLLECTIVE INVESTMENT SCHEMES (Overhead 60)

### 1. AMBIT OF THE SFC'S POWER OF AUTHORISATION

Under the previous regime (Section 15 Securities Ordinance), only 2 categories of products were specifically regulated, namely unit trusts and mutual funds. Other investment products such as investment-linked assurance schemes and pooled retirement funds were regulated only to the extent that their marketing materials were required to be authorised by the SFC under the PIO. The SFO now specifically empowers the SFC to authorise any collective investment scheme subject to any conditions it considers appropriate (ie. to authorise the product itself) (Section 104(1)).

The SFO's new definition of 'collective investment scheme' (see paragraph B.1.3 above) introduced to cover unit trusts, mutual funds and other pooled investment arrangements ensures that a broader range of investment products are now appropriately regulated.

SFC authorisation of a collective investment scheme will be required where it is to be marketed to the 'public' unless invitations in respect of the scheme can rely on any of the exemptions in Section 103 to the offence in Section 103(1). It follows that interests in unauthorised collective investment schemes can be offered only to persons outside Hong Kong or only to 'professional investors' in reliance on the exemptions under Sections 103(3)(j) and (k).

It is also our view that it should be possible to offer unauthorised schemes by way of private placement (see paragraph B.3.4. above) so as not to constitute an 'offer to the public' provided that appropriate precautions are taken. This is, however, very much an untested area under the SFO.

The procedures to be followed in applying for authorisation are set out in the Code on Unit Trusts and Mutual Funds (the 'Code'). As with applications for authorisation of investment advertisements, a new feature of the application process is that the applicant must nominate for approval by the SFC an individual to be served with notices and decisions relating to the scheme (Section 104(2)(a)). On

application, the SFC will vet the constitutive and offering documents of the collective investment scheme against the Code. In general, the SFC will simultaneously grant authorisation of the scheme and the offering documentation under Sections 104 and 105, respectively. If the scheme is a corporate, authorisation will also be given for the prospectus to be registered at the Companies Registry. If the CAB proposals are passed, registration at Companies Registry will no longer be required since offers made in respect of a collective investment scheme authorised under Section 104 whose offering documentation has been approved under Section 105 will be excluded from the definition of 'prospectus'.

## 2. WITHDRAWAL OF AUTHORISATION (Overhead 61)

One of the weaknesses of the previous legislation was that the SFC could not withdraw an authorisation already granted even where the conditions for authorisation had been breached. This is rectified by the SFO (Section 106) which gives the SFC a new power to withdraw authorisation of a collective investment scheme or of the issue of an investment advertisement where:

(1) the SFC decides that:

- any information provided to the SFC was, at the time when it was provided, false or misleading in any material particular;
- any of the conditions that were imposed in respect of the authorisation are not being complied with;
- it is desirable to withdraw the authorisation to protect the interest of the investing public; or

(2) the approved person for the investment scheme or issue of the investment advertisement makes a written request to the SFC to withdraw the authorisation.

The approved person for the scheme or issue must be given a reasonable opportunity of being heard prior to withdrawal of its authorisation.

The SFC is also entitled to amend or revoke any conditions for authorisation of a collective investment scheme or issue of an investment advertisement or to impose new conditions.

# D. <u>OTHER OFFENCES UNDER PART IV SFO</u> (Overhead 62)

## 1. OFFENCE TO FRAUDULENTLY OR RECKLESSLY INDUCE OTHERS TO INVEST MONEY

1.1 The SFO retains the prohibition on the making of fraudulent or reckless misrepresentations for the purpose of inducing others to invest money previously contained in the PIO. The new terminology of the SFO has however widened the scope of the prohibition. Under Section 107(1) a person commits on offence if he makes any fraudulent or reckless representation for the purpose of inducing another person to:

(a) enter into or offer to enter into:

(i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

(ii) a regulated investment agreement; or

(b) acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme.

1.2 A 'fraudulent misrepresentation' is defined as:

(i) any statement which, at the time when it is made, is to the knowledge of its maker, false, misleading or deceptive;

(ii) any promise which, at the time when it is made, its maker has no intention of fulfilling or knows that it is not capable of being fulfilled;

(iii) any forecast which, at the time when it is made, its maker knows is not justified on the facts known to him;

(iv) any statement or forecast from which, at the time when it is made, its maker intentionally omits a material fact, with the result that the statement is rendered false, misleading or deceptive, or in the case of a forecast, the forecast is rendered false or misleading.

