CPA
Hong Kong Institute of
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香港會計師公會

<u>BY FAX AND BY HAND</u>
(2861 1494)

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Financial Services and the Treasury Bureau,
18/F., Admiralty Centre Tower I,
18 Harcourt Road,
Hong Kong.

Attn.: Consultation Paper on Proposed
Amendments to the SFO to Give Statutory
Backing to Major Listing Requirements

Dear Sirs,

Consultation Paper on Proposed Amendments to the SFO to Give Statutory Backing to Major Listing Requirements

The Hong Kong Institute of Certified Public Accountants has considered the proposals contained in the above-referenced consultation paper ("FSTB consultation paper") and the Institute's views on it are explained below. Given the close connection between this consultation and the Securities and Futures Commission (SFC)'s related *Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules* ("SMLR consultation paper"), we have also made reference to the latter document at various points below.

<u>Give statutory backing to more important listing requirements</u>

The Hong Kong Institute of CPAs supports the principle of giving statutory backing to the more important listing requirements by codifying the requirements in the statute, with the aim of strengthening the current enforcement regime and promoting compliance. We believe this should help to raise the standards of corporate governance in Hong Kong and enhance investor confidence in the quality and integrity of our markets.

In broad terms, the Institute has no objection to the proposed areas to be codified in the statute, as they are those that are of most concern to minority shareholders and that affect the public interest.

As regards the specifics, some of our members who are corporate finance practitioners have expressed concern regarding making disclosure of price-sensitive information a statutory obligation. They consider that the decision on whether a piece of information is regarded as price-sensitive at any given point in time often requires a judgement call. This may involve a significant element of subjectivity and it would put practitioners in an invidious position if a judgment made in good faith were, potentially, to render them liable to severe, possibly even criminal, sanction.

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Implementation aspects of statutory listing requirements

We consider that the proposals for statutory backing cannot be completely divorced from the mechanics of their implementation, including the structure for enforcement and, in this connection, the Institute wishes to express serious reservations.

Although the implementation aspects are not addressed in the FSTB consultation paper, reference to the implementation of the statutory listing requirements is, however, contained in the SMLR consultation paper. It is noted that the SFC will be responsible for enforcing the statutory listing requirements, whereas the Stock Exchange of Hong Kong Limited (SEHK) will remain the frontline regulator of listed companies (para. 24 of the SMLR consultation paper). We see problems arising under this structure in view of the current proposals.

1. Inconsistencies between the SFC and the SEHK in handling disclosure materials

Para. 21 of the SMLR consultation paper states that the proposed provisions in the SMLR will not require any pre-vetting or other regulatory approval of disclosure materials. However, the current Listing Rules (R.14.34) stipulates that as soon as the terms of a share transaction, discloseable transaction, major transaction, very substantial disposal or very substantial acquisition (all of which are codified under Schedule 6 of the draft SMLR) have been finalised, the listed issuer must inform the SEHK and send to the SEHK a draft announcement. An announcement requires the SEHK's clearance before it is published.

We are concerned about the potential for inconsistencies to occur between the application of the SMLR and the non-statutory Listing Rules in relation to handling of disclosure materials. Under separate regulations, enforced by two different regulators, there may be situations where, even though an announcement has been cleared with the SEHK, the SFC, which, under the proposals, will not undertake any pre-vetting of documents, may still determine that the company and the relevant directors and officers have breached the statutory rules. In other words, notwithstanding the position of the SEHK on the same matter, the SFC may subsequently take the view that the announcement is not compliant. This could amount to a form of double jeopardy.

Under the circumstances, we would suggest that there needs to be an arrangement or a clear and open understanding in place between the SFC and the SEHK that would allow listed companies and market practitioners to obtain a reasonable level of comfort and certainty in relation to disclosure materials already cleared by the SEHK.

2. Readiness of local market to accommodate the change in approach

As indicated above, under the current Listing Rules, disclosure materials, such as announcements of notifiable transactions, require the SEHK's clearance before they are published. Following the introduction of the statutory listing requirements, there will not be any pre-vetting of disclosure materials by the SFC. Given the potential for inconsistencies, referred to above, the SEHK may also be inclined to adopt a hands-off approach and to put the onus on listed issuers, their directors and advisers to ensure compliance with the statutory requirements. While this might be a reasonable longer-term objective, we doubt whether, currently, the participants in the Hong Kong marketplace are sufficiently prepared to be able to adapt suddenly to a situation where all the responsibility is placed on issuers and their advisers. We would have strong reservations if this were to happen by default and without any orderly and well-planned transition, involving education programmes, the provision of additional guidance on matters of interpretation, etc., to help listed company directors/officers and market practitioners to understand better the statutory listing requirements and their own legal responsibilities and liabilities. The adverse consequences of an abrupt change of approach could be damaging to the reputation of Hong Kong's markets.

