

**Proposed Amendments to  
The Securities (Disclosure of Interests) Ordinance**

**CONSULTATION CONCLUSIONS**

**Hong Kong**

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## CONTENTS

	Page
EXECUTIVE SUMMARY .....	1
Introduction .....	1
Direction for Change .....	1
Consultation Conclusions .....	2
General Matters .....	5
INTRODUCTION .....	7
GENERAL POLICY CONSIDERATIONS .....	8
1. Objectives of the Proposed Amendments .....	8
2. Major Comments Expressed .....	8
3. Direction for Change - The Role of the Ordinance.....	10
SPECIFIC CONSULTATION AREAS .....	13
1. Substantial Shareholding Disclosure Threshold .....	13
2. The Notification Period .....	15
3. Timing to notify the SEHK and Listed Companies .....	18
4. De minimis Change Exemption .....	19
5. Details of Registered Shareholders .....	20
6. Disclosure of Consideration and Agreements .....	21
7. Shareholding Structure of Corporate Substantial Shareholders .....	25
8. Discretionary Trusts .....	27
9. “Concert Party” Agreements .....	30
10. Investment Managers and Trust Companies .....	32
11. Derivatives .....	38
12. Disclosure Forms .....	46
13. Disclosure of Share Pledges .....	47
14. Stock Lending and Borrowing .....	51
OTHER SPECIFIC COMMENTS .....	53
1. Application of the Ordinance to issuers of listed debt securities and derivative warrants .....	53
2. Notice under Section 18 of the Ordinance .....	53
3. Netting off of Interests .....	54
4. Application of the 5% threshold under the Listing Rules .....	54
5. The need for a Rule 33 disclosure under the Takeovers Code .....	55

THE APPENDICES:

Appendix A : Profile of the Respondents and Summary of Responses

Appendix B : Particulars of the Three Options for Aggregation of Derivative Interests

Appendix C : Summary of Current Position under the Ordinance applicable to Derivatives

## **EXECUTIVE SUMMARY**

### **Introduction**

The Securities and Futures Commission (the “*SFC*”) issued a Consultation Paper on Proposed Amendments to the Securities (Disclosure of Interests) Ordinance (the “*Consultation Paper*”) in June 1998. The SFC invited the public to comment on certain proposals to up-date and revise the disclosure regime of Hong Kong. The consultation period ended on 30 September 1998. A total of 37 responses were received. This Paper summarises the public’s responses to the Consultation Paper. It also sets out and explains the rationale for the final proposals adopted by the SFC regarding the amendment to the Securities (Disclosure of Interests) Ordinance (the “*Ordinance*”). This Executive Summary provides an overview of the policy conclusions reached by the SFC and the approach taken in formulating such conclusions.

### **Direction for Change**

The Consultation Paper stated that whilst the Ordinance should continue to fulfill the functions identified by the Securities Review Committee in 1988, for 1998 and beyond, the Ordinance should move towards promoting more transparency for the market with a view to providing investors with more information to make investment decisions. Therefore, proposals were made to lower the disclosure threshold applicable to shareholders holding substantial interests in listed companies, shorten the notification period, and require the disclosure of, for example, the price payable by substantial shareholders in acquiring interests in shares.

With the benefit of comments expressed by the public, the SFC has re-examined the role that the Ordinance should play in Hong Kong. In the SFC’s view, the overriding objective of the Ordinance is to provide investors with more detailed and better quality information to enable them to make investment decisions. Further, the Ordinance should provide a disclosure regime which would enable investors to identify persons who control, or are in a position to control, interests in listed shares; which meets international and regional standards; and which is not difficult to comply with in practice. In proposing ways to increase market transparency, the SFC believes that due regard should be given to the following matters:

- the cost of complying with additional disclosure requirements; and
- the potential risk of providing excessive information to the market.

In formulating the final proposals, the SFC has taken these factors into account.

## **Consultation Conclusions**

The principal conclusions reached by the SFC regarding the 12 specific areas of consultation contained in the Consultation Paper are summarised as follows:

- (1) ***Disclosure threshold*** : Reduce the initial substantial shareholding disclosure threshold from 10% to 5% (pages 13 to 15). No change is made to the original proposals set out in the Consultation Paper.
- (2) ***Notification Period*** : Shorten the disclosure notification period from five days to three business days (pages 15 to 18). It was originally suggested that the notification period should be reduced to two business days.
- (3) ***Timing of Notification to the Stock Exchange and listed companies*** : Remove the requirement that notification of an interest in shares must be made to the Stock Exchange (“SEHK”) prior to notifying the listed company concerned (pages 18 and 19). No change is made to the original proposal.
- (4) ***De minimis change exemption*** : Exempt substantial shareholders from the obligation of disclosure when their interests in shares fluctuate by a de minimis amount across a particular percentage level (pages 19 and 20). No change is made to the original proposal contained in the Consultation Paper.
- (5) ***Details of registered shareholders*** : Remove the existing provisions requiring substantial shareholders to disclose the particulars and shareholdings of registered holders, and to disclose any change in their particulars (pages 20 and 21). No change is made to the original proposal.
- (6) ***Consideration and terms of agreements*** : Substantial shareholders will be required to disclose the consideration payable or receivable by them in acquiring or disposing of interests in shares, whether the transactions take place on-exchange or off-exchange. It is, however, not necessary to disclose consideration in relation to dealings in derivatives as originally proposed (see paragraph (11)(g) below). Further, there is no need for substantial shareholders and directors to disclose agreements or the terms of agreements relating to off-exchange transactions as suggested in the Consultation Paper (pages 21 to 24).
- (7) ***Disclosure of persons who control corporate substantial shareholders*** : When performing a duty of disclosure, an unlisted corporate substantial shareholder will be required to disclose the details of any person in accordance with whose directions or instructions it or its directors are accustomed to act. The proposal that substantial shareholders should also disclose details on its shareholding structure and persons holding 10% or more shares in its issued share capital has been dropped (pages 25 and 26).
- (8) ***Discretionary trusts*** : When performing a duty of disclosure, a “settlor” of a discretionary trust will be deemed to be interested in the shares held by the trust and may, as a result, be under a separate duty of disclosure. A revised

proposed definition of “*settlor*” is included in this Paper. The proposal that trustees of discretionary trusts should be required to disclose the identity of settlor(s) of the trust has been dropped (pages 27 to 30).

