

Legal Week's Corporate Counsel Forum

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Introduction

Thank you for inviting me today. I want to talk to you about two recent developments this morning.

First, the Court of Final Appeal's decision in the Tiger Asia case that has clarified the jurisdiction of the Court in section 213 cases.

And, secondly, an issue that is immediately closer to you as general counsel and especially important and vital for the well-being of our markets, namely good, timely and accurate disclosure of price sensitive information.

Criminal Law, Equity and Market Misconduct

Let me turn to the Tiger Asia decision first.

Earlier last month, the Court of Final Appeal heard Tiger Asia's appeal concerning the court's jurisdiction under section 213 of the Securities & Futures Ordinance. The Court of Appeal ruled that section 213, a provision that permits the Securities and Futures Commission (SFC) to seek a range of remedial orders dealing with contraventions from the Court of First Instance, gave the Court a self-standing jurisdiction that did not depend on nor was ancillary to any other process.

Tiger Asia had argued – with support from a small number of lawyers and academics in Hong Kong – that civil remedies could only be obtained in relation to contraventions *after* there had been a successful conviction in a criminal court or a finding in the quasi-penal Market Misconduct Tribunal (MMT). This argument was wrongheaded from the outset. But it had to be dealt with.

The importance of section 213 in a regulated market cannot be gainsaid. The remedies available to the Court in these types of proceedings have their source in equity, in effect, applying equity's response against fraud to statutory contraventions, like insider dealing.

Section 213 reminds us that the criminal process is not the only response developed by the law to combat fraud. Equity has always reacted aggressively to counteract fraud by moulding remedies to do what is practically just.

The effect of the Court of Final Appeal's decision is that our attack on market misconduct will continue to include not only criminal sanctions but also the moulding of remedies under



section 213 with their inspiration in equity. And this is right because both criminal law and equity share the same foe.

This is not to derogate the role of the criminal justice system. Deterrent sanctions remain vital. But they are not paramount. Nor are they universally applicable. For example, they cannot be sought against defendants who are not in Hong Kong.

So, our approach is that general deterrent or penal outcomes alone are inadequate to deal effectively with the problems raised by misconduct in our markets.

An approach that only focuses on the wrongdoer and ignores the consequential effects of the wrongdoing in our market is simply inadequate.

This is not to say individuals should not bring their own actions, invoking their own causes of action where possible. But the reality of an anonymous market is that relevant causes of action are not readily visible. Even if you suspect you may have been on the wrong end of market misconduct, in an anonymous market, who do you take action against? And in many cases, the quantum of damage, at an individual level, is too small. The diffusion of harm across a wide number of parties does not mean the overall total damage is not significant and material.

This is where securities regulators can play a distinctively helpful role.

The Court of Final Appeal's decision means cases like Hontex International Holdings Company Limited, in which over \$1 billion was returned to minority shareholders following court orders that its IPO prospectus contained false or misleading information, will not be rare birds. This is good news for Hong Kong.

Listed Company Disclosure

Let me now turn to an issue that I suspect may be closer to your immediate concerns, timely disclosure of price sensitive information by listed companies.

Earlier this year, the law changed making listed company disclosure of price sensitive information a statutory obligation for all listed companies in Hong Kong with statutory consequences for non-compliance.

The SFC has published figures that show the number of announcements made by listed companies in the first three months of this year rose by 43% against the corresponding period last year.

Of course numbers ought not to be the measure but this is a good signal if it means the quality and timeliness of information in our market is improving. And this is the regulatory objective: to improve the culture of disclosure in our markets so that prices reflect all relevant information more quickly in a way that is fair to all market participants.

Surely the distortion that can occur between different assessments of value and therefore price is an important driver of market activity. But in the context of disclosure of important information, these gaps between price and value should more closely reflect differences in assessment rather than differences in access to price sensitive information.



SFC's Role

The problems created by unequal access to price sensitive information or the non-disclosure of vital information is not a new issue or one that has suddenly become one as a consequence of the new statutory regime that started this year. We have been very active for a number of years and our actions have helped to pave the way for this reform.

The reason for this is because the connection between corporate governance and market integrity is a close one. Misuse of confidential information through selective disclosure, leakage or insider dealing damages the interests and well-being not only of the company and its shareholders but also the market because asymmetries of information inevitably distorts genuine forces of supply or demand.

Our corporate governance program – one of our six strategic programs of activity in our enforcement work – has been actively attacking poor disclosure practice by listed companies for many years. We have brought dozens of actions against listed company directors largely over disclosure issues. These have been among the first court actions taken in Hong Kong to protect the market from harm caused by poor disclosure practices.

