SFC CONSULTS ON MARKET SOUNDING GUIDELINES

The Securities and Futures Commission (**SFC**) has published a Consultation Paper proposing to introduce new Guidelines for Market Soundings aimed at clarifying the standard of conduct expected of those involved in market sounding and discouraging inappropriate behaviour. Market sounding is a well-established practice involving market participants sharing information with prospective investors before announcing a transaction to assess investor interest in a potential transaction or aid in determining its details (e.g., its size, pricing, structure, and selling method). Market soundings are commonly conducted in relation to capital market activities such as private placements and significant "block trades".

The SFC notes in the Consultation Paper that an increase in trading activities before placings and block trades in recent years suggested that certain intermediaries may have taken unfair advantage of information obtained during market soundings to generate profits, despite this information not being available to the broader market. This led to the SFC conducting a thematic review of the market sounding practices and controls implemented by Hong Kong intermediaries in 2022, the results of which informed the drafting of the proposed guidelines.

The SFC is seeking market feedback on its proposals and the deadline for responding to the Consultation Paper is 11 December 2023.

Proposed Guidelines for Market Soundings: Scope of Application

What is market sounding?

"Market sounding" is defined[1] in the proposed Guidelines for Market Soundings as:

"*the communication of non-public information, irrespective of whether this is price-sensitive information or not, with potential investors prior to the announcement of a securities*[2] *transaction, to gauge their interest in a potential transaction or assist in determining the specifications related to a potential transaction, such as its size, pricing, structure and selling method…*"

The SFC's thematic review of intermediaries' market sounding practices and procedures found that some intermediaries applied them only to market soundings involving the disclosure of inside information.[3] Given the challenges involved in determining whether non-public information amounts to inside information, and the risk for firms of committing misconduct if their determination is wrong, the proposed Guidelines for Market Soundings will apply to the communication of any non-public information during market sounding, irrespective of whether it is price-sensitive information or not.

Who will need to comply with the Guidelines for Market Soundings?

The proposed guidelines will apply to SFC-licensed or registered persons who act as:

- *a Disclosing Person*: a person who discloses information during the course of market sounding, e.g., a sell-side broker acting on behalf of a client, an issuer or an existing shareholder (**Market Sounding Beneficiary**) in a possible securities transaction; or

- *a Recipient Person*: a person who receives information during the course of market sounding, e.g., a buy-side firm sounded out by a Disclosing Person as a potential investor in a possible securities transaction.

The proposed guidelines will apply to all SFC-licensed or registered persons engaged in market sounding. Breach of the guidelines could be taken into account by the SFC in determining whether it considers the person in breach to be fit and proper to remain licensed or registered under section 129 of the Securities and Futures Ordinance.

The SFC notes in the Consultation Paper that some intermediaries conduct market soundings even before receiving a formal mandate from the Market Sounding Beneficiary, due to the short time frames within which deals are often completed. Consequently, the proposed guidelines will apply to the communication of any non-public information (subject to certain carve outs), regardless of whether the Disclosing Person has been formally appointed by, or entered into a written agreement with, the Market Sounding Beneficiary. The question of whether a Disclosing Person is conducting market sounding on behalf of a Market Sounding Beneficiary will depend on the “level of certainty” of the potential transaction materialising, which will be assessed based on various factors including whether the Market Sounding Beneficiary has, orally or in writing:

- expressed an interest in conducting a possible transaction to the Disclosing Person;

- shared any details (e.g., the timing, size, price or structure) of a possible transaction with the Disclosing Person; or

- mandated, requested or agreed that the Disclosing Person should gauge investor appetite.

Carve outs from the proposed Guidelines for Market Soundings

The proposed guidelines will not apply to communications relating to:

- speculative transactions or trade ideas put forward by a Disclosing Person without consulting the potential Market Sounding Beneficiary or without any level of certainty of such transactions materialising;

- transactions whose size (in terms, for example, of average trading volume or market capitalisation), value, structure or selling method, are commensurate with ordinary day-to-day trade execution (e.g, a broker sourcing potential buyers or sellers to execute a trade having received a client’s order instruction); and

- public offerings of securities.

SFC’s Proposed Guidelines for Market Soundings – the Core Principles

The SFC proposes a common set of core principles that all Disclosing Persons and Recipient Persons (together **Market Sounding Intermediaries**) will need to follow when conducting market soundings and specific requirements and procedures which will depend on a party’s role in the transaction.

Core Principle 1 – Market Integrity

Market Sounding Intermediaries will be required to ensure the confidentiality of and not trade on or use any non-public information passed or received during market soundings for their own or others’ benefit or financial advantage until the information ceases to be non-public.

Core Principle 2 – Governance

Market Sounding Intermediaries will need to have robust governance and oversight arrangements to ensure that their market sounding activities are subject to senior management oversight. The specific requirements include designating a committee or person(s) sufficiently independent from the "front-office" to monitor market soundings in support of senior management's oversight.