- (9) **“*Concert party agreements*”** : Extend the scope of a “*concert party agreement*” under section 9 of the Ordinance to include any arrangement under which a controlling shareholder of a listed company provides any loan or security to another person on the understanding, or with the knowledge, that the loan or security will be used or applied to facilitate the acquisition of an interest in shares of the same listed company by that other person (pages 30 and 31). No change is made to the original proposal set out in the Consultation Paper.
- (10) ***Investment managers and trust companies*** : Remove the exemption currently made available to Hong Kong registered investment managers and trust companies under the Securities (Disclosure of Interests)(Exclusions) Regulations (pages 32 to 37). No change is made to the original proposal.
- (11) ***Derivatives*** :
- (a) ***Derivatives in respect of unissued shares***: Extend the scope of derivative interests to cover those in respect of unissued shares (page 38).
- (b) ***Calculation of derivative interests***: Use the last known total number of issued shares of a listed company as the denominator or the basis for calculating the percentage of derivative interests (page 39).
- (c) ***Short positions of derivatives***: Require disclosure of short positions of derivatives (e.g. the writing of a call option and the holding of a put option (pages 39 and 40)).
- (d) ***Netting-off between long and short positions***: Netting-off between long and short positions of derivatives would not be allowed (pages 40 and 41).
- (e) ***Stock futures and purely cash-settled derivatives***: Require disclosure of interests derived from stock futures and purely cash-settled derivatives (pages 41 to 43).
- (f) ***The three options relating to aggregation of interests***: Adopt Option 3 as set out in pages 46 and 47 of the Consultation Paper for the purpose of aggregating derivative interests (page 43).
- (g) ***Consideration and terms of agreements of derivatives transactions***: The original proposal is changed so that an exemption will be created for derivatives transactions. The proposal would not require disclosure of the consideration, the strike price, the option premium or the option price of a derivative. However, it is still necessary to disclose the

exercise period, the expiry date and the number of underlying shares in the notifiable interest that are held through derivatives or the interest of which is derived from derivatives (page 44).

- (h) ***Changes in the nature of an interest:*** Require disclosure of all changes in the nature of an interest in share, whether resulting from an exercise or expiry of a derivative or otherwise, even if the percentage of interest remains unchanged (pages 44 and 45).

Apart from paragraph (g) above, no changes are made to the original proposals regarding disclosure of derivatives.

- (12) ***Disclosure Forms :*** As mentioned in the Consultation Paper, new prescribed notification forms will be designed to enable substantial shareholders and directors to file their notifications systematically (pages 46 and 47).

The Consultation Paper also invited the public to comment on two general issues: first, the disclosure of share pledges made by substantial shareholders in favour of their creditors; and secondly, the practical difficulties that the proposed changes may create for bona fide stock lending and borrowing activities. Having considered public views on these issues, the SFC has formulated its policies as summarised below.

- (13) ***Disclosure of pledges of shares :*** Under the existing Ordinance, substantial shareholders who pledge shares as security for loans are not required to disclose interests subject to the pledges unless they have defaulted on the loans, lenders have enforced the security under the pledges, and such actions have resulted in a change in the interest of substantial shareholders in a listed company. The SFC has considered the arguments for and against requiring substantial shareholders to disclose pledges of shares before the enforcement of security by lenders. On balance, the SFC does not consider that it is appropriate to impose such requirement. Reasons for this are set out in pages 47 to 50 below. However, the SFC proposes that provisions should be included in the Ordinance clarifying the circumstances under which lenders would be regarded as having enforced security under share pledges.
- (14) ***Stock borrowing and lending :*** The current position under the Ordinance with respect to stock borrowers would remain the same, i.e. a stock borrower is regarded to have acquired an interest in the borrowed shares, and as a result, would need to disclose his interest as a substantial shareholder should his interest exceeds the disclosure threshold. However, the proposal under paragraph (11)(h) above will affect the disclosure obligation of a stock lender. As the “loaned” shares are regarded as a disposal of interests by the lender with a right to call for delivery of the same number of shares, the share lending transaction will be regarded as a change in the nature of the interests and, disclosure is required accordingly (pages 51 and 52).

Apart from the above, the SFC also wishes to raise the following points:

- (15) **Clarification of the “bare trustee” exemption:** Whilst the SFC cannot give authoritative guidance on how the courts will interpret the Ordinance, in practice, the SFC would regard a “bare trustee” as someone whose interest in shares is entirely “passive”, i.e. a person who holds property in trust for the absolute benefit and at the absolute disposal of other persons, and who has no present beneficial interest in the property and no duties to perform in respect of it, except to convey or transfer it to persons entitled to hold it, or in accordance with such persons’ directions. The exemption is accordingly, very narrow (page 35).
- (16) **Disaggregation of group interests for investment managers, custodians and trustees:** The SFC recognises that substantial shareholders whose interests in shares are derived from their business of managing the investments of other persons or safeguarding the assets belonging to other persons, should be treated differently from shareholders who control, or seek to influence the control of, interests in shares. Accordingly, the SFC proposes that where the organisational structure of a corporate group is such that the voting and investment powers over interests in shares held by a company which carries on the business of an investment manager, a custodian, or a trustee are exercised by it independently from its holding or related entities, then aggregation of interests held by such a company with those held by its holding or related entities is not required. The SFC suggests that the Ordinance should be amended to allow “disaggregation” of group interests as mentioned above. This proposal is made with the view to reduce the compliance burden of corporate groups which have investment managers, custodians, and trustees (wherever incorporated or registered) within their structures (pages 35 and 36).
- (17) **Clarification on interests which subsist by virtue of any authorised unit trusts and mutual fund corporations:** In view of the uncertainty regarding the scope of section 14(1)(b)(i) of the Ordinance, the SFC proposes that the Ordinance be amended to clarify that (i) interests held by a person as the trustee of a collective investment scheme authorised by the SFC will be disregarded for the purposes of disclosure; (ii) interests held by a holder of such a scheme will also be disregarded; and (iii) interests held by the fund manager or “operator” of such a scheme may be “disaggregated” from those of its group members on the basis as set out in paragraph (16) above (pages 36 and 37).

## **General Matters**

As one of the objectives of this Paper is to enable the public to understand the basis upon which the SFC formulates the final proposals, the proposals are described in broad and conceptual terms. It is intended that the more technical issues will be dealt with in the draft Bill of the Ordinance.



As stated in the Consultation Paper, if the revised Ordinance can be finalised before the enactment of the composite Securities and Futures Bill, the revised version of the Ordinance will form part of the composite Bill. If the revised Ordinance cannot be finalised before the enactment of the composite Bill, the revised version of the Ordinance will be enacted as a separate Securities (Disclosure of Interests) (Amendment) Ordinance.

Apart from the matters raised in the Consultation Paper, the public has commented on certain other aspects of the Ordinance. These principal comments are also summarised in this Paper (pages 53 to 55).

The SFC wishes to thank the public for providing its views on the proposed amendments to the Ordinance.

**Note:**

***Whilst this Paper briefly summarises certain provisions of the Ordinance, these summaries are not an exhaustive examination of the Ordinance and they cannot be relied upon as an authoritative legal opinion on the Ordinance's contents. Accordingly, this Paper should not be relied upon as a substitute for seeking detailed legal advice on any specific case.***

## INTRODUCTION

The Consultation Paper was issued on 30 June 1998. It contained 12 specific proposals to amend the Ordinance and consulted the public on two further issues regarding the disclosure of interests regime of Hong Kong.

The consultation period was originally scheduled to end on 31 August 1998. In response to public requests, however, it was extended until 30 September 1998.

The SFC received 37 responses in total. Only 35 responses were taken into account as two responses were submitted well after the end of the consultation period. *Appendix A* contains brief descriptions of the respondents and a summary of the responses received.

As was expected in a consultation exercise of this nature, comments varied considerably in range and depth, with some respondents focusing on the broad principles behind the proposals and others on specific proposals put forward in the Consultation Paper. The final proposals set out in this Paper were adopted and endorsed by the Commission.

