HKIFA members' feedback on SFC consultation on the Draft Guidelines on Disclosure of Inside Information (June 2010)

Members support the SFC's initiative to make it a statutory obligation that listed companies must disclose price sensitive information ("PSI") to the public as soon as practicable. It should be able to reduce the risks of fund managers to inadvertently trade on inside information due to the failure of listed companies to identify price sensitive information and to make timely disclosure. Members also welcome the draft guidelines issued by the SFC which should be able to help listed companies identify PSI.

However, although it is understood that the draft guidelines are intended to elaborate on SFC's views (in particular in relation to analysts' research reports) and thus to give greater clarity to the market, members have reservations as to whether the approach adopted is the most appropriate.

The SFC has taken the approach to define "inside information" as having the same definition as insider information under the insider trading rules. In theory, whilst there may be more clarity to the market if both issuers and investors were to work off the same definition of "inside information", the reality remains that disclosure and insider trading are inherently different concepts and to merge the definitions may lead to less (and not more) disclosure by issuers. Therefore, SFC may wish to consider whether "inside information" should instead be defined more simply and broadly as "all material information related to the issuer (subject only to safe harbors)" versus the current proposed definition which is more prescriptive.

Furthermore, the proposed guidelines actually create a lot of uncertainties for fund managers. Thus, if SFC maintains that it would stick to its proposed approach, it is important that it helps address the following concerns/questions of the fund industry:

- The assessment of whether a piece of information is "inside information" is subjective and open to interpretation. Hence, there may be cases where a listed company may not think the information is inside information yet the recipient may think otherwise. However, given the severity of the consequences where a recipient acts on a piece of information and it is later found that such information is considered inside information, it is important for SFC to provide guidance on what measures recipients of information such as fund managers can take in order to ensure compliance as well as to protect themselves.

  It is understood that analysts are not allowed to use any inside information in producing their research reports. Therefore it is reasonable for fund managers to presume the research report is based on public information and hence may rely on it in making investment decisions. Similarly, listed companies are prohibited from providing inside information to analysts or selected investors. To avoid uncertainties, listed companies should be asked to upload any information or materials that they provide to analysts (include presentation in analysts' meeting) onto the HKEx website as well as their own investor relations website.

  Furthermore, guidance should be provided on the interaction between the

disclosure regime and the insider dealing regime. Will a company's own breach of the disclosure regime have an impact on any proceedings against an entity which is suspected of insider dealing in securities of that company? For example, if an entity can show that (i) it made its decision based on information which it understands to be public, e.g. through analyst reports (which would normally be fine assuming the company is not in breach of the disclosure guidelines), and (ii) that it was the company's breach of the disclosure regime that allowed inside information to be contained in the analyst report, can this be used as a defense under the insider dealing regime where the entity had made its own assessment and had no reason to believe the analyst report contained inside information (even though as a matter of fact it did contain inside information)?

It would be helpful if SFC imposes a requirement on analysts and listed companies to add a standard statement in their reports or presentations that no material non public information is included in such materials. Although the regulations already require analysts not to use any material non public information in research reports, the standardized statements will make it explicit and clear to both the preparers and readers of the reports.

- Paragraphs 12 and 17-20 – The draft guidelines require that to be disclosable, information be "not generally known" and in providing guidance on this, the SFC noted that there may be times where information in analyst reports, press articles and other publications of wide circulation may still be considered "not generally known." The implication is that in reviewing an analyst report, for instance, investors cannot automatically assume that all information in such report is public and therefore tradable, unless an exemption applies under the insider trading rules. Can SFC consider an alternative to remove this requirement from the definition of inside information on the basis that issuer disclosure should not depend on whether the information is public? This alternative approach would broaden the scope of information that is disclosable by issuers. Additionally, it would relieve issuers from engaging in the vexing exercise of determining whether a piece of information is public or not.

- Paragraphs 12 and 21-25 – To be disclosable, the draft guidelines require that information "materially affect the price of issuer's listed securities." The SFC's commentary on this suggests that information is material if (i) the information would likely impact a security's price, and (ii) the likely price change would be of a sufficient degree (and not mere fluctuations) – otherwise known as the "price impact" test. The alternative to the price impact test is the "reasonable investor" approach as the test for materiality – under this test, the focus is on whether there's a substantial likelihood that reasonable investors would consider the information important in making their investment decisions. The SFC may wish to consider the alternative test.

- Re Paragraph 19, members agree that listed companies should, as a matter of good practice, provide material information to the broadest possible group of investors through the appropriate channels. They can understand that analyst research reports, electronic subscription database and rumours in the market cannot be contended to be known to the public in all cases. However, it would be reasonable to expect that press reports (such as information published in a

retail magazine or newspaper) are widely available to the public. Is it that what SFC wishes to cover here is press release since it is up to the press to select the release and not all releases are published? Thus, press release cannot be considered as "generally known to the public". A clarification on this would be helpful.

- Paragraph 40 – It is agreed that listed companies should be required to disseminate any price sensitive information on the HKEx system, and in addition should also post the same information on the company's investor relations website, as suggested above. However, it is not practical to assume that HKEx website is the ONLY way to ensure information becomes publicly available. The investing public obtains information from the press more than from the HKEx website and the financial industry relies mostly on Bloomberg as the primary source of information and third party brokers to supplement. It is understood that there is a need to have an "official" channel for dissemination of inside information, however, SFC should recognise there are other channels and sources of information which can result in inside information being "disclosed" and be made public to the extent that anyone acting on that information would not contravene the insider dealing rules.