Core Principle 3 – Policies and procedures

Market Sounding Intermediaries will be required to establish and maintain effective policies and procedures specifying how market soundings are to be conducted. These would need to cover, among others, prescribed procedures for market soundings, the allocation of roles and responsibilities among staff involved in market soundings, and restrictions to prevent the firm and its staff from trading on or misusing non-public information obtained during market soundings.

Core Principle 4 – Information barrier controls

Market Sounding Intermediaries will need to implement adequate and effective physical and electronic information barrier controls to prevent the inappropriate disclosure, misuse and leakage of non-public information during the course of market soundings. This would include information sharing principles for staff and keeping track of individuals who have received non-public information as a result of market soundings.

Core Principle 5 – Review and monitoring controls

Market Sounding Intermediaries will be required to establish effective procedures and controls to monitor and detect suspicious or inappropriate behaviour, unauthorised disclosure or misuse of information, and non-compliance with internal guidelines related to market soundings. These would include periodic trade and communication surveillance controls.

Core Principle 6 - Authorised communication channels

Market Sounding Intermediaries will be required to only use recorded communication channels that have been authorised by senior management or independent functions (such as legal and compliance) to conduct market soundings.

Additional Requirements for Disclosing Persons under the Proposed Guidelines for Market Soundings

Under the proposed guidelines, Disclosing Persons will also be required to:

- conduct pre-sounding procedures, including: (i) assessments of information to be disclosed during different stages of market soundings and determining whether the information would constitute non-public information; (ii) obtaining consent from the Market Sounding Beneficiary to engage in market soundings; and (iii) determining in advance (on a case-by-case basis) matters such as the standard set of information to be disclosed to Recipient Persons or other potential investors in each market sounding, the timing for the market sounding and an appropriate number of Recipient Persons or other potential investors to contact;

- adopt a standarised script pre-approved by senior management for all market soundings. This will need to be regularly reviewed by the senior management or independent functions (such as legal and compliance). The script will need to include the minimum expected information and follow the sequence of information specified in the Guidelines for Market Soundings, which require:

  a) a statement that the purpose of the communication is market sounding and that the Recipient Person, or other potential investor, is required to maintain the confidentiality of any non-public information disclosed and refrain from trading on or using such non-public information for their own or others' benefit or financial advantage until the information ceases to be non-public;

  b) a statement that the communication is being recorded and requesting the consent of the Recipient Person or other potential investor to proceed with the recording;

  c) confirmation that the individual is the person designated to receive market soundings;

d) a statement informing the Recipient Person or other potential investor that they will receive non-public information and seeking their consent to receive such information. A Disclosing Person will be required to terminate a market sounding if the Recipient Person or other potential investor does not give their consent. Any preliminary information provided before receiving that consent must be sufficiently broad, limited, vague, and anonymised to minimise the chances of the Recipient Person or other potential investor being able to guess the name of the relevant security; and

e) where possible, an estimation of when the information will cease to be non-public;

- conduct best endeavours assessments to determine if the information disclosed during market soundings has ceased to be non-public and inform the Recipient Person(s) or other potential investor(s) of this in writing as soon as possible; and

- keep records in relation to market soundings for at least seven years, which include: (i) consent from the Market Sounding Beneficiary to engage in market sounding; (ii) a list of Recipient Persons or other potential investors who have declined to receive any market soundings; (iii) audio, video or text recordings of market soundings; (iv) records of assessments and discussions with the Market Sounding Beneficiary and conclusions reached as to whether information to be disclosed during market soundings is non-public information and whether that information has ceased to be non-public; (v) a list of all internal and external persons who possess non-public information as a result of market soundings, including specified details of each market sounding and all consents obtained; and (vi) notifications informing Recipient Persons or other potential investors when information ceases to be non-public.

Additional Requirements for Recipient Persons under the Proposed Guidelines for Market Soundings

Under the proposed guidelines, a Recipient Person will also be required to:

- designate an appropriately trained specified person(s) to receive market soundings and to inform Disclosing Persons that they are the person(s) designated by the Recipient Person to receive market soundings;

- inform Disclosing Persons whether or not it wishes to receive market soundings either for all potential transactions or for particular types of potential transactions; and

- keep records of market soundings for at least seven years, which include: (i) any notifications provided to Disclosing Persons of its wish to receive, or not receive, market soundings; (ii) audio, video, or text recordings of market soundings received; and (iii) a list of all internal and external person(s) who possess non-public information as a result of the market soundings, including specified details of each market sounding.

Implementation Timeline

The consultation is open for comments until 11 December 2023. The SFC will publish its consultation conclusions at the same time as the final version of the Guidelines for Market Soundings which will become effective upon gazettal. The SFC is proposing a six-month transition period from the date of gazettal to allow the industry to make the necessary updates to their internal procedures and controls to ensure their compliance with the guidelines.

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[1] At paragraph 1.2 of the proposed Market Sounding Guidelines.
[2] As defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (the **SFO**).
[3] As defined in sections 245 and 285 of the SFO.
[4] At paragraph 3.2 of the proposed Guidelines for Market Soundings

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