The consultation conclusions should be read in conjunction with the Consultation Paper.

## **GENERAL POLICY CONSIDERATIONS**

This section describes the objectives in amending the Ordinance and the direction that the SFC has adopted in formulating the final proposals.

### **1. Objectives of the Proposed Amendments**

In the Consultation Paper, the SFC identified four principal objectives in amending the Ordinance:

- to remove unnecessary and unduly burdensome requirements currently laid down by the Ordinance and to streamline the reporting of interests in shares;
- to bring Hong Kong's securities disclosure regime in line with international and regional disclosure standards;
- to bring the Ordinance up-to-date with recent developments of the Hong Kong securities market; and
- to improve transparency in the Hong Kong market by improving the extent of information available on price, securities dealings and persons having interests in shares.<sup>(1)</sup>

The public supported these objectives and agreed that for Hong Kong to remain competitive as an international financial centre, it was imperative that its disclosure regime be kept up-to-date with market developments and be compatible with international and regional standards.

### **2. Major Comments Expressed**

Whilst respondents to the Consultation Paper supported the above objectives, they requested that the SFC be mindful of the following matters in formulating the final proposals for amending the Ordinance:

#### ***(a) Cost considerations***

Some respondents were concerned that the proposed changes would increase the cost and compliance burden. They were concerned that the cost of acquiring, developing and then staffing and maintaining the necessary systems to ensure compliance with the revised Ordinance would add a significant burden to operating costs which would be felt acutely at a time of economic downturn.

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<sup>(1)</sup> Page 6 of the Consultation Paper.

**(b) *Legal complexity considerations***

Several respondents emphasised the importance of making legislation that was “*comprehensible and compliant with in practice*”. They recommended that care should be taken to ensure that the proposed changes would not add significant complexity to the disclosure regime and to the Ordinance.

**(c) *Excessive information considerations***

Whilst respondents were supportive of increasing transparency in general, some were concerned that proposed changes to the Ordinance would generate so much information that the market would be “*overwhelmed*”: investors might find the information difficult to understand; they might be confused by the volume of new information generated; market professionals might potentially mis-use the information disclosed to the detriment of the person who filed the notification or to the market as a whole; and information on the control of a listed company might be distorted as a result.

The SFC believes that the above are legitimate concerns. In formulating the final proposals for amending the Ordinance, due regard has been given to these considerations.

**3. Direction for Change - The Role of the Ordinance**

As mentioned in the Consultation Paper, the Securities Review Committee identified the following four areas as the main objectives of the Ordinance in May 1988:

- “(a) *to force disclosure of shareholdings of 10% or more within five days of the duty arising. The Bill looks through corporate interests to get at the reality of the controlling shareholder;*
- (b) *to give companies the right to require a shareholder to provide information about his holding;*
- (c) *to force the directors and chief executive of a listed company to disclose their interests in the company and of any dealings in the company’s shares; and*
- (d) *to enable the Financial Secretary to appoint inspectors to investigate the ownership of a listed company.”*<sup>(2)</sup>

The Consultation Paper stated that in the SFC’s view, the objectives of the Ordinance in 1998 should remain substantially the same as those identified by

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<sup>(2)</sup> Page 4 of the Consultation Paper.

the Securities Review Committee. The SFC further noted that as the Hong Kong market became more sophisticated and more diversified ways were used to conceal interests in shares, for investors to make informed investment decisions in 1998 and beyond, it was not sufficient that they only have information currently required to be disclosed under the Ordinance. Accordingly, the SFC recommended that the Ordinance should offer more transparency to the market in relation to price, securities dealings and persons who have an “*economic interest in shares*”, etc., which would enable investors to make informed investment decisions.<sup>(3)</sup>

A number of respondents, however, believed that the Ordinance should not be used to promote transparency, but should focus on providing the market with information about the “*control*” of listed companies. These respondents argued that by moving away from the “*control*” concept, Hong Kong would be taking an approach that is contrary to other international markets, such as the U.S..<sup>(4)</sup> In their view, the Ordinance should provide the market with information on (i) whether persons are accumulating significant voting securities to effect a change of control of a listed company; and (ii) whether insiders are dealing in the company’s securities.

Some other respondents considered that, by making the proposed changes to the Ordinance, the SFC might have turned the Ordinance into a “*tool of surveillance*”. Whilst they agreed that certain information referred to in the Consultation Paper should be disclosed to regulators (e.g. derivative positions of large firms), disclosure of the same information to the public at large was inappropriate and not necessary.

After considering these views, the SFC is convinced that the scope of the Ordinance should not be limited to the disclosure of information on persons who have “*control*” of shares or listed companies. As pointed out in the Consultation Paper, even at present, the concept of “*interest in shares*” under

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<sup>(3)</sup> Pages 9 to 10 of the Consultation Paper.

<sup>(4)</sup> Sections 13(d) and 13(g) of the U.S. Securities Exchange Act 1934 require persons who acquire or hold beneficial ownership of more than 5% of a class of voting equity securities that is registered under Section 12 of the Exchange Act to report such ownership in accordance with rules adopted by the Securities Exchange Commission, subject to certain exemptions. Under Rule 13d-1, the acquisition of more than 5% of a class of registered equity securities must be reported on a long-form Schedule 13D within 10 calendar days, unless the beneficial owner is eligible to file on short-form Schedule 13G. The short-form reporting is only eligible to entities (including broker/dealers, banks, investment companies, pension funds and insurance companies, etc.) provided that they (a) acquired the securities in the ordinary course of business; (b) did not acquire them with the purpose of changing or influencing the control of the issuer; and (c) notified any other person on whose behalf they were holding in excess of 5% of the securities (on a discretionary basis) of any acquisition or transaction carried out by them on behalf of such other person which might otherwise be reportable. When these conditions are satisfied, the reporting entity is only required to file a notice of its holdings in the Schedule 13G format at the end of the calendar year in which the reporting obligation arises. Further, it is only obliged to report its shareholding as of the last day of that calendar year if the shareholding is over 5% on such date.

the Ordinance is much wider than the concept of control.<sup>(5)</sup> The same comment applies to Part VI of the Companies Act 1985, the U.K. equivalent of the Ordinance. To limit the Ordinance purely to providing the market with information regarding the “*control*” of listed companies would be a retrograde step.

The argument that the Ordinance may be used as a surveillance tool does not take into account the fact that under current law, regulators can already require disclosure of most of the information referred to in the Consultation Paper. There is, therefore, no need to revise the Ordinance in order to obtain the necessary information for surveillance or investigative purposes. The proposed changes contained in the Consultation Paper are not driven by market surveillance needs. If the amendments are adopted, the information to be disclosed under the Ordinance will be available to the public and shareholders of listed companies at large.

With the benefit of public comments and in light of the policy considerations raised in paragraph 2 above, the SFC has reviewed the proposals contained in the Consultation Paper and reconsidered how best the four objectives referred to in paragraph 1 above could be achieved. The SFC wishes to restate the approach to be taken as follows:

- (i) For 1998 and beyond, the overriding objective of the Ordinance is to provide investors with more detailed and better quality information which would enable them to make investment decisions. Such information includes information that can affect perceptions of the value of listed companies.
- (ii) In addition to increasing market transparency, the Ordinance should also provide a disclosure regime which enables investors to identify persons who control, or are in a position to control, interests in listed shares; which meets international and regional standards; and which is not difficult to comply with in practice.

