Appendix

Hong Kong Institute of Certified Public Accountants
Comments on the Proposed Revised Regulatory Regime to Give Statutory Backing to Certain Listing Requirements

A. Introduction

1. While the Institute has previously given broad support for statutory backing of certain of the listing rules, we raised a number of concerns in our 14 May 2005 submission on the earlier proposals put forward by the Securities and Futures Commission ("SFC") for implementing statutory backing. We questioned the approach put forward at the time, which was to incorporate the detailed rules in the legislation.

2. We acknowledge the effort that has been made in the revised proposals to deal with some of those concerns through a revised three-tier approach comprising (i) general principles (fundamental obligations and safe harbours that disapply them in specified circumstances) to be set out in a new Part IIIA of the Securities and Futures Ordinance ("SFO"); (ii) elaboration of the relevant definitions and factors for consideration in determining whether there is a breach of the general principles, to be set out in a separate schedule to the SFO, and (iii) more detailed and technical requirements to be set out in a non-statutory code to be made by the SFC.

3. We note also that the Institute's concern regarding the status of accounting standards under the original proposals and whether they were in effect being given statutory backing by the proposals, has been recognised. The revised proposals seek to address this issue by adopting a different approach, as explained in a footnote contained in the *Consultation Conclusions* (footnote 4 on page 3 of Appendix 1).

4. Although we believe that, overall, the revised approach represents a step forward, the Institute continues to have difficulties with some aspects of the proposals, which we explain in sections B and C below. Concerns include:

   - The way in which the different elements of the three-tier approach will interact with one another is not clear and could be confusing to the market. In addition, more guidance may be required on the interpretation of certain fundamental principles (e.g. price sensitive information).

   - Some of the specific provisions in proposed subsidiary legislation, which borrow text not only from the existing listing rules, but also from various overseas sources, including IOSCO and OECD principles and Australian and UK listing rules, are complicated and not easy to follow. In some cases, the drafting seems to make matters less clear than under the existing listing rules.

   - The whole package, including the draft non-statutory code, should be presented together to facilitate understanding and enable the proposals to be considered in their entirety.

5. Under the circumstances, we consider that further discussion with the market is required. More information also needs to be provided in relation to enforcement – both the infrastructure and responsibilities of the SFC and the Stock Exchange of Hong Kong ("SEHK"), including transitional arrangements, and the enforcement policies. We note, for example, that in the focus group discussion attended by representatives of the Institute, it was suggested that criminal sanctions would be sought only where real damage has been done to the market as a result of wrongful acts, and not in relation to technical breaches or where market practitioners have acted in good faith on matter of judgments. How will this, and other important matters of policy, be reflected in the revised proposals?

6. The changes being proposed are fundamental, precedents from around the world seem to be few and it is not clear that close comparisons can be made with any other jurisdictions. This makes it all the more important that sufficient time be allowed, and adequate opportunities be given, for a proper discussion on issues that continue to give cause for concern, with a view to reaching consensus on the way forward.

B. General Comments

7. Under the revised approach, for compliance with the statutory listing requirements, a listed issuer would have to refer to three inter-related but separate documents, each with a different standing. The different status of the general principles, the schedule and the SFC code, and the manner in which they will interact with each other in practice, needs to be clearly spelled out to the market. Any ambiguity in this regard would put advisers, especially those who are not lawyers, in a difficult position. The problem is compounded by the fact that the proposed contents of the code have not been made known.

8. The current Listing Rules are contractual obligations that listed companies undertake to the SEHK to fulfil and breach of the rules does not give rise to criminal sanctions. Although the proposal is that relevant Listing Rule requirements will be codified in substantially the similar language in the statutory provisions, it is essential that any statutory provisions be clear and unambiguous to facilitate compliance and enforcement.

9. Additional guidance may also need to be provided on how terms such as "material" and "timely" will be interpreted, given that criminal sanctions may apply to breaches of the statutory principles.

10. More specific comments on the drafting of the general principles are set out in Part C below. It is considered to be essential that the full set of the statutory and non-statutory requirements (i.e., the draft Part IIIA of the SFO, the schedule and the SFC code) be made available at the same time for review and comment by the public, as these form part of a single, complete package.

11. The consultation document and conclusions did not provide any comparison and cross-referencing indicating how the relevant provisions of the existing Listing Rules will be transposed to the new framework, i.e., which provisions are to be incorporated in the new Part IIIA of the SFO, which in the schedule and the non-statutory code. It would be helpful if such an exercise were to be conducted, as it would assist in understanding the overall approach.

12. While it is noted that in the process of codification of Listing Rules, some re-drafting may be necessary to clarify interpretive difficulties and minimise duplications, inevitably the act of redrafting or modifying the language of the Listing Rules may result in the occurrence of discrepancies or unintended differences in meaning. Therefore, it would be helpful if any changes to the existing Listing Rules could be highlighted for consideration by the public.

