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Price-Sensitive Information and Safe Harbors in Hong Kong

JULIANNE DOE, JEFFREY TSANG, AND SAM FOWLER-HOLMES

The authors discuss a bill pending in the Hong Kong Legislative Council that seeks to tighten financial regulation.

Last Summer, following more than a year of consultation, the Securities and Futures (Amendment) Bill 2011 was introduced to the Hong Kong Legislative Council. The bill seeks to place the provisions of the Hong Kong Stock Exchange Listing Rules concerning disclosure of price-sensitive information on a statutory footing as part of the wider evolutionary process of Hong Kong's financial regulation.

The declared intention of the legislation is to protect investors by providing greater market transparency and quality. Underlying the changes, however, is an apparent recognition that financial regulation is an area in which Hong Kong needs to keep up with its global financial peers.

The bill introduces a new Part XIVA into the existing Securities and Futures Ordinance ("SFO") requiring listed companies to disclose inside information.

THE DUTY TO DISCLOSE

A listed company must disclose inside information to the public "as soon as reasonably practicable after any inside information has come to its

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knowledge." Whether information has come to the company's knowledge will be assessed on the basis of what was known by the company's officers and what reasonably ought to have been known by the company's officers.

WHAT IS INSIDE INFORMATION?

Inside information is defined in the same way that "relevant information" is defined in statutory provisions relating to insider dealing. In summary, there are three core elements:

- The information about the company must be specific.
- The information must not be generally known to that section of the market which deals or which would likely deal in the company's securities.
- The information would, if so known, be likely to have a material effect on the price of the company's securities.

HOW THE TEST WILL BE APPLIED

Although all three elements must be satisfied, the reference to a "material effect" on the price can be seen as the lynchpin to the whole system. There are two limbs to this element. The first limb asks whether the information would be "likely" to materially affect the price. This requires an objective assessment of whether the information is more likely than not to affect the price of the company's listed equities.

The second limb focuses on the "materiality" of any price change. A slight change in price in either direction is unlikely to amount to a material change. The key question is whether the information is such that it would affect an investor's decision to buy or sell a particular share.

The latter underlines the central task for any company in assessing whether something amounts to inside information or not — whether the information would be likely to affect an investor's decision to deal in the company's shares. How stringently this requirement is interpreted will perhaps provide the strongest indication of the level of investor protection that the new legislation will or, indeed, can provide.

SAFE HARBORS

The bill provides four safe harbor exemptions to the duty of disclosure. These exemptions are intended to strike a balance between the stated objectives of market transparency and investor protection and protecting the "legitimate interests"[1] of listed corporations in relation to certain confidential information.

The four safe harbors are as follows:

- When the disclosure is prohibited by a Hong Kong court order or when disclosure would contravene Hong Kong legislation
- When the information relates to an incomplete proposal or negotiation
- When the information is a trade secret
- When the information concerns the provision of liquidity support to the listed company by the government's Exchange Fund or a central bank or any institution that performs the functions of a central bank

In order to rely on safe harbors B, C and D, the company must show that it has taken reasonable steps to preserve the confidentiality of the inside information and that such confidentiality has been achieved. Where confidentiality has not been maintained, and Safe Harbor A is not applicable, disclosure must be made.

ADDITIONAL POTENTIAL SAFE HARBORS

Hong Kong's Securities and Futures Commission will also have discretion (i) to authorize non-disclosure or waivers if appropriate; and (ii) to create new safe harbors if appropriate.

One potential safe harbor not addressed in the bill relates to the exercise of business judgment by the officers of the listed company. In certain jurisdictions, such as the United States, Australia and Malaysia, the "business judgment rule" may be used as a safe harbor. A director may raise a defense based on this rule against claims arising from breaches of the duty of care.

The business judgment rule is similar to the well-established common law principle that a director should not be held responsible for making a wrong business decision if he/she has acted in good faith and in the best interests of the company.

For example, in an Australian decision, Rogers J observed:

> The courts have recognized that directors must be allowed to make business judgments and business decisions untrammeled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against allegations of negligence by the entrepreneur?"[2]

Under common law, a director relying on this rule should show that his/her judgment was made in good faith and for a proper purpose and that he/she had no material personal interest. In addition, a director should show that he/she rationally believed that his/her judgment was in the best interest of the company and for a proper purpose.

Although there is no statutory business judgment rule in Hong Kong, Hong Kong courts have been reluctant to apply hindsight in analyzing the commercial merits of decisions made by directors if proper procedures have been followed before reaching such decisions. In other words, as long as a director's decision is made on a reasonable basis through rational thinking and in good faith, even if the decision made is wrong or catastrophic, generally the director should not be held responsible.

Nevertheless, every officer of a listed company must take all reasonable measures to ensure that proper safeguards exist to prevent the company from breaching the statutory disclosure requirement. This includes establishing and maintaining appropriate internal control and reporting systems.

PENALTIES

The SFC will be charged with enforcing the new disclosure provisions and is empowered to bring proceedings directly before the Market Misconduct Tribunal ("MMT"). The MMT can impose a range of civil sanctions on both the company and its officers as follows:

- A fine of up to HK$8 million for the company and/or its directors;
- Disqualification of an officer from being a director of the company for up to five years;
- The referral of the officer to his/her professional body for disciplinary action;
- A costs order against the company and/or the officers;
- A "cease and desist" order on the company or officer;
- A "cold shoulder" order against the officer preventing him or her from accessing market facilities for up to five years; and
- Any other order the MMT sees fit to impose, including additional training requirements or the appointment of independent compliance officers for the company.

These penalties provide the "teeth" to the statutory regime, which have been missing under the current Stock Exchange rules. Reference to previous MMT case law on insider dealing suggests that it is not afraid to exercise the range of sanctions available to it. However, whether it will be willing to take a proactive approach in the context of the statutory disclosure regime may well be influenced by how the bill proceeds through the Legislative Council and the number of cases that are brought before it in the early stages of implementation.

CONCLUSION

The Securities and Futures (Amendment) Bill 2011 marks a clear step in the right direction as Hong Kong seeks to tighten its financial regula-

tion. The focus on increased transparency and the distribution of important information in a timely manner will help to increase investor confidence and market awareness. From the perspective of the officers of listed corporations, it is vitally important that adequate reporting and monitoring procedures be put in place to deal with the new disclosure requirements. Appropriate training for directors and senior management will be critical to enable them to properly identify when the disclosure obligations may be triggered and the correct response to receiving inside information.

NOTES

[1] Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations, Financial Services and the Treasury Bureau (March 2010).

[2] *Daniels v Andersen* (1995 NSW Supreme Court).