The SFC recognises that in proposing ways to increase market transparency, due regard should be given to the following matters:

- the cost of complying with additional disclosure requirements; and
- the potential risk of providing excessive information to the market.

The SFC acknowledges the need to strike an appropriate balance between the costs and benefits of providing more transparency. In formulating the final proposals, the SFC has taken the above factors into account.

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<sup>(5)</sup> *Page 9 of the Consultation Paper.*

## **SPECIFIC CONSULTATION AREAS**

This section summarises public comments on the 14 areas of consultation included in the Consultation Paper and sets out the SFC's current proposals to amend the Ordinance.

In this section, references to the "*proposed changes*" mean the changes to the Ordinance as proposed in the Consultation Paper; and references to the "*final proposals*" or "*current proposals*" mean the proposals to change the Ordinance as adopted by the Commission after taking into account public views.

The principal objective of this section is to enable the public to understand the policy considerations that the SFC has taken into account in formulating the final proposals. Descriptions of the final proposals are meant to be broad and conceptual. The more technical issues will be dealt with in the draft Bill.

### **1. Substantial Shareholding Disclosure Threshold**

#### ***The Proposed Changes***

The Consultation Paper proposed that the initial disclosure threshold should be reduced from the existing 10% to 5%. Therefore, if the changes were adopted, any person who has an interest in shares in a listed company which is equal to or more than 5% of its issued share capital of any class carrying rights to vote at general meetings would be obliged to disclose his interest under the revised Ordinance. The proposed changes aimed to ensure that Hong Kong's disclosure regime would be in line with international practice, to discourage insider dealing and to increase transparency of the market.

#### ***Public Comments***

Comments generally supported reduction of the threshold to 5%. Of the 35 respondents, 12 (34%) agreed with the proposal, 8 (23%) agreed with qualifications, and 2 (6%) disagreed.

Respondents who supported the proposal agreed that the threshold should be reduced to bring Hong Kong's regime in line with international and regional standards. They considered that a 5% threshold would be more appropriate for Hong Kong, given the small public float of most companies listed on the SEHK.

Respondents who gave the proposed changes limited support made the following comments:

- (a) They believed that the disclosure regime should distinguish persons with "*beneficial interests*" in shares from persons who did not hold

such interests, such as investment managers, custodians and trustees. These respondents believed that, as in the U.K., a less stringent disclosure threshold should apply to investment managers because such persons did not have real interests in shares, and they did not normally acquire interests in shares with a view to influence or obtain control of listed companies.<sup>(6)</sup>

- (b) Some respondents were concerned that the compliance cost and burden would be significantly increased if the current threshold were reduced to 5%. In order to reduce the perceived cost and workload, they suggested that the corporate interest deeming provisions (or the “*one-third rule*”) under sections 8(2) to (4) of the Ordinance should be revised with a view to allowing “*disaggregation*” of group interests where members of the same group were separately managed.

### ***The Final Proposals***

For the reasons set forth in the Consultation Paper,<sup>(7)</sup> the SFC considers that the initial disclosure threshold applicable to substantial shareholders should be reduced from 10% to 5%.

The SFC has considered the suggestion mentioned in paragraph (a) above of applying a less stringent threshold to investment managers, custodians and trustees. The SFC believes that it is important to maintain a level playing field for all market participants as far as possible. Therefore, it is not inclined to propose a separate disclosure threshold to apply only to such market participants.

However, the SFC acknowledges that persons who carry on the business of an investment manager, custodian, or trustee are different from other substantial shareholders in that their interests in shares are derived from their business of managing the investments of other persons, or safeguarding the assets belonging to other persons, and that such interests are not owned or controlled by them. To recognise such a difference, the SFC proposes to allow such persons to “*disaggregate*” their interests in shares from those held by other members of the same group along the lines suggested in paragraph (b) above. These proposals are set out in detail in paragraph 10 below.

As the concerns of interested parties have been addressed, the SFC believes that the 5% disclosure threshold will receive support from the market.

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<sup>(6)</sup> Under Part VI of the U.K. Companies Act 1985, persons with “*material interests*” in shares are required to disclose their interests at the 3% threshold, but persons with interests other than “*material interests*” are required to disclose their interests at the 10% threshold. Persons who are treated as not having “*material interests*” include investment managers who are authorised persons under the U.K. Financial Services Act 1986.

<sup>(7)</sup> Pages 11 and 12 of the Consultation Paper.



## 2. **The Notification Period**

### *The Proposed Changes*

The Consultation Paper proposed that the notification period of five days should be shortened to two business days. The SFC considered that the current notification period was too long to provide adequate information to the market. The proposed change would also make Hong Kong's regime more compatible with international and regional standards.

### *Public Comments*

The public was not in favour of shortening the notification period to two business days. Of the 35 respondents, only 4 (11%) agreed with the proposal, 3 (9%) agreed with qualifications, and 18 (51%) disagreed.

Respondents who objected to the proposed change considered that the two business days period was "*too short*" and "*impracticable*" to comply with. The following reasons were cited:

- (a) ***International nature of businesses and time difference*** - A significant number of respondents considered that the international dimension of Hong Kong's markets would make compliance with the shortened notification period difficult. In their view, a notification period of two business days would create significant difficulties for a diverse business group with operations spread over several countries, particularly where different time zones were involved, even taking into account advanced communications technology. As the shortened notification period would be calculated by reference to Hong Kong time, respondents considered that it would be very difficult for an overseas entity to comply with the notification period.
- (b) ***Increased volume of information to be disclosed*** - Some respondents believed that if all the proposed changes included in the Consultation Paper were to be adopted, the amount of information to be disclosed would be significantly increased. They represented that the more information to be disclosed, the more impracticable it would be to comply within two business days.
- (c) ***Complicated ownership structure of listed companies*** - Some respondents pointed out that the ownership structures of most Hong Kong listed companies were more complicated than those of other jurisdictions. In their view, the practical difficulties of making disclosures would be increased by the lengthy corporate ownership

chains (which frequently involved overseas parties), and the corporate interests deeming provisions of the Ordinance.<sup>(8)</sup>

- (d) ***The lack of an established international standard*** - Respondents pointed out that although the U.K., Singapore and Australia had a two business days notification period, the U.S. had adopted a much longer notification period of 10 days. Accordingly, there is no established international practice in favour of two business days which Hong Kong should follow.

As the disclosure regime of the Mainland operates on a three working days basis, 11 respondents suggested that instead of adopting a notification period of two business days, three business days should also apply to Hong Kong.

In light of the U.S. provisions allowing a delayed reporting period for persons who acquire shares otherwise than with a view to influence control of listed companies (such as fund managers and broker/dealers),<sup>(9)</sup> six respondents advocated that a longer notification period should apply to such persons.