13. The SFC consultation paper states, "*Australia and Singapore gave their listing rules "statutory backing" and empowered government agencies and courts to take statutory action against those breaching the rules. The UK transferred its listing regulatory role from the London Stock Exchange to the Financial Services Authority (FSA), which re-promulgated the listing requirements as statutory rules with statutory enforcement.*" However, no detailed information has been provided regarding these different approaches, or the actual experience of these jurisdictions in implementing statutory backing for listing requirements. It would be useful to compare and contrast the proposed framework and approach in Hong Kong with other overseas markets. Such an exercise may help to provide greater assurance to the market on the practical application of the proposed approach.

14. It is proposed that the SFC will undertake the administration and implementation of the new statutory regime. However, the transitional arrangements have not been made clear. There is also uncertainty over whether there would be significant differences in the interpretation of essentially the same rules, and their application to specific situations, between the approach to be adopted by SFC and the existing approach of the SEHK, which is familiar to the market.

15. It is stated in the consultation conclusions paper (para. 54) that "[t]*he SFC's overall approach will be to encourage and assist compliance … through education, policy guidance, rulings … The SFC will monitor issuers' behaviour and provide warnings or guidance where non-compliance or suspected breaches are detected. In most cases, the SFC will seek remedial action, rectification, or other non-disciplinary measures.*" However, we believe that further information and assurance should be provided in relation to the SFC's proposed approach toward initiating prosecution action, given, particularly, that the SFC has been primarily a regulator, whose responsibilities and focus are geared towards the enforcement of rules and regulations.

C. <u>Specific Comments</u>

Re. Indicative Summary of General Principles proposed for the new Part IIIA of the Securities and Futures Ordinance – Appendix 1 to the Consultation Conclusions on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules

16. We should like to reiterate a basic concern raised by corporate finance practitioners amongst our members, reflected in our May 2005 submission, that making the disclosure of price-sensitive information a statutory obligation is likely to be problematic, as a decision on whether or not certain information may be regarded as price sensitive is subjective and involves a strong element of judgment.

17. We also noted in our previous submission that the proposals for statutory backing cannot be divorced from the mechanics of their implementation. In this regard, we have concern about some of the drafting in the "Indicative summary of general principles proposed for the new Part IIIA", as contained in Appendix 1 to the Consultation Conclusions. The proposed legislation adopts wording from a variety of different sources, other than the existing Listing Rules, which, in some cases improves clarity, while in other cases, seems to confuse the issue. This raises questions about the integrity and coherence of the whole, given the approach of seeking to combine principles and provisions from different source materials from around the world (e.g., OECD and IOSCO principles, EU directives, UK and Australian listing rules). The following are some examples of differences that we have noted between the existing Listing Rule provisions and the proposed legislation, which give rise to uncertainty. It is not intended to be an exhaustive list.

<u>Periodic financial reporting</u>

18. Principle 2 – "A listed issuer's annual report shall contain all material information relating to the financial condition and operating performance of the issuer …"

    The wording needs to be further clarified since the source is IOSCO (*Principle V-A*), but the IOSCO principle has itself been modified and no reference can be drawn from the existing Listing Rules. For example:

    (i) How should the term "all material information" be construed in practice? The IOSCO principle does not include the word "all" but, rather, lists out the areas of material information to be included.

    (ii) The term "financial condition" used in Principle 2 may be interpreted differently from "financial information" and "financial position", which are used in the existing Listing Rules (LR Appendix 16, paragraphs 6 and 32, respectively), or "financial and operating results" in the IOSCO principle.

19. Principle 3 – "A listed issuer shall ensure that its annual financial statements give a true and fair view of the financial position … and of the financial performance for the financial year."

    LR Appendix 16, paragraph 2, requires that financial statements "shall provide a true and fair view of the state of affairs of the listed issuer and of the results of its operation and its cashflows …". This seems to be clearer and more specific.

20. Principle 4 – "A listed issuer shall ensure that its financial statements are audited by … (b) a person that has a qualification and registration that is recognised by the Commissioner … as equivalent to an auditor, …"

    This provision seems to be very open-ended and no indication is given of the circumstances in which this section may be invoked. Is there intended to be any further guidance on this matter?

21. Principle 5 (b)(i) – "details of any material departure with the reasons for each such departure"

    The reference to "material departure" may not be sufficiently clear. Material departure in what respect? The requirement in LR Appendix 16, paragraph 2,

note 2.1 is to "disclose and explain difference of accounting practices … which have a significant effect on their financial statements … ". This is considered to be clearer.

While we appreciate, from the *Consultation Conclusions*, that the current drafting of Principle 5 attempts to deal with the concern that, under the original proposals, accounting standards were being given de facto statutory backing, there is a danger that the wording of current proposal could give the impression that adopting HKFRS / IFRS is a matter of choice, unless it is made clear elsewhere that this is not the case. We should be grateful for further clarification on this point.

22. Principle 6 reads: "A listed issuer shall keep such accounting records and documents…

    (a) in order that financial statements that comply with the requirements can be prepared and audited …

    (b) to enable its directors to verify its financial statements comply with the requirements and provide a copy of such accounting records and documents to any directors …"

    It is unclear what "requirements" Principle 6(a) is referring to.

