Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/CFC, M33794 18 March 2005

Securities and Futures Commission
8th Floor, Chater House,
8 Connaught Road Central,
Hong Kong.

Attn.: Secretary to the Securities and Futures Commission

Dear Sirs,

Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance

The Hong Kong Institute of CPAs has considered the above-referenced consultation paper, which seeks comments on proposals to address market concerns identified in the course of the review of Part XV of the Securities and Futures Ordinance (SFO) by the Securities and Futures Commission, as well as on proposals to make the SFO more user-friendly.

The Institute's comments on the issues raised in the consultation paper are set out in the --- Appendix to this letter.

We hope that you find our comments to be helpful. If you have any questions on our submission or wish to discuss it further, please contact me at the Institute on 2287 7084.

Yours faithfully,

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Appendix

Comments from Hong Kong Institute of CPAs in response to the Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance

FORMS AND CODES

Question 1: *Are there any suggestions for additional codes or changes to the forms that you would consider useful?*

The fundamental problem with the forms is that they are difficult to complete and the codes are confusing. In some complex transactions, it is difficult for a person who is required to file a notice to find a relevant code to indicate the capacity in which the interests are being held, or to indicate the change in nature of interests. It is also difficult for a reader to tell what transactions have taken place from the disclosures made.

The Institute supports the Securities and Futures Commission (SFC)'s proposal to add more codes and narrative boxes with the aim of making it easier to fill in the forms, and enable the public to more readily understand the nature of the transactions giving rise to the notification. We do not have any specific suggestions for additional codes or changes to the forms other than those already set out in the consultation paper, as we understand that, given the continuing development of the financial market and the increasing complexity in stock/business transactions, it is impracticable to specify codes to cover all the circumstances. The SFC should keep the forms and the codes under review on an ongoing basis with the ultimate goal of keeping them simple and user-friendly.

We note from the consultation paper that the SFC will continue market education efforts on how to interpret the forms and the disclosures. However, in practice, there may be complex cases that require clarification or direction from regulators to ensure that forms can be completed and notices filed correctly. We suggest that the SFC should provide a channel for market practitioners/substantial shareholders/directors to seek clarification or advice when they encounter problems in completing or understanding the notification forms.

PRINCIPAL ISSUES FOR FURTHER CONSULTATION

1. Security interests given by substantial shareholders

Question 2: *Should the current exemption for security interests be removed or narrowed either in relation to qualified lenders or substantial shareholders? Do you agree with the proposal to make sure information about impending forced sales is disseminated forthwith (as described above) as a possible way forward? Do you consider "forthwith" practicable and do you have any views on requiring disclosure of the impending sales for a threshold higher than 5%? If not, please suggest other methods that would address issues highlighted above.*

The Institute considers that, from the perspective of good governance, and for the sake of promoting market transparency, a disclosure should be made by the pledgor at the time the shares are pledged. This was the position taken by the Institute in 1998, in response to the SFC's consultation on proposed amendments to the Securities (Disclosure of

Interests) Ordinance in 1998. However, we also acknowledge that this is inevitably a compromise and not a perfect mechanism. Some of our members who are in corporate finance practice agree with the argument in the consultation paper that disclosure at the time the shares are pledged would not in itself be very informative or useful. Shares may be pledged for a wide variety of reasons and the disclosure of a pledge does not provide any indication as to the likelihood of a default and a possible change of control of the issuer whose shares have been pledged. Notwithstanding these concerns, we believe that disclosure would put investors and shareholders on notice of the possibility of a future change of control and thus it would serve as a statement of "caveat emptor".

Another reason that the Institute favours disclosure by the pledgor is that we doubt the efficacy of disclosure by the lender following a default. In general, we believe that it would not be practicable or meaningful for a lender that has an interest of 5 % or more in a listed company to "forthwith" (as opposed to the current requirement of within 3 business days) inform the Stock Exchange and the listed company as soon as it becomes entitled to exercise voting rights in respect of the security interest as a result of a default, or that its power of sale of pledged shares has become exercisable and it has offered the shares or part of the shares for sale in the market. In practice, this form of notification amounts to "shutting the stable door after the horse has bolted" given that, in an efficient stock market such as Hong Kong's, we believe that people would be aware that something had happened as soon as the shares were disposed of in the market and this could already have resulted in a substantial drop in share price. It is likely that the relevant events would all happen very quickly and before the affected company had made an announcement.

In addition, requiring a lender to disclose an impending forced sales of pledged shares as a result of default would be likely to give a signal to the market that could trigger a series of immediate sale of shares held by other shareholders, resulting in substantial drop in the share price of the affected company. This would put the lender in an unfavourable position, since, if the price of the relevant shares were to decrease substantially upon making such disclosure, the value of the original collateral could be largely extinguished, which in turn would adversely affect the security and legitimate business interests of the lender. Furthermore, announcing a default as it occurs could immobilise the market and prevent a restructuring of the company involved.