### ***The Final Proposals***

- (i) ***The notification period***

The SFC notes that in relation to share transactions executed on the SEHK, Hong Kong is presently adopting a strict T+2 settlement period. Theoretically, there is no reason why transactions in shares can be settled within two trading days after the transaction date, but cannot be reported to the SEHK and listed companies within the same period. Allowing the notification period under the Ordinance to be longer than two business days would arguably be inconsistent with the T+2 settlement requirement.

That said, the SFC notes that in many cases, substantial shareholders take a much longer time to accumulate a 5% interest or to trigger a subsequent disclosure obligation involving a whole percentage level change. In these cases, substantial shareholders would need to review and extract information from previous trading records before a proper disclosure could be made. If a two business days period were to apply, substantial shareholders may well find it difficult to file the notification on time for purely practical reasons. This would be more difficult where an overseas party is involved and records are kept overseas.

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<sup>(8)</sup> Sections 8(2) to (4) of the Ordinance.

<sup>(9)</sup> *ibid*, see note (5) above.

Accordingly, the SFC proposes that the existing notification period be shortened to three business days in this revision exercise. The SFC, however, believes that Hong Kong should ultimately aim to put in place a disclosure regime that is competitive with the U.K., Singapore and Australia in this respect. Hence, the SFC recommends that the proposal of moving to a two business days period be reviewed in several years time in light of the practical experience gained from operating on a three business days basis.

In the interest of increasing transparency and maintaining a level playing field for all market participants, the SFC is not inclined to adopt the U.S. approach. The SFC, however, believes that the proposals to allow “*disaggregation*” of group interests mentioned in paragraph 10 below, coupled with a three business days notification period, should adequately address the perceived problems of institutional investors.

**(ii) Definition of “business day”**

The SFC proposes that “*business day*” be defined to exclude Saturdays, public holidays, gale warning days and black rain storm warning days in the revised Ordinance.

**(iii) Actual knowledge -v- Constructive knowledge**

Quite a number of respondents raised the question of whether the corporate interests deeming provisions (the “*one-third rule*”) under sections 8(2) to (4) of the Ordinance operate on an “*actual knowledge*” basis or on a “*constructive knowledge*” basis.<sup>(10)</sup> These respondents requested that this issue be clarified as it affects the time at which a duty of disclosure arises, and therefore, when the notification period starts to run.

In the SFC’s view, the current knowledge test in relation to section 8 can be described as being one of “*actual*” rather than “*constructive*” knowledge. In the situations described in sections 8(2) and (3), the

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<sup>(10)</sup> At present, section 8(2) provides that a person is taken to be interested in shares if a corporation is interested in them, and (a) that corporation or its directors are accustomed to act in accordance with his directions or instructions, or (b) he is entitled to exercise or control the exercise of one-third or more of the voting power at general meetings of that corporation. Further, section 8(3) provides that where a person is entitled to exercise or control the exercise of one-third or more of the voting power at general meetings of a corporation, and that corporation is entitled to do the same in relation to another corporation (the “*second corporation*”), then the person is taken to have effective voting power of the second corporation. The operation of section 8(3) means that, the person is taken to be interested in shares held by the second corporation. Section 12 (in particular, section 12(3) to (6)) specifies the relevant time when a person is deemed to know that he has acquired or ceased to have an interest in shares under section 8(2) and (3). There is no intention to revise section 8 or 12 of the Ordinance in this respect.

notification period would start to run when the holding or the intermediate holding company has actual knowledge of the associated corporation's interest in shares. Therefore, where companies of the same group are operated independently, and interests in shares are dealt with without the knowledge of the holding or intermediate holding company, aggregation of the companies' interests in shares for the purposes of the Ordinance is unlikely to be necessary. Aggregation would, however, be necessary where the holding or intermediate holding company becomes aware of the associated company's interests in shares.<sup>(11)</sup>

*It must be noted that the above observations only represent interpretation of the relevant sections of the Ordinance by the SFC. As the SFC cannot give authoritative guidance on how the courts will interpret the Ordinance, interested parties should take their own legal advice on the issue raised.*

### **3. Timing to notify the SEHK and Listed Companies**

#### *The Proposed Changes*

The Ordinance currently provides that a disclosure of interest notification should be made so that it is received by the SEHK before it is received by the listed company. To avoid the technical problems that arise when company secretaries are requested by directors or substantial shareholders to complete notifications on their behalf, the Consultation Paper proposed that notification to the SEHK should be made at the same time as, or immediately following, notification to listed companies.<sup>(12)</sup>

#### *Public Comments and the Final Proposals*

As all respondents who expressed views on this subject (19 out of 35 (54%)) supported the proposed changes, the changes will be incorporated into the revised Ordinance. Notification to the SEHK first will continue to be permissible.

### **4. De minimis Change Exemption**

#### *The Proposed Changes*

To reduce the burden of substantial shareholders in reporting insignificant changes of interest in shares, the Consultation Paper proposed that substantial

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<sup>(11)</sup> For example, in the circumstances referred to in section 12(3).

<sup>(12)</sup> Page 14 of the Consultation Paper.

shareholders should be exempted from making a disclosure if their interests in shares fluctuate by a small amount of 0.5% across a percentage level. The Consultation Paper contained examples illustrating how the exemption would operate in practice.<sup>(13)</sup>

### ***Public Comments***

The public had mixed views on this proposal. Of the 35 respondents, 10 (29%) accepted the exemption, 4 (11%) supported the concept of a de minimis change exemption, but had reservations on the suggested exemption, and 7 (20%) objected to the exemption.

Respondents who either objected to the proposed exemption or expressed reservations gave the following reasons:

- (a) ***The exemption too complicated*** - Respondents found the proposed exemption difficult to understand. They believed that the need to retain simplicity outweighed the need to provide an exemption for de minimis changes.
- (b) ***The exemption would not reduce compliance burden*** - Some respondents believed that the exemption would not reduce the compliance burden on market participants. On the contrary, they considered that company secretaries might have additional work in keeping track of whether the exemption would apply to a given case.
- (c) ***The exemption too limited in scope*** - A number of respondents considered that the exemption was too limited in scope as it only applied to cases where interests in shares fluctuated across a percentage level. These respondents proposed that the exemption should apply to any 0.5% change in interest irrespective of whether or not there was any “crossing over” of a percentage level.

### ***The Final Proposals***

The SFC considers that, on balance, it would be preferable to introduce a de minimis change exemption in the Ordinance in the form proposed.

Although the exemption may appear to be complex to some market participants, this should not prevent others who welcome and understand it from taking advantage of it. Market participants who have doubts on whether or not the exemption would apply to a given case can file a notification as if the exemption does not apply.

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<sup>(13)</sup> Pages 15 to 17 of the Consultation Paper.

The SFC acknowledges that the proposed exemption does not reduce the compliance burden on substantial shareholders to a great extent. In practice, the exemption only relieves substantial shareholders from the work involved in completing and filing a notification to the SEHK and the listed company concerned. It does not relieve them from keeping track of their percentage holding in a listed company. This is something which a prudent substantial shareholders should do in any event.

The argument that the exemption is too limited in scope overlooks the fact that the objective of such an exemption is to relieve substantial shareholders from a duty of disclosure only in cases where their interests in shares fluctuate in a small amount across a percentage level, i.e. when the operation of the existing “*rounding down rule*”<sup>(14)</sup> gives rise to an obligation to disclose information which would not be of significant value to the market.