    Principle 6(b) seems to contain two requirements – (i) that accounting records and documents should be kept to enable verification of financial statements, and (ii) that an issuer should provide relevant documents to directors upon their request. If so, it would be clearer to incorporate these requirements in two separate provisions.

23. Principle 7, which is in relation to interim reports – see comments on Principle 2, set out in paragraph 18 above.

<u>Disclosure of price sensitive information</u>

24. Principle 8 – although the drafting follows closely the equivalent Listing Rule 13.09, it may not be sufficiently specific or clear to be incorporated in statute. It may be difficult to prove whether or not the information is necessary "to enable the public to appraise the position of the issuer and its subsidiaries" or "to avoid the creation or continuation of a false market." Given that there are no proposed criteria relating to this provision to be included in the schedule, clarity in the primary legislation is all the more important.

    The Australian Stock Exchange Listing Rules (ASX) 3.1 seems to adopt a clearer approach, as it indicates specific factors (i.e., material effect on the price or value of the entity's securities) to be taken into account in determining whether there is a requirement for information to be disclosed to the public.

25. Principle 9 states that the means for disseminating information is reasonably expected to "provide for equal, timely and effective access to such information …"

    It is unclear what would be considered as "equal, timely and effective access to information" and accordingly, additional guidelines in this respect would be desirable.

It is noted that the IOSCO principle requires "efficient, effective and timely means of dissemination", and the EU Directive (transparency) Article requires "effective dissemination of information to the public". Both of these requirements adopt the perspective of the issuer (i.e., the manner of dissemination of information) rather than the perspective of the recipient (i.e., means of access of information) and, in our view, it would be better to follow the former approach, as ensuring appropriate means of dissemination is easier to establish.

26. Principle 10 – "… information that affects the market … and is readily observable to the investing public."

It is noted that the source of this principle is the Australian Corporations Act ("ACA") 2001 s.674(2) and s.676. The original text of ACA 2001 refers to information "generally available" to the public, and "readily observable" is only one example given of what would be considered to be generally available. We cannot see why Principle 10 should propose to adopt a more restrictive scope than the ACA.

27. Principle 11 – It would be more appropriate were this principle to refer to "delay" the public disclosure of information rather than "withhold" information, as currently drafted.

More generally, the drafting of this principle is somewhat obscure as it tries to combine different elements from four different sources, which tends to confuse the reader:

- It is unclear whether all the four subsections, (a), (b), (c) and (d), would need to be satisfied before a listed issuer may withhold / delay the disclosure.

- The current drafting appears to require the satisfaction of both subsection (c) and one of the conditions set out under subsection (d). However, it does not seem logical or reasonable to combine subsections (c) and (d)(iii), as it would be inappropriate to communicate to advisers and rating agencies in the ordinary course of business, information that was a commercial secret, disclosure of which would be likely to prejudice seriously the listed issuer's legitimate interests.

- In the light of the above, it is also considered that subsection (b) may not be workable in practice.

Principle 11(b) refers to "… the information is disclosed to the public under paragraph (a)", which does not seem to be the correct cross-reference, as paragraph (a) refers to withholding rather than disclosing information.

28. Principle 12 – "… where information is released to the other market the same information is released in Hong Kong simultaneously or as soon as practicable thereafter."

The drafting of this principle seems to assume that information will not be released in Hong Kong before other markets.

In addition, it may be clearer if the word "also" were added as follows: "If a listed issuer is <u>also</u> listed on a non-Hong Kong stock market, …"

29. Principle 13 – "… the listed issuer shall, if requested to make a disclosure, promptly disclose to the public –

(a) details of any matter or development of which it is aware …"

The requirement for a listed issuer to disclose "details of any matter" is potentially of concern as it could result in a leak of sensitive information. The extent of "detail" that is expected to be disclosed is not clear. Usually, if an issuer is aware of relevant information, it is regarded as sufficient to explain the situation in general terms.

<u>Certain notifiable transactions and connected transactions which require shareholders approval</u>

30. It is noted, from footnote 10, that the new SFO Schedule will define a "connected transaction" and contain the more important listing disciplines as factors for consideration in determining whether a listed issuer has complied with the general principles as regards the announcements, circulars and voting on a connected transaction. The more detailed and technical provisions to be contained in the circulars will be found in the Listing Code.

Under the existing Listing Rules, SEHK has the power to deem a person to be connected and to specify that certain exemptions will not apply to particular transactions. It is unclear whether it is intended that the SFC will, under the statute, have a similar discretionary power. It is believed that such discretion should be removed together with the move away from pre-vetting.

Corporate finance practitioners among our members have expressed some concern regarding how the possible overlooking of certain connected party transactions will be treated (e.g., those relating to inter-group transactions which may be subject to complex disclosure rules). They believe that there should be a clear mechanism for distinguishing between "innocent oversight" and "malicious intent", and that a fair and lenient approach should be taken if a relevant party has acted honestly and in good faith. We believe that criminal sanctions should only be imposed where the act is intentional and fraudulent.