FINANCIAL SERVICES DEVELOPMENT COUNCIL
香港金融發展局

FSDC Paper No. 12

Disclosure of Interests Regime in Hong Kong

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I. INTRODUCTION

1. Part XV of the Securities and Futures Ordinance sets out the Disclosure of Interests (or "**DOI**") requirements for Hong Kong. These DOI provisions require holders of certain long positions and holders of certain short positions, in Hong Kong shares, to disclose to the market those positions in order to enhance transparency for investors as to who owns/controls listed companies and who has short positions in those shares. Part XV is helpfully supplemented by guidance issued by the Securities and Futures Commission (the "**SFC**") in its "Outline of Part XV of the Securities and Futures Ordinance – Disclosure of Interests".

2. Most if not all mature securities markets in the world have analogous provisions. However, there is considerable range amongst them, including: the threshold ownership that triggers a disclosure obligation?; what type of interests count?; whether you can net long and short positions?, etc.

3. There is broad consensus amongst practitioners in this area that the Hong Kong DOI regime contains some of the most detailed and overly complex rules in the world, and the risk of inadvertently breaching them and risking criminal prosecution is high.

4. This paper seeks to give a flavour of that complexity and suggests some improvements that could be made to those provisions without adversely affecting, and in many ways improving, market transparency.

5. Currently many investors in the Hong Kong market actually stay below the Hong Kong threshold so as to avoid the Hong Kong DOI regime altogether but even this requires an understanding of how to monitor and calculate their interest which is extremely difficult. Given the complexity of the DOI regime, market participants (including both local intermediaries that actively trade the Hong Kong market as well as global financial intermediaries) are required to implement extensive compliance policies and complex IT infrastructure in order to comply with their disclosure obligations. This will affect their cost/benefit analysis when making business plans in Hong Kong. One investment bank in Hong Kong estimates, very roughly, its annual compliance costs relating to the Hong Kong DOI rules at approximately US$1 million – taking into account extra staff, systems, compliance, etc. Also, considering the complexity of the disclosure of interests regime, the interest level disclosed by investors for market transparency purposes is not as meaningful for the investing public as originally intended. Amongst other things, the investing public would need to have a thorough understanding of the disclosure rules (and exemptions) to be able to decipher many filings.

6. Failure to comply with the DOI regime constitutes a strict liability offence and potential criminal liability – a person who fails to make a disclosure in accordance with the DOI regime *without reasonable excuse* commits a criminal offence. This may also trigger undue cross jurisdiction reporting requirements for financial intermediaries with worldwide operations. Even if a breach is only technical or inadvertent and without any criminal intent, committing an offence in Hong Kong will trigger reporting requirements for the intermediary group to regulators in other

relevant jurisdictions worldwide. Given the fact that this is a strict liability offence, it would be extremely helpful to know what constitutes a "reasonable excuse" for these purposes.

7. The SFC has issued the revised "Outline of Part XV of the Securities and Futures Ordinance – Disclosure of Interests" on May 22, 2014 providing additional guidance addressing certain concerns regarding the DOI regime. The SFC has stated in the revised outline that the revision is prompted by, among others, the need to address comments and queries relating to the DOI regime received since the publication of the previous version of the outline in August 2003. This reflects concerns expressed by market participants in connection with the complexity of the DOI regime.

8. In addition to the SFC's revised guidance, rather than seeking to provide further guidance based on existing DOI provisions or amending just some of the DOI provisions, we think this is a good opportunity to look at the DOI rules afresh and consider a complete rewrite of them. For example, the 2005 "Consultation of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance" was never implemented. Separately, in light of the newly proposed Shanghai-Hong Kong Stock Connect regime and other regional initiatives to promote cross-listings/listings in Hong Kong, there is an increasing investor base outside Hong Kong that may be subject to, but which is not familiar with, the relevant disclosure obligations under the DOI regime. This is a good opportunity for Hong Kong to further refine its DOI regime in preparation of its increasing global reach and aim to attract investors investing in Hong Kong listed securities. Upon completion of this project, the SFC could seek to engage other global regulators on and see if a global initiative to harmonize (as much as possible) the numerous different DOI rules in the world's more mature markets, could be undertaken, possibly under the auspices of the International Organisation of Securities Commissions ("IOSCO"). Separately in addition to the DOI regime, other substantial shareholding disclosure and limits regimes (for example the Securities and Futures (Contracts Limits and Reportable Positions) Rules[1]) may also be reviewed to further streamline the overall regulatory framework in Hong Kong.