## 5. **Details of Registered Shareholders**

### *The Proposed Changes*

The Consultation Paper suggested that the existing provisions which require substantial shareholders to disclose the particulars and shareholdings of registered holders, and any change in their particulars, should be removed. The purpose was to reduce the compliance burden of market participants.<sup>(15)</sup>

### *Public Comments*

The majority of the respondents (18 out of 35 or 51%) agreed with the proposed changes. Most respondents considered this to be a significant step in reducing the compliance burden.

Some respondents, however, were concerned that removing the requirement to disclose the identity of registered shareholders would make it impossible for investors to compare information in a company’s share register with the disclosures made by substantial shareholders under the Ordinance. These respondents argued that the comparison was essential in order to obtain a thorough understanding of the ownership or “*control*” of a company.

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<sup>(14)</sup> Section 5(1) of the Ordinance. Operation of the “*rounding down rule*” was explained in page 15 of the Consultation Paper.

<sup>(15)</sup> Pages 17 and 18 of the Consultation Paper.

## ***The Final Proposals***

The SFC notes the above concern. As a substantial number of shares are registered in the name of HKSCC Nominees and held through CCASS or through major nominee companies, changes of disclosed interests often do not involve changes of registered shareholders. Therefore, even at present, disclosure of the details of registered shareholders does not provide meaningful information to the public. Further, if a listed company is interested in finding out from a substantial shareholder information about the registered holder of shares, it can continue to do so under section 18 of the Ordinance. Accordingly, the SFC considers that it would be appropriate to remove the requirement to disclose details of registered shareholders in the notification forms.

## **6. Disclosure of Consideration and Agreements**

### ***The Proposed Changes***

To improve market transparency and bring Hong Kong's disclosure regime closer to international standards, the Consultation Paper made the following proposals:

#### **(a) Disclosure of consideration**

Substantial shareholders were to be required to disclose the consideration (in cash or otherwise) payable or receivable by them with respect to their acquiring or ceasing to have an interest in shares, or with respect to a change in their interest in shares:

- Where the acquisition or disposal of interests in shares took place “*on-exchange*”, the highest and the average price of the shares should be disclosed.
- Where the acquisition or disposal of interests in shares took place “*off-exchange*”, the amount and nature of consideration should be disclosed.
- With respect to the initial notification of a substantial interest, it was proposed that a person should only be required to disclose consideration paid for the relevant interest acquired in the four months before the day he became a substantial shareholder.

#### **(b) Disclosure of agreements/terms of agreements of off-exchange transactions**

In addition, where the acquisition or disposal of interests in shares took place “*off-exchange*”, both substantial shareholders and directors were to be required to provide copies of contracts, agreements or documents in relation to the interest they acquired or ceased to have; and if there were no written contracts or agreements, to provide a memorandum specifying the material terms of any agreement, scheme, arrangement or understanding pursuant to which they acquired, or ceased to have, the relevant interest in shares.<sup>(16)</sup>

### ***Public Comments***

The comments did not support the proposed changes. Of the 35 respondents, 4 (11%) agreed with the changes, 4 (11%) agreed with qualifications, but 16 (46%) disagreed.

### **Disclosure of consideration**

Respondents who objected to the proposed changes gave the following reasons:

- (i) ***Substantial compliance burden*** - Respondents believed that the average and highest prices of on-exchange transactions were not information that could easily be obtained from their records or systems. In their view, the proposed changes would put a substantial burden on market participants. For off-exchange transactions, difficult questions might arise as to what consideration had been paid in various circumstances: there could be cases where the amount of consideration had to be computed and extracted from agreements. These respondents argued that to provide information on consideration in these cases would be burdensome and time-consuming.
- (ii) ***Expose commercially sensitive information*** - Respondents represented that the disclosure of consideration in relation to derivatives would result in market participants disclosing commercially sensitive information or financing techniques which would put them under competitive disadvantages. They believed that if the consideration relating to derivative transactions were disclosed, far from increasing the transparency of the market, the information might constrain the ability of counterparties to effect hedging transactions and might encourage others to use such information to manipulate or otherwise affect the price of the underlying shares. The respondents were particularly concerned that the use of such information by others would disrupt trading strategies or hedging activities.

### **Disclosure of agreements/terms of agreements of off-exchange transactions**

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<sup>(16)</sup> Page 20 of the Consultation Paper.



Most respondents were not in favour of disclosing agreements or terms of agreements of off-exchange transactions. The following reasons were cited:

- (1) ***Intrusion of privacy and confidentiality*** - Respondents considered that the proposed changes would impose a requirement to disclose otherwise private financial transactions to the public. They believed that market transparency considerations should not override the important principle of confidentiality save in exceptional circumstances.
- (2) ***Effect on competitiveness*** - Some respondents pointed out that documentation on derivative products contained proprietary business information (especially about products, structures and pricing). In their view, a requirement to put terms of agreements into the public domain would effectively require them to disclose information to competitors. They believed that the potential commercial disadvantages of having to publicise information of this nature would discourage financial institutions from buying and selling exposures in Hong Kong shares.
- (3) ***Excessive information*** - Some respondents were concerned that the proposed changes, if implemented, would substantially increase the compliance burden and the volume of documentation to be filed with the SEHK and listed companies. The public might find the information confusing, difficult to interpret and in some cases, might find the disclosures repetitive.
- (4) ***The lack of an established international standard*** - Respondents pointed out that although the disclosure regime of the U.S., Australia and New Zealand required disclosure of the terms of agreements, there was no such requirement in the U.K. and Singapore. Accordingly, there is no established international practice in this respect which Hong Kong should follow.

## ***The Final Proposals***

### **Disclosure of consideration**

For the reasons set out in the Consultation Paper,<sup>(17)</sup> the SFC considers that the changes mentioned in paragraph (a) above should be adopted: substantial shareholders should be required to disclose the consideration payable or receivable by them with respect to their dealings in interests in shares, whether the transactions take place on-exchange or off-exchange. The SFC, however, understands the market's concerns regarding the disclosure of consideration in relation to derivatives. It is, therefore, inclined to exempt substantial

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<sup>(17)</sup> Pages 19 to 21 of the Consultation Paper.

shareholders from the obligation to disclose consideration regarding all dealings in derivatives (see paragraph 11 below).

The SFC acknowledges that the requirement to disclose consideration would increase the compliance workload of market participants. However, the following should be noted:

- Where a person is deemed to be interested in shares because of another person's interest (for example, in the circumstances described in section 8 (notification of family and corporate interests) and section 10 (duty to disclose "*concert party agreements*"), consideration need not be disclosed by the former unless he is aware of it.
- The proposal to allow disaggregation of group interests mentioned in paragraph 10 below should have the effect of reducing the perceived workload; and
- Compared with the two business days notification period, the proposed notification period of three business days would give the market more time to compile the necessary information and to file the relevant notification.

**Disclosure of agreements/terms of agreements of off-exchange transactions**

Having regard to public comments, the SFC is inclined not to include in the revised Ordinance the requirement that agreements and terms of agreements regarding off-exchange transactions should be disclosed. Therefore, the proposed changes mentioned in paragraph (b) above will not be included in the Ordinance.