1.3 A 'reckless misrepresentation' is defined as:

(i) any statement which, at the time when it is made, is false, misleading or deceptive and is made recklessly;

(ii) any promise which, at the time when it is made, is not capable of being fulfilled and is made recklessly;

(iii) any forecast which, at the time when it is made, is not justified on the facts then known to its maker and is made recklessly; or

(iv) any statement of forecast from which, at the time when it is made, its maker recklessly omits a material fact, with the result that the statement is rendered false, misleading or deceptive, or in the case of a forecast, the forecast is rendered false or misleading.

1.4 The offence under Section 107 carries a maximum fine of HK$1 million and up to 7 years' imprisonment.

## 2. CIVIL LIABILITY FOR INDUCING OTHERS TO INVEST MONEY

2.1 The SFO also preserves a right of action for investors to seek compensation for any pecuniary loss suffered as a result of any fraudulent, reckless or negligent misrepresentation. Again the new terminology of the SFO has increased the number of investment products to which the statutory right applies. Section 108 imposes civil liability for pecuniary loss on any person who makes a fraudulent, reckless or negligent misrepresentation by which another person is induced:

(a) to enter into or offer to enter into:

(i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

(ii) a regulated investment agreement; or

(b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme.

2.2 Fraudulent and reckless misrepresentation have the same definitions as in Section 107. 'Negligent misrepresentation' is defined as:

(i) any statement which, at the time when it is made, is false, misleading or deceptive and is made without reasonable care having been taken to ensure its accuracy;

(ii) any promise which, at the time when it is made, is not capable of being fulfilled and is made without reasonable care having been taken to ensure that it can be fulfilled;

(iii) any forecast which, at the time when it is made, is not justified on the facts then known to the maker and is made without reasonable care having been taken to ensure the accuracy of those facts; or

(iv) any statement or forecast from which, at the time when it is made, its maker negligently omits a material fact, with the result that the statement is rendered false, misleading or deceptive or, in the case of a forecast, the forecast is rendered misleading or deceptive.

2.3 ***Directors' Liability***

Where a company has made any fraudulent, reckless or negligent representation in the circumstances described in Section 108(1), any director of the company at that time is also presumed to have made the misrepresentation unless it is proved that he did not authorise the making of the misrepresentation.

## 3. OFFENCE TO ISSUE ADVERTISEMENTS RELATING TO THE CARRYING ON OF REGULATED ACTIVITIES

It is an offence under Section 109 for a person to issue, or have in his possession for the purposes of issue:

(a) an advertisement in which to his knowledge, a person holds himself out as being prepared to carry on Type 4, Type 5, Type 6 or Type 9 regulated activity and the person is not licensed or registered for such regulated activity under the SFO; or

(b) any document which to his knowledge contains such an advertisement.

The offence is subject to a fine and imprisonment. Defences are available where a person issues an advertisement holding himself out as prepared to carry on one of the specified regulated activities to an intermediary which is licensed or registered for that regulated activity (or to a representative of such an intermediary). There are also defences for conduits and live broadcasters in similar terms to those available in relation to investment advertisements and for a person who can establish that he took all reasonable steps and exercised all due diligence to avoid the commission of the offence.

## E. APPEALS TO THE SECURITIES AND FUTURES APPEALS TRIBUNAL

Decisions of the SFC in relation to the authorisation of investment advertisements and collective investment schemes may be appealed to the new Securities and Futures Appeals Tribunal under Part XI SFO.

## IV. STABILISATION UNDER THE SECURITIES AND FUTURES (PRICE STABILISATION) RULES

### 1. INTRODUCTION

The SFO allows the SFC to make rules creating defences to the market misconduct provisions of Parts XIII and Part XIV of the SFO. The Securities and Futures (Price Stabilising) Rules (the 'Rules') made under that provision prescribe the circumstances in which price stabilisation may be carried out without constituting market misconduct under the provisions of the SFO. Without the safe harbour established by the Rules, price stabilisation, being potentially manipulative, could contravene those provisions. The Rules are modelled largely on the UK Price Stabilising Rules and, like the SFO, came into effect on 1 April 2003.

### 2. PREVIOUS POSITION

Prior to the introduction of the Rules, a restricted form of stabilisation was permitted under policy statements issued by the SFC and the Stock Exchange of Hong Kong. This involved over-allotments of securities by the underwriters and covering the short position by an over-allotment option granted by the issuer (ie. a 'greenshoe') and/or share borrowing arrangements. 'Genuine purchases' to satisfy the over-allotment which also reduced excess supply created by investors selling into the after-market were permitted and could rely on the policy statements that such action did not breach the relevant market misconduct legislation.