[1] For example, with respect to stock options contracts (on shares listed on the Stock Exchange of Hong Kong), under the current regime, holders of the relevant stock options contracts are required to report positions if they reach a certain level of open contracts and are subject to position limits on the number of open contracts that could be held. The stock options contracts are traded by reference to the underlying share's board lot size (i.e. the contract size is calculated by referent to number of shares under the prevailing board lot size). In the event there is a decrease in board lot size (i.e. each open contract will cover a lower number of underlying shares), there is inflexibility in adjusting the stock options contracts size and causing the reporting threshold and position limit to be triggered with exposure to a lower number of underlying shares. Such inflexibility could represent a hurdle in further developing the options derivatives market in Hong Kong. We appreciate, however, that the SFC, the Stock Exchange of Hong Kong Limited and the Hong Kong Futures Exchange Limited, may want to monitor concentration risk at an appropriate level.

II. SPECIFIC AREAS FOR CHANGE

We now set out 15 areas within the DOI regime where improvements could be made.

A. Right of use, rehypothecation, borrow, on-lending etc. (ROU) over clients' shares

- **Description:** pursuant to the terms of most industry-standard client agreements, the securities firm/bank/investment bank etc. ("firm") may have a ROU over clients' shares. ROU is a reportable interest even though the firm has not yet exercised the right.

- **Rationale for Change:** the firm's interest may be inflated even when the firm may not use the shares. There would be a spike in the firm's positions when taking a large block of client shares simply as custodian or into the client's account for future trading. This may create confusion in the market and unnecessary speculation.

- **Recommendation:** it would be more meaningful to align the timing of the substantial shareholding notification with the time the ROU is actually exercised (in particular where the interest is acquired by way of a security interest) i.e. aggregate the client shares with the firm's positions when actual borrow/rehypothecation takes place – similar to the exemption applicable to exempt security interests. In Australia for example, ASIC provided Class Order relief in 2011 on these terms.

B. Cash settled derivatives

- **Description:** cash settled derivatives (i.e. not involving any physical receipt/delivery of the underlying shares even on an optional or possible basis) are reportable interests in Hong Kong. The definitions of long and short positions to be taken into account for the purpose of equity derivatives requires an analysis, in the case of cash-settled derivatives, of whether or not a loss can be avoided or reduced if the share price increase or decreases, as the case may be. This is extremely difficult to monitor and inconsistent with the purpose of these disclosure obligations.

- **Rationale for Change:** the firm does not have any proprietary interest in, nor any control over, the underlying shares of the cash settled derivative - nor does the firm have any control over the voting rights attached to the underlying shares. There is therefore little information value to equity investors. Side issue: the firm will invariably hedge its derivative position vis-à-vis its client, with a cash equity hedge, however that position will be opposite to the derivative position (and thus the firm is ''hedged'') and the firm may choose not to hedge, or only partially hedge (depending on how close to being ''in the money'' is the derivative). Any such hedging by the firm is already treated as a reportable interest.

- **Recommendation:** treat cash settled derivatives as exempt so that they need not be included in the reportable interest or short position, as the case may be. Hong Kong is one of the few jurisdictions in Asia where the product scope of the DOI regime includes cash-settled derivatives.

C. Aggregation/attribution within a corporate group

- **Description:** some holding companies find the aggregation exemption not practical as the definitions of those relevant parties and relationships are very specific.

- **Rationale for Change:** Part XV requires attribution of interests held by a company up a 33.3% or more (a controlled corporation) owned corporate chain. Under the "aggregation exemption" a holding company may disregard, or "disaggregate" from its own, the interests of an investment management corporation within the corporate group if the investment management corporation acts independently "without reference to" any other entity within the group (s316(5) of the SFO). The analysis to determine whether the entities are able to rely on the dis-aggregation exemption can be very complex, particularly when there is an affiliate or sister entity relationship, as opposed to a parent/subsidiary.