## 7. Shareholding Structure of Corporate Substantial Shareholders

### *The Proposed Changes*

For the purpose of promoting market transparency, the Consultation Paper suggested that where an unlisted company is a substantial shareholder of a listed company, the notification filed by it should state:

- (a) the substantial shareholder's issued share capital;
- (b) the name and address of any person who had 10% or more interest in its issued share capital;
- (c) the name and address of any person in accordance with whose directions the substantial shareholder or its directors were accustomed (whether legally or otherwise) to act; and
- (d) where any shareholder of the substantial shareholder was a director of the listed company concerned, the name of the director and his shareholding in the substantial shareholder (regardless of the amount of shareholding held by the director).<sup>(18)</sup>

### *Public Comments*

The market had mixed views on the proposed changes. Of the 35 respondents, 7 (20%) agreed with the changes, 6 (17%) agreed with qualifications, and another 6 (17%) disagreed.

Respondents who objected to or expressed reservations on the proposed changes had the following principal concerns:

- (i) ***Confusion with the one-third rule*** - Respondents considered that the proposed changes would confuse the market. In their view, the proposed disclosure of persons who hold 10% of the substantial shareholder's issued share capital is easily confused with the "*one-third rule*".<sup>(19)</sup>
- (ii) ***Effectiveness of the proposed changes in revealing the beneficial owners*** - Many respondents questioned the effectiveness of the above proposals because disclosure of the 10% shareholders of a substantial shareholder may not necessarily result in disclosing the person who controls the substantial shareholder, or who controls the shares held by

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<sup>(18)</sup> Pages 23 and 24 of the Consultation Paper.

<sup>(19)</sup> *ibid*, note (11) above.

the substantial shareholder. For example, the 10% shareholder of a substantial shareholder may well be another trustee or private company.

### ***The Final Proposals***

The SFC accepts these comments. It is suggested that the proposed changes should be revised as follows:

- (1) Where a company is a substantial shareholder of a listed company, the notification filed by it should state the name and address of any person in accordance with whose directions or instructions the substantial shareholder or its directors are accustomed (whether legally or otherwise) to act.<sup>(20)</sup> Whether a disclosure has to be made in a given case depends on the facts of each case. If the situation is such that the substantial shareholder and its board act independently and not in accordance with the directions of, or instructions from, any other person, then no disclosure could in practice be made. If, however, the substantial shareholder or its directors do act in accordance with another person's directions or instructions, then the details of such person should be disclosed.
- (2) Substantial shareholders which have equity securities listed on an exchange (whether in Hong Kong or elsewhere) will not be subject to the above disclosure requirement. They should, however, disclose the exchange on which their securities are listed.
- (3) For a substantial shareholder which is a subsidiary of a listed company, only the name of the listed parent and the exchange on which the parent's shares are listed need to be disclosed.

The SFC considers that the current proposals would be more likely to result in the disclosure of the real person who controls a substantial shareholder or the interests in shares held by a substantial shareholder. It is possible that such a person may not have any shareholding or interest in the substantial shareholder, whether directly or indirectly.

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<sup>(20)</sup> *This means that only paragraph (c) of the original proposals would be adopted.*

## 8. Disclosure of Settlers of Discretionary Trusts

### *The Proposed Changes*

The Consultation Paper proposed that:

- (a) In performing a duty of disclosure under the Ordinance, a substantial shareholder who was a trustee of a discretionary trust would be required to disclose the identity of the “*settlor*”. The same would apply to a director of a listed company who was also a trustee of a discretionary trust.
- (b) A person who knew, or became aware, that a discretionary trust in relation to which he was a “*settlor*” had a notifiable interest, would *for the purposes of the Ordinance only*, be deemed to be interested in the shares held by that trust. The same would apply to a director of a listed company who was also a “*settlor*” of a discretionary trust.<sup>(21)</sup> A proposed definition of “*settlor*” was included in the Consultation Paper for comment.<sup>(22)</sup>

These proposed changes aimed to address concerns that non-director substantial shareholders could make use of discretionary trusts to hide their interests in shares and to increase the transparency of discretionary trusts.

### *Public Comments*

Most respondents who expressed views on this issue were not in support of the proposed changes. Of the 35 respondents, 12 (34%) disagreed with the proposal, 5 (14%) agreed and 2 (6%) agreed with qualifications.

Respondents who agreed with the proposed changes believed that substantial shareholders should not be allowed to “*hide behind*” discretionary trusts. Respondents who disagreed with the changes raised the issues set out below.

In relation to the proposal that trustees of discretionary trusts should be required to disclose the identity of the “*settlor*”, respondents had the following comments:

- (i) ***Infringement of privacy and breach of confidentiality*** - Many respondents represented that requiring trustees to disclose settlers of

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<sup>(21)</sup> *This means that if a discretionary trust holds a 5% interest in the issued share capital of a listed company, the settlor of the trust will be deemed to be a substantial shareholder and be subject to a duty of disclosure.*

<sup>(22)</sup> *Pages 30 and 31 of the Consultation Paper.*

discretionary trusts would involve them in a “*mandatory breach of client confidentiality*”.

- (ii) ***Undesirable to reveal settlors of trusts which hold small interests*** - Respondents pointed out that many trust companies accumulated interests in shares by being trustee to more than one trust, i.e. the 5% threshold is not determined on a trust-by-trust basis, but rather, each trustee would need to determine its aggregate holdings for all trusts which it controls. Therefore, there may be situations where a single discretionary trust has reached the 5% threshold in relation to a listed company, but the aggregate interests of the trustee is more than 5% after taking into account minor shareholdings in the same company held by other unrelated discretionary trusts to which it also acts as trustee. In those circumstances, if the proposed changes were adopted, the trustee would be obliged to disclose not only the settlor(s) of the particular trust which has a 5% notifiable interest, but also the settlors of all other unrelated trusts which only have minor shareholdings. Respondents believed that exposing the settlors of unrelated trusts which hold insignificant interests in these situations was unreasonable and unnecessary.
- (iii) ***Duplication of obligations*** - As the proposed changes also imposed a duty of disclosure on settlors of discretionary trusts, respondents questioned the need for trustees to disclose identity of the settlors in their notification forms.
- (iv) ***Increased compliance burden and costs*** - Many respondents believed that the proposed changes, if adopted, would create significant additional cost and burden for trustees, particularly for larger trust companies. In their view, this was caused by the obligation to aggregate interests held by all discretionary trusts under the control of the same trustee as mentioned in paragraph (ii) above and the suggested definition of “*settlor*”. Respondents considered that the proposed definition of “*settlor*” was too wide.

In relation to the proposal that “*settlers*” of discretionary trusts should be deemed to be interested in the shares held by the trusts, respondents made the following comments:

- (1) ***Failure to see the need for the proposed changes*** - Many respondents believed that the market already knew who controlled most Hong Kong listed companies. Therefore, they did not see the need for any amendment to increase the transparency of discretionary trusts. Respondents also represented that most discretionary trusts were established for asset protection and tax planning reasons (especially for estate duty reasons), and not for the purpose of avoiding the Ordinance.
- (2) ***The definition of “settlor” and the concept of discretionary trust too wide*** - As mentioned above, some respondents considered the proposed

definition of “*settlor*” to be too wide. They also considered that the concept of discretionary trusts was sufficiently wide to include retirement schemes, pension schemes and some employees’ schemes. Market participants believed that in relation to these schemes, identification of the “*settlor*” would not be an easy task.