In the last 18 months, for example, we have taken or completed actions against:

- Former chairman and an executive director of Sunlink International Holdings Ltd centering on a number of material events which were not disclosed to the market when they should have been, including the presentation of a winding up petition for failure to pay a trade debt at a time of mounting financial difficulties that included a threat from its banker to withdraw support; a strike at its Mainland factory and severe liquidity problems. External administrators were subsequently appointed to the company.
- Disqualifications of former directors of Warderly International Holdings Ltd (Warderly) over similar problems including the commencement of legal proceedings to recover unpaid debts; labour strikes and the appointment of an insolvency specialist to advise the company's syndicate of lenders. In total the SFC has taken action against six directors of Warderly over disclosure problems;
- Action against the former CEO of China Forestry Holdings Co. Ltd. who sold shares in the blackout period whilst, so we allege, the auditor was raising issues concerning the company's financial position. The sale proceeds, amount to about \$400 million, remain frozen pending further order by the Court. We also allege insider dealing.
- Proceedings against the former chairman and directors of Styland Holdings Ltd in respect of numerous transactions which had the effect of conferring financial benefits totaling \$85 million on them either personally or through private companies owned by them. This was the first case in which we sought and obtained an order that the misused funds be returned to the company.
- Proceedings against the former chairman of GOME Electrical Appliances Holding Ltd over allegations of an undisclosed and improper purpose behind a \$2.4 billion share buyback.



- Proceedings against former directors of Medical China Limited in respect of false or misleading announcements and the improper use of company funds. This was the second case in which we have obtained a compensation order in favour of the company.
- The jailing of the chairman of VST Holdings Ltd for failing to disclose his interest in the number of shares in the company held through three different accounts that he controlled in a price-rigging scheme.
- A number of insider dealing cases against senior company executives, including a senior executive in CITIC Pacific Limited who was jailed for insider dealing after selling his shareholding in CITIC Pacific after becoming aware of the company's foreign exchange losses in 2008 but before those losses had been disclosed to the market; criminal proceedings against a former non-executive director of Hong Kong Aircraft Engineering Company Limited for trading on information given to him about an impending takeover offer for the company before it was announced; and civil proceedings against a Singapore-based senior executive of Titan Petrochemicals Group Limited over allegations that he sold his shares in the company after learning the company was to default on repayment obligations owed under US\$105 million Senior Notes facility before the information was announced to the market.

All of these cases demonstrate the interlocking of regulatory and legal risks associated with late or non-disclosure of price sensitive information and trading by company directors, senior management and insiders.

In most of them, the absence of disclosure to the market was substantial and clearly had an impact on the market's capacity to properly value and price relevant securities.

Our view is that an uninformed market causes as much loss or damage to the integrity of our market and to the investing public as a misinformed one.

We have not studied in any scientific way the medium to long term impact of information not being delivered to the market at the right time and in the right way in any of these cases. Such a study would need to examine the way in which misinformation and incomplete information may have distorted supply and demand and therefore prices of stocks in each of these companies.

But there is no doubt shareholders who deal in shares on the basis of incomplete or inaccurate information that is required to be disclosed run the risk of losses that can be caused by their informational disadvantage.

To put it another way, investors looking to buy shares in a company would presumably change their investment decision if, for example, they knew the company was facing a winding up demand that it was unable to meet, or at least consider any investment that would need to be priced differently before proceeding.

This I think gets to the most acute point for listed companies who need little encouragement to announce good news to the market but perhaps have a tendency to withhold or delay bad news, sometimes mistakenly believing that to do so is in the company's best interests or that the bad news will simply go away all by itself.



One of the key points of the new law is that there is no longer any basis for any company to think that materially adverse news that is disclosable under the statutory regime can or should be withheld or delayed from the market. And companies that do so risk sanctions as well as civil claims by shareholders who may have suffered financial loss because of the delay.

The New Regime on Disclosure of Inside Information

Under the new regime, a listed company is obliged to disclose what is called 'inside information' "as soon as reasonably practicable".

"Inside information" is given the same meaning it has in the legislation in relation to the prohibition against insider dealing. This means it is "specific information" about a company, its shareholders or officers or its listed securities or their derivatives that is not generally known to those accustomed or likely to deal in the listed securities but would, if generally known to them, be likely to materially affect the price of the securities. In short form, it is price sensitive information.