- Paragraph 19 - Regarding analyst research reports, there should be recognition that such reports are widely distributed and known to a wide range of investors through distribution channels (e.g. private bankers) or other technological means. In UK, a research report is considered publicly available information after it is issued. Even though it is published on a platform which is only available on payment of a fee, e.g. Bloomberg, it is considered published in a general public domain for the investment market to use, therefore the fund managers can presume it is public information and act on it (please refer to Appendix A for extract of UK rules). Members believe it would be reasonable for HK to follow this practical model and adopt the same approach. Furthermore, in HK, the availability of research reports is not restricted to institutional, professional or persons with above average financial resources, expertise or competence. Retail investors are able to get such information if they choose to pay for it. In practice, the fund industry operates such that retail investors do not have to pay for every piece of research but instead pay the fund managers (who in turn pay for such research) to make investment decisions on their behalf. Members therefore urges the SFC to clarify that the fund managers should be able to treat published research reports as widely circulated and "generally known" to the investment market (even though it may not represent the total population of the public) and thus unlikely to commit insider dealing based on the information in a research report.

- Paragraph 28 - This is similar to Paragraph 19. Although listed companies should make disclosure of material information to the broadest group (i.e. not assume information already in a research report constitute generally known to the public), fund managers should be able to rely on research reports as public information since analysts are prohibited from using inside information in their reports. The second part of Paragraph 28 is thus confusing. Can the SFC clarify its view and make this distinction clear in its draft guidelines?

- Paragraph 29 of the draft guidelines sets out a list of events that the SFC believes may be disclosable. Our members believe the following should also be included in this list: (i) Entry into, or termination of, a definitive agreement; (ii) Creation of a direct financial obligation or an obligation, direct or contingent, under an off-balance sheet arrangement, and triggering events that accelerate or increase such obligation; (iii) Impairment of goodwill; (iv) Notice of delisting or failure to satisfy a continued listing standard; (v) Unregistered sales of equity securities; (vi) Knowledge of error in previously issued financial statements or audit report; (vii) Modification to rights of security holders, etc.

- Paragraphs 61 and 62 - Except under certain circumstances, issuers are under no obligation under the draft guidelines to respond to press speculation or market rumors. Our members believe there is a better approach: in the event that an issuer is aware that a rumor (true or false) is likely to have, or has had, an effect on the trading of its securities or would likely have a bearing on investment decisions, the issuer should be required to publicly clarify the rumor.

- Paragraph 67 - It is not practical to allow listed companies to only provide public information to analysts. Non-public information should be allowed to be provided to analysts so long as it is not price sensitive. It is the job of analysts to put together information about a company and then form their own views. The analysts may obtain public and non-public information on a company and it is their job to ensure such information is not inside information (or material) before they can use them to perform their analysis and form their views. Even their view then becomes price sensitive (i.e. when made public will materially affect the price), their view and any information in their report is not inside information, hence their recommendation would not constitute an offence. Fund managers may either rely on the analysts' view or disagree with the analysts' view in making their investment decisions. It would be helpful if the SFC can clarify whether Paragraph 67 intends to create a presumption in favour of analysts and users of analysts reports such that they can presume any information they receive from the company would not be classified as inside information and that the onus is on the company, not the analyst or users of the analysts reports to make a call on whether inside information has passed. If this is the case, we urge the SFC to clarify that fund managers should not be regarded as insider dealing if they rely on the analysts' report/ information to make investment decisions provided that the fund managers have no reason to believe that the company has breached their disclosure obligations and have allowed inside information to be contained in such report/ information (i.e. it's not known in the report/information that the information is material non-public or it is from an insider). Paragraph 67 only recognises "public information" and "inside information". The factor of materiality in the non-public information should be recognised.

  The SFC provides that insider dealing is based on relevant information from a person whom he has reasonable cause to believe held the information as a result of being connected with the company. Would the SFC confirm that when the fund managers use research reports, they are able to presume that the analysts are not connected with the company?

- Paragraph 68 - Correcting some fundamental misconception or mistakes in an analyst report may have a price effect in the market. Can the SFC clarify whether a public disclosure obligation arise if the information which is used to correct the analyst report is non-public but in itself is not price sensitive (i.e. not inside information by definition in isolation)?

- Paragraph 71 - There should be a clear exception that so long as the impact of such external developments on the listed company can be ascertained without the need for further information, then that impact should not be disclosable inside information. Members think that the company should not have to do the work of investors. Investors, fund managers and analysts should be entitled to draw their own conclusions in relation to external developments without having to be concerned with whether the impact of the external developments on the listed company might be considered inside information.

(End)

Appendix A

FSA Handbook - Market Conduct MAR 1.2.11 -1.2.14:

In the opinion of the FSA, the following factors are to be taken into account in determining whether or not information is generally available, and are indications that it is (and therefore not inside information):
(1) whether the information has been disclosed to a prescribed market through a regulatory information service or RIS or otherwise in accordance with the rules of that market;
(2) whether the information is contained in records which are open to inspection by the public;
(3) whether the information is otherwise generally available, including through the Internet, or some other publication (including if it is only available on payment of a fee), or is derived from information which has been made public;
(4) whether the information can be obtained by observation by members of the public without infringing rights or obligations of privacy, property or confidentiality; and
(5) the extent to which the information can be obtained by analysing or developing other information which is generally available. [Note: Recital 31 Market Abuse Directive]

MAR 1.2.13 01/07/2005
(1) In relation to the factors in MAR 1.2.12E it is not relevant that the information is only generally available outside the UK.
(2) In relation to the factors in MAR 1.2.12E (1), (3), (4) and (5) it is not relevant that the observation or analysis is only achievable by a person with above average financial resources, expertise or competence.

MAR 1.2.14 01/07/2005
For example, if a passenger on a train passing a burning factory calls his broker and tells him to sell shares in the factory's owner, the passenger will be acting on information which is generally available, since it is information which has been obtained by legitimate means through observation of a public event.

(End)