In essence, the Rules provide a safe harbour for stabilisation conducted in relation to ***public offerings of at least $100 million*** (excluding any over-allocated securities) where the detailed provisions of the Rules are complied with. The offer size restriction means that stabilisation in respect of offers below $100 million now potentially constitutes market misconduct, whereas previously it did not if conducted in accordance with the policy statements.

Other key features of the Rules are that:

- a Stabilising Manager must be appointed to carry out or oversee all stabilising activity and keep records of such activity;
- stabilising bids for shares are subject to upper price limits;
- time limits apply to core stabilising actions for both debt and equity securities;

- prior disclosure is required of proposed stabilising activity; and

- after the end of the stabilising period, disclosure is required of specified information relating to stabilising actions undertaken.

## 3. CONDITIONS TO BE SATISFIED

In order to qualify for the safe harbour under the Rules, the offer must be of *relevant securities* and meet the following conditions:

(a) the offer must be for cash;

(b) the securities must be listed on a recognised stock exchange or traded through an authorised automated trading system;

(c) the size of the offer (excluding any over-allocated securities) must be not less than $100 million;

(d) the offer must be to the public;

(e) the offer must be:

  (i) the subject of a prospectus or a document authorised by the SFC under Section 105 SFO (this ensures that offers of debt securities by government agencies are covered by the Rules); or

  (ii) a placing or other offer of shares of a class which is already listed to Companies Ordinance *professionals*. It must not comprise a sell-down element and must be the subject of a public announcement containing the offer price and the disclosure and warnings relating to the proposed stabilisation required by the Rules.

Thus an offer which is not the subject of a prospectus should be made exclusively to CO '*professionals*', that is persons '*whose ordinary business* is to buy or sell shares or debentures, whether as principal or agent'. In practice, this means that investors (including large corporate investors) who are not buying or selling shares or debentures in *the ordinary course of their business* may not, strictly speaking, be within the 'professionals' definition.

*What securities can be stabilised?*

Only 'relevant securities' can be stabilised. These are defined as equity securities, debt securities or depositary receipts of equity or debt securities.

Price stabilisation is permitted only in the same type of securities as are the subject of the offer. Dealing in associated securities to support the price of relevant securities is not allowed. Dealing in the underlying securities of a convertible or exchangeable issue or in derivatives to achieve an equivalent effect to stabilisation are not therefore covered by the Rules.

*Placings and other Offers of Shares of a Class which is already Listed*

Offers of shares of a class which is already listed and placing and top-up transactions meeting the offer size requirement which are not the subject of a prospectus will need to be to CO professionals only if they are to rely on the Rules. In addition, a public announcement is required containing the offer price and the disclosure relating to the proposed stabilising activity required by the Rules.

*Existing Shares*

One of the anomalies of the Rules is that where a new issue is combined with an offer for sale of shares by existing shareholders, the safe harbour will be available if a prospectus is issued. However, if a prospectus is not issued, a placing which has a sell-down element is not covered by the Rules: the argument being that the sell-down precludes the offer being regarded as for corporate fund raising purposes, notwithstanding that this is equally so where in the some circumstances a prospectus is issued and reliance on the Rules is permitted.

## 4. PRIMARY STABILISING ACTIONS

Section 6 of the Rules allows the Stabilising Manager to buy relevant securities in the secondary market in order to prevent or minimise a reduction in their price. Such purchases may (*but do not have to*) be conducted to satisfy an over-allotment of the securities. Hence the Stabilising Manager can now hold net long positions for the purposes of stabilisation, whereas previously such purchases were permitted only to cover an over-allotment.

All stabilising purchases must be for the account of the Stabilising Manager, rather than the issuer. No stabilising actions may be taken by the issuer through a repurchase of its issued securities. Purchases in the secondary market to satisfy an over-allotment are therefore categorised as primary stabilising

action and accordingly are subject to the time and (in the case of equity securities) price limits described below.

## 5. ANCILLARY STABILISING ACTIONS (Overhead 43)

Permitted ancillary stabilising activity under Section 7 of the Rules allows the Stabilising Manager to:

(a) over-allocate or establish a short-position in the relevant securities;
(b) exercise an over-allotment option to close out any position created under paragraph (a); and
(c) liquidate net long positions in relevant securities acquired in the course of primary stabilising activity.

The SFC has indicated that securities borrowing arrangements and the subsequent return of borrowed securities should also be covered under permitted ancillary stabilising actions, although they are not specifically mentioned in the Rules.

Ancillary stabilising actions are not subject to the time and price limits as for primary stabilising actions. To qualify for the safe harbour, they should however be carried out with a view to facilitating primary stabilising activities. In addition, the SFC remains of the view that any over-allotment should be limited in size by the greenshoe.