- **Recommendation:** the SFC in its "Consultation Conclusions on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance" (May 2005) recommended the law to extend the aggregation exemption to cover the additional circumstances where (i) qualified investment managers within a group communicate with each other only in relation to investment strategy; (ii) 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.

D. Aggregation/attribution within a corporate group

- **Description:** the aggregation exemption operates in relation to "qualified investment managers", which must be regulated in Hong Kong or in a recognized jurisdiction with equivalent regulation.

- **Rationale for Change:** the operations of global investment management groups are not restricted to the jurisdictions approved by the SFC (e.g. Singapore and Japan are not approved). In practice it makes no sense and it is difficult to apply a dis-aggregation rule to only part of a group's global investment management business.

- **Recommendation:** relax or remove the approved jurisdictions requirement[2].

[2] The SFC in its "Consultation Conclusions on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance" (May 2005) noted that it is important any exemption should continue to apply only in respect of foreign investment managers in approved jurisdictions. The basis for approving the jurisdiction is that the SFC is assured the entities operate in a proper inspection regime, so as to be adequately supervised and the SFC can secure necessary information from the relevant authorities in that jurisdiction. The SFC expects more jurisdictions will sign the relevant International Organization of Securities Commissions (IOSCO) memorandum of understanding that would allow the SFC to be in a position to recognize them as approved jurisdictions.

E. De minimis exemption

- **Description:** market participants often choose not to rely on the de minimis exemption due to its complexity.

- **Rationale for Change:** according to the SFC, the policy intent of the de minimis exemption was to reduce the compliance burden that might arise where a substantial shareholder's interest fluctuated only by a small amount around a whole percentage level. However, many participants find the exemption too complex and difficult to apply and understand. Such difficulties include:-

    a. Correctly identifying the "last notification", which can be easily taken to mean the last filed DOI. Only DOI filed in respect of change crossing a percentage level qualifies as "last notification" for the purpose of claiming the *de minimus* exemption.

    b. Keeping track of the fluctuation of the percentage figures to ensure that they remain, at all times, within the 0.5% band.

    c. In applying the *de minimus* exemption, separating the part of the interest that has not changed from the rest and keeping track of the unchanged interest to ensure they stay, at all times, within the 0.5% range.

- **Recommendation:** in 2005 the SFC in its "Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance" (Consultation Paper) consulted on the de minimis exemption. The majority of the feedback favoured a simplification of the current de minimis exemption on the basis of the existing disclosure regime.

A de minimis exception is a sensible exemption but it needs to be made workable.

F. Trade date/settlement date

- **Description:** the filing period differs for buy and sell transactions. The discrepancy in the filing period means that the relevant shares are "double counted" for 2 to 3 days.

- **Rationale for Change:** for the buyer, the usual notice filing period for the purchased shares is within 3 business days after the date on which the buyer contracted to buy the shares i.e. filing must be completed by T+3. For the seller, the notice filing period for the sale is within 3 business days after the settlement day. The "double counting" of the interests during this window means that investors may not get a meaningful/complete picture of the shareholdings in the listed corporations. The requirement to calculate interests resulting from the sale of shares differently from interests resulting from the purchase of shares exists in very few jurisdictions and it is extremely time-consuming and expensive to implement the hybrid system necessary to comply with this requirement.

- **Recommendation:** to align the timing of notification for buy and sell transactions so that both are calculated as at trade date and disclosed, where necessary, within 3 business days of trade date.

G. Security interests (long) and narrow nature of an exempt security interest

- **Description:** a lender will need to recognize as a type of long position, when it holds a security interest in shares (e.g. shares charged by the borrower as security for a loan made by the lender). Currently there is an exemption applicable to exempt security interests with respect to qualified lenders.

- **Rationale for Change:** the current exemption has narrow application covering qualified lenders (mainly regulated entities) and only for purposes of a transaction entered into in the ordinary course of business as such a qualified lender. Furthermore, a security interest does not usually, on its own, confer voting rights on the holder.