3. <u>Inconsistency between the draft SMLR and the Listing Rules</u>

The SMLR consultation paper states that the new provisions in the draft SMLR are taken from the existing Listing Rules and are drafted in plain language. The opportunity has also been taken to clarify some interpretive difficulties and reduce duplications (para. 18). We are concerned that, although the requirements may be intended to be the same as the existing Listing Rules, in practice, adopting different wording will tend to increase the likelihood of inconsistencies occurring, as suggested above, particularly if the current version of the rules continue to exist as non-statutory Listing Rules issued by the SEHK. Whether or not it is envisaged that two separate sets of rules, covering the same matters, will be in place at the same time is not made clear in either the SMLR consultation paper or the FSTB consultation paper.

In addition, we are concerned that there may be unintended material differences between the current Listing Rules and the proposed statutory rules, which would cause confusion to the market. Some examples are set out below.

<u>Example 1</u>

The draft SMLR defines "affiliate" to mean "*another corporation which is recorded or required to be recorded in the first mentioned corporation's accounts as being an associate or jointly controlled entity pursuant to the applicable reporting standards*" (Schedule 1). The Listing Rules, on the other hand, define affiliated company as "*a company, which, in accordance with Hong Kong Financial Reporting Standards [HKFRS], is recorded using the equity method of accounting in an entity's financial statements. This includes associated companies and jointly controlled entities as defined in those standards*" (Rule 13.11(2)). Given that, for example, jointly controlled entities may, under HKFRS, be proportionately consolidated rather than accounted for using the equity method, the scope of affiliated companies, would appear to be different under the existing Listing Rules and the draft SMLR.

<u>Example 2</u>

A second example relates to the continuing disclosure requirement of amounts due from and commitments to affiliates. Although both the draft SMLR (para. 14 of Part 2, Schedule 2) and Listing Rules (R.13.22) require an issuer to include in its interim report and annual report a combined balance sheet of such affiliates, the Listing Rules also provide that, where it is not practicable to prepare the combined balance sheet of affiliated companies, the SEHK may consider accepting, as an alternative, a statement of the indebtedness, contingent liabilities and capital commitment as at the end of the period reported on by affiliated companies. Since the SMLR does not provide for any alternative to inclusion of a combined balance sheet of the affiliates, it is uncertain whether the Listing Rules' provision for an alternative would still be applicable.

The question, therefore, is whether, in future, there will be two differently-worded sets of rules, covering the same subject matter, which will be administered and enforced by different regulators? If so, in our view, not only this would cause confusion to the market, but it would also impose additional compliance costs on listed issuers. (See section 4 below.)

We are very firmly of the view that there should be only one set of rules and one form of words in relation to those matters to be covered in the statute.

4. <u>Two different documents or one combined document?</u>

As indicated above, following the introduction of the revised SMLR, it is not clear whether, for example, the non-statutory Listing Rules will still continue to include those provisions on which the SMLR will have been based or, whether the existing Listing Rule provisions will be replaced by the SMLR and removed altogether from the "red book", except perhaps for a cross-reference to the SMLR; or whether, alternatively, the SMLR will be incorporated into the red book verbatim and separately identified.

We note from the SMLR consultation paper that the Listing Rules may go further than the SMLR, i.e., be more rigorous than the corresponding statutory rule, which implies the continuing existence of the Listing Rules in some form. One possible approach would be for the red book to reproduce the statutory requirements in bold print and to differentiate from them any additional non-statutory requirements imposed by the SEHK.

Generally, the proposed interface between the rules issued by SEHK and the SMLR has not been made clear, which is a concern to the Institute and, I am sure, to other interested parties.

5. <u>Maintaining and updating post-listing requirements</u>

A further area of uncertainty is how future changes to the SMLR will be initiated. Given the dynamic nature of financial markets, it is essential to establish a mechanism to ensure that the statutory requirements are kept up-to-date on a timely basis, to meet the changing needs and expectations of the market, market participants and investors.

The SMLR consultation paper indicates that the SFC will keep the provisions in the SMLR under ongoing review and consult the market and the public when potential changes are identified (para. 17). However, it appears that the SFC's primary focus will be enforcement.