## 6. TIME LIMITS FOR STABILISING ACTIONS

*Primary Stabilising Actions*

The 'stabilising period' during which primary stabilising actions are permitted runs from the commencement of trading on a recognised exchange or through an ATS, after the issue of the offer document (which includes the public announcement issued on an offer to CO professionals only ) and the offer price is announced. It ends 30 days after the earlier of the closing date or the commencement of trading on a recognised stock market.

The original proposal was for the stabilising period to commence on the date of the prospectus. The amendment to allow stabilisation to begin only after the commencement of trading makes clear that no stabilising activity is permitted in the grey-market.

*Ancillary Stabilising Actions*

There are no time limits for conducting ancillary stabilising actions since they are likely to occur before the commencement of trading, such as the grant of the over-allotment option or after the end of the stabilising period, notably the liquidation of the Stabilising Manager's net long positions. However, with respect to the liquidation of net long positions, the SFC has indicated that, as a matter of good practice, these should be liquidated as soon as it is practicable to do so at a profit without disrupting the market.

## 7. PRICE LIMITS FOR STABILISING ACTIONS

*Primary Stabilising Actions*

Under Section 11 of the Rules upper pricing limits apply to primary stabilising actions for offers of **equity securities**, including the purchase of securities in the secondary market to close out the short position created by the over-allotment. These are set out below.

| Item | Action | Maximum Price |
|---|---|---|
| 1 | Initial stabilising action | The offer price |
| 2 | After the initial stabilising action, when there has been no deal or transaction described in item 3. | The initial stabilising price |
| 3 | After the initial stabilising action, where there has been an independent* deal or transaction on a recognised stock market or through an ATS at a price above the initial stabilising price. | The lower of the offer price and the price at which the deal or transaction was effected |

The 'initial stabilising action' is the first stabilising purchase made by the Stabilising Manager.

The 'initial stabilising price' is the price of the first stabilising purchase.

* With respect to item 3, the deal or transaction must be truly independent. Any deal or transaction effected by or on the instructions of the Stabilising Manager does not count.

In summary therefore, stabilising can never be carried out above the offer price. The upper price limit for the first stabilising purchase by the Stabilising Manager is the offer price (A). After the initial purchase, the Stabilising Manager can stabilise at or below the new price limit which is now the initial stabilising price (B). If an independent deal or transaction is effected on a recognised stock market or through an ATS at a price (C) which is higher than the initial stabilising price (B) but below the offer price (A), the new maximum price is C. The Stabilising Manager may then stabilise at or below the price at which the independent deal was effected (ie. C).

If the Stabilising Manager is unable to close out the short position created by the over-allotment by purchases within the prescribed price limits, the SFC expects that it will exercise the over-allotment option to close out the position.

**The price limits described above do not apply to stabilising actions for debt securities.**

*Ancillary Stabilising Actions*

Price limits do not apply to ancillary stabilising actions. There are therefore no limits on the price at which the Stabilising Manager liquidates any net long position.

## 8. RESTRICTIONS ON STABILISATION

The Stabilising Manager is prohibited from taking any stabilising action if:

(a) at the time the offer price was fixed, the market price of the relevant securities or of rights to them was, or could reasonably be anticipated to be, artificial; **and**

(b) the Stabilising Manager *knew, or ought reasonably to have known,* that the artificiality was attributable wholly or partly to market misconduct activities (Section 10(1)).

Stabilising activity is also prohibited in relation to:

1. debt securities which are convertible into, or give rights to purchase, equity securities where the terms of conversion, purchase or subscription have not yet been publicly announced (Section 10(2)); and

2. any relevant securities where the Stabilising Manager or any of its associates holds an option granted by the issuer over the securities which are to be stabilised, the terms of which have not been disclosed to the public as required by the Rules (Section 10(3)).

## 9. THE ROLE OF THE STABILISING MANAGER?

The Rules require the appointment of a Stabilising Manager who must be either a licensed corporation, such as a registered securities dealer, or a registered institution, eg. a licensed bank under the SFO. The Stabilising Manager is responsible for overseeing compliance with the Rules including ensuring that the disclosure and record keeping requirements of the Rules (see below) are met.

*Responsibility for Agents' actions*

The Rules permit the Stabilising Manager to appoint agents, local and overseas, to make bids and effect transactions in the course of stabilisation. The Stabilising Manager is however ultimately responsible for the conduct of the agent and for ensuring that it complies with the Rules. In global offerings where the issuer's securities are also offered overseas, the underwriter responsible for stabilising the securities overseas, if different from the Hong Kong Stabilising Manager, should be appointed as an agent of the Stabilising Manager under the Rules.