- **Recommendation:** expand the exemption to cover all types of lenders or simply exempt the holder of a security interest altogether until the security interest is realised and legal title has passed to the lender at which point it will hold an interest in the shares as their legal owner and holder of voting rights instead.

H. Approved lending agent ("ALA")

- **Description:** there is extensive complexity around being an ALA under the stock borrowing and lending ("SBL") regime

- **Rationale for Change:** ALAs may operate within a simplified disclosure regime for SBL activities and only disclose changes in the percentage level of their "lending pool". However there have been comments from the industry that the existing restrictions make it hard to carry out the following activities:

  a. lending shares in which an affiliate is interested via the lending pool operated by an ALA within the same group;

  b. lending shares from the lending pool of an ALA within the same group to an affiliate; and

  c. lending shares in which an ALA is interested via the lending pool.

- **Recommendation:** in its Consultation Paper the SFC sought views on whether the ALA regime should be expanded to cover the activities that are not currently possible within the stock borrowing and lending reporting regime under Part XV. The SFC concluded that if any exemptions were to apply, the SFC would need to ensure that the affiliates and the ALA's businesses are carried out at arm's length and between independent business units. Generally, the disclosure regime around SBL activities should be simplified.

I. Aggregation/attribution for fund management entities

- **Description:** fund managers with discretionary authority over fund vehicles under their management are required to aggregate the interests held through portfolios (funds and managed accounts) for which they have investment discretion.

- **Rationale for Change:** in context where there are multiple managers/sub-managers for the same fund vehicle (in particular where such managers/sub-managers are within the same group) – this creates undue complexity for each manager/sub-manager to aggregate the fund vehicle's position. This is an issue particularly where reporting is made on a wholly owned group basis where determination of interests at the manager/sub-manager level and the need to avoid double counting, would be complex. Where the manager and its delegate belong to the same group, the controlling parent company will have to consider whether to aggregate the interest held by the manager and its delegate (the sub-manager) in the same shares (i.e. on the one hand it should avoid trying to double-count an interest in the same shares, but on the other hand it must aggregate all its attributed interests, when calculating its own aggregate interest as their parent which could result in distorted information within the public domain).

- **Recommendation:** where the discretionary investment power has been delegated to another entity within the same group, only the interest held by the entity first granted such power should have to be disclosed and taken into account for the purpose of calculating the deemed interest of the parent company of both entities.

J. Wholly owned group exemption

- **Description:** the current wholly owned group exemption is restricted to 100% owned group entities and distinguish circumstances between initial filings (e.g. in context of an IPO) and ongoing filings.

- **Rationale for Change:** the current exemption is not applicable even when the shareholding relationship is substantial but falls short of 100%. Also it can be practically burdensome to put in place different measures for "initial notifications" and ongoing filings.

- **Recommendation:** to expand the exemption to cover all majority owned subsidiaries (not necessarily wholly owned subsidiaries) and remove the distinction between initial filings and ongoing filings. Also clarify whether or not the exemption applies to LLC and any other legal forms or if it is limited strictly to entities which are limited companies and which issue shares as opposed to entities (such as LLCs and limited partnerships) in which interests are held.

K. Sale of rights in a rights issue

- **Description**: on a rights issue by a company listed on the Stock Exchange of Hong Kong ("SEHK"), if a shareholder intends to partially sell its "nil paid rights" prior to

the completion of the rights issue (i.e. not subscribing for its entitlement under the rights issue in full), what DOI filings need to be made and when?

- **Rationale for Change**: in order to provide transparency around dealings in "nil paid rights", both the seller and the buyer of such rights should make a DOI filing to disclose their dealings on the date agreement is reached with respect to the sale and purchase of such rights – i.e. not on the date on which the sale and purchase of such rights completes.

- **Recommendation**: on the day the nil paid rights are sold, the seller ceases to have a deemed interest in such rights (or in the underlying Hong Kong listco shares) and therefore should make a DOI filing immediately to disclose the drop in its deemed percentage shareholding in the shares issued by the SEHK-listed company.