As an observation, information is not valuable or price sensitive because it is intrinsically or fundamentally important although invariably it will be.

The route that is taken by the legislation defines what is important to the market by reference to what the market is likely to think and do about the information. It is premised on likely behaviour of investors or the community of investors who may invest in the stock rather than on inherent features of the information.

Although it must be information that is about the company, the essence of the definition is that it is information that, if generally known, it would affect the behaviour of those who generally or who are likely to deal in the shares.

This definition has been part of our law for a long time because it is the definition that is also used to define inside information for the purposes of the insider dealing prohibition. There is a body of case law in both our courts and in the MMT and its forerunner - the Insider Dealing Tribunal - dealing with this definition and its consequences. The SFC has issued guidance based on these cases as well to assist companies with the definition.

The definition was I think based on similar wording in the Australian legislation. I have not traced it back further but the sentiment within the definition is akin to John Maynard Keynes's approach to investment, as he described it in his seminal work *The General Theory of Employment, Interest and Money* (1936) which focussed on the behavioural traits of investors to measure value rather than on intrinsic assessment of value¹.

¹ Keynes likened an investor in the market to a person entering a newspaper beauty contest in which there were photos of 100 women and entrants were invited to nominate the faces they liked the most with the winner being the person who picked the most popular face. As Keynes wrote "It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be." (Keynes, *The General Theory*, p. 154.)



Our definition is not so differently angled. Inside information is specific information that is not generally known to persons accustomed or likely to deal in the shares but if generally known would be likely to materially affect the price of the listed securities. Thus, the focus is based on the likely behaviour of typical investors rather than the intrinsic assessments of the information. The relevant question is: how would a typical investor react if the information was known to him or her?

And I think there may be consequential benefits from listed companies and their senior management thinking more constructively about how investors are likely to think and react. In effect, the definition requires the company and its senior management to assess potentially disclosable information from the investor's perspective.

Keynes incidentally was an expert stock picker and advised Kings College, Cambridge on investments. Apparently, between 1926 and 1946, Keynes' stock picks outperformed the market by an average of 8% annually.

The Defence

A key component of the new regime on disclosure of inside information is the incentive for companies to establish proper protocols and disciplines to ensure there are reasonable measures in place to prevent the company from breaching the new obligation. The existence of reasonable measures can be a defence to an allegation that new disclosure requirements were contravened.

This measure compels companies to consider, in a top-down sense, how to govern confidential information.

At the very least, a responsible custodian of confidential information should develop protocols and standards for:

- training and decision-making to ensure material and confidential information is properly identified when it emerges within a company's business operations (how does important information flow within the company ?);
- safe-custody of material confidential information to ensure it is kept securely (what should be done with confidential information to protect it from misuse ?);
- measures for limiting, controlling and governing access to confidential information within the company and its advisers so that the company knows who knows the information and who should not have access to it (how do we know the information is being kept confidential ?) and
- clear gateways and delegations in place for decisions to be made quickly in relation to disclosure (is there a clear process for deciding whether the information must be disclosed and can it operate as soon as practicable as required ?).

Let me return to the behavioural focus of the definition of what is inside information. Instinctively, many listed companies will seek legal advice when they are concerned about disclosure issues. In the first instance, they may seek your advice and perhaps also external legal advice.



Of course legal advice is a component in understanding whether the disclosure obligation has been triggered. For example, important questions might arise as to whether a relevant exception or carve-out applies. These are not going to be very difficult or time-consuming issues. But assessing the likely behaviour of typical investors, which is at the heart of the assessment of whether information is inside information, does not involve any legal analysis.

The definition is designed to be usable by company directors who have a close understanding of their business and its stakeholders, especially its investors. A board of directors ought to be able to make educated judgments, based on their experience, as to how typical investors are likely to react to news. Of course many directors will also be investors themselves, so the point ought not to be too lost on them.

But no doubt there may be cases where it is prudent or appropriate to seek advice on this issue. Again, it is unlikely lawyers will be especially authoritative on this point.

In prosecuting insider dealing cases using the same definition, the court doesn't rely upon expert lawyers to assist in answering this question. Usually market experts, brokers, fund managers are employed to give expert evidence.

I will leave you with my concern. In applying the new disclosure requirements, companies may place too much reliance on a legal assessment of whether the information meets the relevant legal definition and in doing so will miss the point of the definition, which focuses on the likely behaviour of typical investors.

Getting the right advice from the right person does not always involve choosing the right law firm or lawyer.

Once again, thank you for inviting me this morning and I wish you all well.