*Separation of stabilising and other trading activities*

The SFC expects the Stabilising Manager to properly separate its activities as Stabilising Manager from its other trading activities, including proprietary trading. All stabilising actions must be recorded in the register required to be maintained under the Rules in order to qualify for the safe harbour.

*Transactions between the Stabilising Manager and its agents as principals*

The Rules prohibit dealings in the securities to be stabilised between the Stabilising Manager and its agents as principals, unless at the time of the transaction, neither party knew or ought reasonably to have known the identity of the counterparty (Sub-sections 12(5) and (6)).

These provisions will not however affect proprietary trading activities of the Stabilising Manager and its agents where transactions are effected through the order matching mechanism in the open market where the identity of counterparties is unknown. Likewise, client transactions where the Stabilising Manager acts as agent for its clients are not prohibited.

## 10. DISCLOSURE REQUIREMENTS

*Prior Disclosure*

The Rules require that adequate disclosure of the fact that stabilising action may be undertaken in relation to the offer should be made in the first public announcement of the offer (ie. the first public announcement indicating that an offer of the relevant securities is intended) and in all subsequent communications issued on behalf of the issuer or Stabilising Manager until detailed disclosure and warnings are made in the prospectus or other offer document (which includes the public announcement required on an offer to CO professionals only). Schedule 1 to the Rules sets out what will be regarded as adequate disclosure of proposed stabilising activity for different types of communication. Suggested

wording for detailed disclosure and prior warnings to be given in the prospectus or other offer document is also provided in Schedule 1.

*Interim and Post-Stabilisation Disclosure*

The Stabilising Manager is responsible for ensuring that the following public announcements are made by or on behalf of either the Stabilising Manager or the issuer:

*Exercise of Over-allotment Option (Section 9(1))*

A public announcement must be made as soon as reasonably practicable after any exercise (wholly or partly) of an over-allotment option. The announcement must include the following information:

- the number of securities purchased or subscribed for; and
- the number of securities still available under the unexercised portion of the option.

*Post Stabilisation Disclosure (Section 9(2))*

A public announcement must be made within 7 days of the end of the stabilising period containing the following information:

- the ending date of the stabilising period;
- whether or not any stabilising action was taken;
- where there were more than one purchase in the course of any stabilising action, the price range between which purchases were made;
- where applicable, the date of the last purchase in the course of any stabilising action and the price at which it was made; and
- where applicable, the extent to which any over-allotment option was exercised.

## 11. RECORD KEEPING OF STABILISING ACTIONS TAKEN

Section 13 of the Rules requires the Stabilising Manager to establish a register of all stabilising actions taken which must be updated immediately or on a daily basis (from business day to business day). The details required to be included in the register are specified in Section 13. Stabilising activity is prohibited if the Stabilising Manger does not comply with its record keeping obligations. The Stabilising Manager is also responsible for ensuring that its agents comply with the requirement to keep their own registers up-to-date.

The register is required to be kept for at least 7 years after the end of the stabilising period. If it is not kept in Hong Kong in either English or Chinese, it must be capable of being reconstituted in Hong Kong and translated into either of those languages within 48 hours of the Stabilising Manager being notified that a person entitled to inspect the register requires access to it.

Persons entitled to inspect the register

The issuer is entitled to inspect the register within 3 months of the end of the stabilising period by giving written notice to the Stabilising Manager. The issuer is only entitled to inspect specified sections of the register which must me made available by the Stabilising Manager within a reasonable time of receipt of notice. The SFC may inspect and take copies of the register at any time.

## 12. OVERSEAS STABILISATION

The Rules accept that where securities are traded both in Hong Kong and overseas, stabilising activity may need to be undertaken overseas. The market misconduct provisions of the SFO are far-reaching, catching both actions in Hong Kong and overseas which may impact on the price of securities traded on an exchange or through an ATS in Hong Kong. Stabilisation conducted in an overseas market which might affect the price of the securities traded on the Hong Kong market could therefore amount to market misconduct under the SFO. The Rules therefore provide that stabilising activities conducted overseas will not constitute market misconduct if they are conducted in compliance with the price stabilising rules of certain recognised jurisdictions to be specified by the SFC in Schedule 4 to the Rules and the offer is governed by the laws of the relevant jurisdiction (Section 15). The UK has been included as a recognised jurisdiction in Schedule 4.

It should be noted, however, that the overseas price stabilising rules are recognised only in relation to stabilisation conducted in the relevant overseas jurisdiction. Stabilising activities in Hong Kong must be conducted in accordance with the Rules.