L. Criminal liability

- **Description:** the contravention of the DOI regime is a strict liability offence that triggers potential criminal liability – it is a criminal offence if a person *without reasonable excuse*, fails to make a disclosure in accordance with the DOI regime.

- **Rationale for Change:** the vast majority of breaches of the DOI regime are technical breaches or inadvertent breaches (e.g. late filings, misunderstanding of filing obligations, error in calculation of interests, etc.) without any criminal intent. However, it is accepted that a strong deterrent is desirable to uphold the integrity of market transparency.

- **Recommendation:** decriminalise breaches of the DOI regime unless there is criminal intent.

M. Conditional interests

- **Description:** a person has an interest in shares (which may trigger a DOI filing obligation) even if such person's right to the shares is conditional and, in particular, it is irrelevant whether the condition has a reasonable chance of being fulfilled or whether the person can influence the outcome of the condition. If the condition is not satisfied ultimately, this may also trigger a filing obligation for the person who ceases to have a conditional interest.

- **Rationale for Change:** there could be premature recognition of interests of a person with conditional interests that are unlikely to vest (i.e. the relevant condition is unlikely to be satisfied). This may impose undue filing obligations on such person and in particular if the condition is not satisfied this also triggers a filing obligation on the person who ceases to have the conditional interest.

- **Recommendation:** to consider limiting the scope of recognising conditional interests, perhaps to circumstances where the condition can be influenced by the person interested in the shares.

N. Exempt custodian interest

- **Description:** if a custodian retains a discretionary right to set off any other obligations/liabilities of a client against any securities held in custody for that client or otherwise has authority to exercise voting rights of the securities, the custodian will not be able to rely on the exempt custodian interest exemption. Similarly, the exemption is not available if the custodian retains the discretionary right to take up or retain unclaimed or fractional dividends (cash and/or scrip), which in practice is the case where a custodian operates on an omnibus model basis.

- **Rationale for Change:** it is common practice (and prudent) for custodians (i) to take some form of security interest over assets under custody when performing its custody services – for example to have the right to set off; and/or (ii) to have discretion to take up or retain unclaimed or fractional dividends. There are contractual rights conferred by the client under the custodian agreement.

- **Recommendation:** to expand the exempt custodian interest exemption to allow more practical application so that custodians can safely rely on such exemption even if the "standard" custody documents give them security interests such as right of set off, or discretion to take up or retain unclaimed/fractional dividends.

O. Qualified Overseas Schemes

- **Description**: the definition of "Qualified Overseas Scheme" does not include:

  a. An arrangement under which less than 100 persons hold, or have the right to become holders of, interests (whether described as units or otherwise) that entitle the holders, directly or indirectly, to the income or property of the arrangement; or

  b. An arrangement under which less than 50 persons hold, or have the right to become holders of, interests that entitle the holders, directly or indirectly, to 75% or more of the income or property of the arrangement.

- **Rationale for change**: this is very difficult to monitor for holders who cannot know, at any particular time, what percentage of the scheme they hold.

- **Recommendation**: this exemption should be available whenever it can be shown that genuine efforts are being made to promote the scheme widely (as per the Inland Revenue's practice note in relation to similar provisions in the Inland Revenue Ordinance).

III. CONCLUSION

Above we have set out 15 specific areas where the DOI rules in Part XV of the SFO could be improved. It is submitted that these changes would greatly simplify (and "de-risk") this area of the law for market participants. Moreover, not only would it NOT lead to a diminution in the quality of information available to investors in the Hong Kong market; but to the

contrary we believe it would simplify the data available to the public, remove its capacity to be misleading and help investors better understand what is really happening in the market.

Given the breadth of the proposed changes, it is worth considering the merit of a wholesale rewrite of Part XV and trying to achieve consistency across major financial markets globally (perhaps under the auspices of IOSCO).

Separately in addition to the DOI regime, other substantial shareholding disclosure and limits regimes (for example the Securities and Futures (Contracts Limits and Reportable Positions) Rules) may also be reviewed to further streamline the overall regulatory framework in Hong Kong.

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

Contact us

Room 931, 9/F, West Wing, Central Government Office
11 Ice House Street Central, Hong Kong
(852) 2493 1313
www.fsdc.org.hk