The SEHK, which will remain in the frontline of market supervision, is likely to be in a better position to understand the market needs as they develop from time to time, through its day-to-day direct contact with listed companies and market practitioners. However, it is not clear what role, if any, the SEHK is intended to have in relation to future development of the SMLR. In its own regulatory role, as noted above, the SEHK will be able to introduce provisions that go beyond the statutory rules, which are intended to be the minimum requirements applicable to all listed issuers (SMLR consultation paper, para. 15). With this in mind, we have the following questions:

(i) Is the process of reviewing and updating of statutory requirements to be the responsibility of the SFC alone?

(ii) What procedure will be adopted if and when the SEHK sees a need to update or impose additional regulatory requirements in relation to any of the areas covered in the SMLR?

(iii) As it is likely to be easier and quicker to change the Listing Rules than the statute, and the SEHK may add its own requirements on top of the SMLR, will there be any specific mechanism and procedure to ensure that the two sets of rules remain fundamentally in alignment with one another?

Introducing civil fines on issuers and directors for breaches of statutory listing rules

We are, in general, supportive of the proposal to introduce civil fines on issuers and directors/officers for breaches of the statutory listing requirements.

The institute has no objection to empowering both the SFC and the Market Misconduct Tribunal (MMT) to impose civil fines, given that there is a provision in law to prevent "double jeopardy", which should mean that powers to impose civil sanctions will not be exercised by both the SFC and the MMT under the concurrent civil regime (i.e. the SFC disciplinary regime and the MMT regime) in respect of the same breach of statutory listing requirements. As such, it is important that the criteria to be adopted for breaches/misconduct to be subject to the SFC or the MMT disciplinary processes, respectively, should be clearly defined and transparent.

As regards the distinction between matters to be dealt with by the SFC and those to be referred to the MMT, we note that the proposed levels of maximum fine that may be imposed by the two bodies are relatively close, which suggests a possible overlap in types of cases that they might handle. In our view, it should be made clear that the SFC will deal with the more routine matters and the MMT, with more serious allegations of breach. It would be preferable, therefore, for the gap between the maximum fines to be wider than currently proposed. One way of giving this effect would be to lower the ceiling on fines that may be imposed by the SFC. As a general observation in relation to civil penalties, it is clear that the impact of imposing the maximum civil fines would be different on issuers of different sizes, whose market capitalisation may range from more than a trillion to less than a million dollars.

In addition, we consider it to be important that:

(i) the process and decision-making proceedings of the SFC and the MMT should be seen to be fair and transparent;

(ii) the level of fines and other types of sanctions imposed should be relevant and proportionate to the seriousness of the fault involved and have regard implicitly to the "mens rea" element. This will be essential if, as proposed, the concept of strict liability is introduced (FSTB consultation paper, para. 2.27). We would suggest, therefore, that some assurance should be given that the punishment will fit the offence. In this regard, we note that even the largest of companies may, for example, sometimes completely innocently overlook a connected transaction; and, as regards the timing of the publication of accounts, information required from overseas jurisdictions may on occasions not be released in a timely manner as a result of commercial disputes, etc., and this may be beyond the control of locally-based officers; and

(iii) the maximum possible transparency should apply in respect of breaches of the statutory listing rules on which action is taken. As such, we are of the view that any such breaches should be made public and the information to be disclosed should include the parties involved, the relevant findings and decisions made by the regulators, as well as the sanctions imposed. Information on individual settlements (FSTB consultation paper, para. 2.32) should also be made public, and the general criteria for pursuing this option rather than other forms of enforcement action should be transparent.

Given the various doubts about issues of implementation, to which we have referred in this submission, corporate finance practitioners have expressed understandable concern about whether criminal sanctions should be introduced for breaches of the SMLR from the outset. Consideration should be given to deferring the introduction of criminal sanctions, at least until the SMLR have been in place and operating for a period, so that any significant problems of interpretation and enforcement can first be ironed out.

Other matters

1. Enforcement of the statutory rules

The SFC will be responsible for enforcing the statutory listing requirements but, as noted previously, it will not undertake any pre-vetting of disclosure materials. It will have the power to investigate and hold persons liable where they break the statutory rules (SMLR consultation paper, paras. 21 and 22).

A question arises as to how in practice the process will occur. Will the SFC review all published materials to check if they comply with the statutory requirements, or will it only respond to complaints/allegations, etc? In the latter case, how would the SFC be kept informed of possible breaches, i.e., which parties, is it envisaged, would alert the SFC and what reporting mechanism/procedure would be adopted?

We hope that you find our comments to be helpful. Should you have any questions on our submission, please feel free to contact me at the Institute on 2287 7084.

Yours faithfully,

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