We believe that the rationale for requiring disclosure is primarily that a forced sale, were it to occur, could result in a sudden change in control and/or possibly a significant drop in the share price. The threshold for disclosure should be set at a level that is meaningful in this context. We would suggest, therefore, that a reasonable option would be to require controlling shareholder(s) (i.e. shareholder(s) holding, directly or indirectly, 30% or more of the issued share capital of a listed company) to make a disclosure at the time that they pledged 5% or more of the issued share capital of the listed company.

2. Disclosure thresholds and *de minimis* exception

Question 3: *Should we:*

(a) simplify the de minimis exception along the lines described, or in some other way;

(b) change the Part XV disclosure regime from one where disclosure is triggered by crossing percentage bands to one that operates by reference to actual percentage changes? If so, what should be the disclosure trigger?

We are of the view that the current *de minimis* exception is very complex and difficult to apply and understand. This defeats the original purpose of reducing any undue compliance burden that might arise where a substantial shareholder's interest fluctuates only by a very small amount around a particular percentage level.

We consider that the principal objective should be to simplify the *de minimis* exception mechanism and make it as user-friendly as possible. However, in our view, the two alternatives set out in the consultation paper are not sufficiently simple to improve the current situation to any great extent.

3. Aggregation exemption

Question 4: *Should the aggregation exemption be extended on conditions described above to cover:*

(a) the circumstance where qualified investment managers within a group communicate with each other on investment management strategies?

(b) the circumstance where a qualified investment manager has different businesses (including investment management) that are carried out by different divisions within a single legal entity, with strict segregation of the investment management businesses?

Question 5: *In view of the fact that aggregation exemption would not extend to investment management entities in jurisdictions outside the SFC's approved list, would the proposed changes be useful in practice?*

We agree that the aggregate exemption should be extended on the basis of the conditions described in the consultation paper, to cover the circumstances mentioned in questions 4(a) and 4(b). We would advocate a standardised, simplified approach being applied as far as possible.

4. Stock borrowing and lending

Question 6: *Should the current ALA regime be amended in relation to the activities described above and if so, how?*

We are of the view that same level of transparency should apply to all players in the market. We suggest that consideration should be given to lifting the prohibitions while requiring full disclosure of stock borrowing and lending activities.

5. Credit derivatives

Question 7: *Should credit derivatives with convertible bonds and exchangeable bonds be exempted from disclosures, or will a code on the forms for credit derivatives suffice?*

Question 8: *If you favour an exemption, how should the exemption be drafted to ensure that only the appropriate credit derivatives are exempted?*

Again, for the sake of promoting market transparency, we take the view that credit derivatives with convertible bonds and exchangeable bonds as reference assets should not be exempted from disclosures. The person with obligation of disclosure should be the party entitled to exercise the conversion rights under the convertible/exchangeable bonds.

However, we also take the point that in transactions involving credit derivatives, the interest in the underlying equity may not always be relevant to the transaction or to the parties to it. Under the circumstances, we consider that to provide a specific code on the disclosure forms for credit derivatives would be sufficient.

6. Index-linked equity instruments

Question 9: *Are there any other indices in respect of which a similar exemption to that proposed for the Hang Seng Index would be appropriate?*

We are not aware of any other indices in respect of which a similar exemption to that proposed for the Hang Seng Index would be appropriate.

As general observations, we believe that the Hang Seng Index would be perceived to be more independent if it were to be compiled by an independent body, rather than by a subsidiary of one of the constituents of the index. In addition, there is scope for debate as to whether the index should continue to be limited to 33 constituents

7. Change in nature of interest

Question 10: *Are there any other situations where a change in nature of a person's interest in shares should give rise to a disclosure obligation?*

We do not have any further suggestions.

VIEWS OF THE PUBLIC ON OTHER MATTERS

Question 11: *Do you have comments on any other matters discussed in the Consultation Paper or on any of our proposals for changes that are not covered in questions 1 to 10 above?*

Question 12: *Do you have comments on any other matters relating to the disclosure of interests regime under Part XV of the Ordinance not dealt with in this Paper?*

While we note the SFC's position as regards the language of the legislation, we remain of the view that the language used in Part XV of the Securities and Futures Ordinance is convoluted and difficult, and that further consideration should be given to simplifying it and making it more user-friendly. In addition, the notification forms provided to capture the required information, and the notes contained therein, should be redrafted in plain English to facilitate understanding.