- (3) ***The lack of an established international standard*** - Respondents argued that no other markets had similar features as proposed, therefore, Hong Kong should not seek to be different.

### ***The Final Proposals***

As mentioned in the Consultation Paper, the SFC considers that there is scope for abuse in the use of discretionary trusts in that settlors of these trusts could, in practice, control or influence the discretion of trustees, or have the power (either directly or indirectly) to manage trust assets. The SFC is not convinced that, at present, there is adequate market transparency on discretionary trusts and the sources of control of these trusts. The prevalent use of discretionary trusts is a special feature of the Hong Kong market. Therefore, the fact that similar provisions are absent in other jurisdictions does not offer much by way of argument. Further, since many respondents still regard the Ordinance as playing an important role in identifying the “*control*” of listed companies and interests in shares, the SFC does not see any reason why provisions should not be included in the Ordinance to provide more information on who may be in control of, or in a position to influence, the discretion of trustees or the management of trust assets in cases where substantial shareholding of a listed company is held under a discretionary trust.

That said, the SFC understands the market’s concerns regarding the proposal that trustees should be required to disclose the identity of settlors. The SFC accepts that these are legitimate concerns and it is inclined not to include such requirement in the revised Ordinance.

The SFC, however, takes that view that the proposal to treat interests in shares held by discretionary trusts as the interests of settlors, and to require settlors to disclose their interests in shares if they have a notifiable interest (i.e. the proposed changes referred to in paragraph (b) above), should be included in the Ordinance. In this connection, the SFC agrees that the definition of “*settlor*” should be reviewed to limit its scope. Respondents have made a few good suggestions in this respect. Subject to further suggestions/consideration, the SFC may adopt a revised definition of “*settlor*” along the following lines (changes marked):

“*Settlor*”, in relation to a discretionary trust, means a person:

(a) who:

- (i) *directly or indirectly has provided, or undertaken to provide, property for the purpose of the trust; or*

- (ii) *has entered into a reciprocal arrangement with another person leading, directly or indirectly, to the creation of the trust, or who has procured another person, directly or indirectly, to create the trust; and*
- (b) (i) *whose consent is required as a condition precedent (whether legally or otherwise) to the exercise by any trustee of his discretion in connection with the trust property; or*
- (ii) *in accordance with whose wishes (whether legally or otherwise) any trustee is accustomed, or would expect, to act.*

The SFC welcomes any comments on the above draft definition, and on whether the application of this definition to discretionary retirement schemes, pension schemes or employees' schemes would cause any practical problem.

## 9. **“Concert party” Agreements**

### ***The Proposed Changes***

The Consultation Paper suggested that an agreement to which section 9 of the Ordinance (a “*concert party agreement*”) applied should include the following: an agreement or arrangement under which a “*controlling shareholder*” or a director of a listed company provides a loan, or security for a loan, to any person, on the understanding or with the knowledge that such loan or security would be used or applied by that person for the acquisition of an interest in the relevant share capital of a listed company. It was proposed that these provisions, however, should not apply to a “*controlling shareholder*” or director who extended financing to any person within the ordinary course of its/his business:

- (a) as an “*authorised institution*” as defined in the Banking Ordinance (i.e. licensed banks, restricted licensed banks and registered deposit taking company);
- (b) as a “*money lender*” licensed under the Money Lenders Ordinance; or
- (c) as a “*stockbroker*”, “*registered dealer*” or “*exempt dealer*” within the meaning of the Securities Ordinance.<sup>(23)</sup>

It was proposed that a “*controlling shareholder*” should mean any person entitled to exercise, or control the exercise of, 35% (or such lower amount as may from time to time be prescribed) or more of the voting power at general meeting of the company.

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<sup>(23)</sup> *Pages 33 and 34 of the Consultation Paper.*



In addition, the Consultation Paper proposed that parties to a “concert party” agreement should be required to provide a copy of the agreement; and if the agreement was not reduced in writing, to produce a memorandum of its material terms.

The objective of the proposed changes was to expose the “warehousing” of shares by controlling shareholders, and to avoid breaches of the minimum public float that a listed company should maintain under the Stock Exchange Listing Rules. The effect of the amendments was explained in the Consultation Paper.

### ***Public Comments and the Final Proposals***

The comments supported the proposed changes in general. Of the 35 respondents, 11 (31%) agreed with the changes, 2 (6%) agreed with qualifications, and 3 (9%) objected.

The SFC considers that the proposed changes should be incorporated into the Ordinance. As pointed out by one respondent, the rationale is that shares acquired by the borrower in the situation described above are either implicitly subject to a “trustlike” arrangement under which the borrower is impliedly holding the acquired shares to the order of the controlling shareholder, or is deemed to be acting in concert with him. The effect of extending section 9 to the borrower and the controlling shareholder is to create an “irrebuttable presumption” that any such loan or funding would be made pursuant to an agreement regarding the borrower’s use, retention or disposal of the interests in shares acquired. Parties to such a funding arrangement should be required to provide a copy of the agreement; and if the agreement was not reduced in writing, to produce a memorandum of its material terms.

Several respondents mentioned that controlling shareholders sometimes provide funds to group employees to help them buy shares in the listed companies. In the SFC’s view, these loan arrangements should be caught under the proposed changes and would be regarded as concert party agreements between the controlling shareholder and the employees.

## **10. Investment Managers and Trust Companies**

### ***The Proposed Changes***

For the purpose of increasing market transparency and creating a level playing field for all market participants, the Consultation Paper proposed that the exemptions currently available to locally registered investment managers and trust companies under the Ordinance should be removed. This would result in regulations 3(2) and 3(1)(c) of the Securities (Disclosure of Interests) (Exclusions) Regulations being repealed.<sup>(24)</sup>

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<sup>(24)</sup> Pages 34 to 37 of the Consultation Paper.

## ***Public Comments***

The market had mixed views on the subject. Of the 35 respondents, 9 (26%) agreed with the removal of the exemptions, 5 (14%) agreed with qualifications, and 4 (11%) disagreed.

Respondents who agreed with the proposed changes gave the following reasons in support:

- (a) ***The exemptions were out of date:*** Respondents considered that the existing exemptions had “*fallen behind good market practice*”.
- (b) ***Create a level playing field*** - Respondents believed that if the proposed changes were made, a level playing field would be created for all investment managers and trustees operating in Hong Kong.
- (c) ***Remove potential situation of conflict of interest*** - Some respondents pointed out that an investment manager might not be able to give objective investment advice if it owned or had acquired shares in a company that was the subject of investment advice or recommendation. In such circumstances, unless full disclosure was made of the adviser’s interests in shares, any investment advice given could be perceived as not sufficiently objective or independent.

Respondents who disagreed with the removal of the exemptions considered that requiring locally registered trust companies and investment managers to prepare, file and update disclosures would impose “*very substantial costs*” on them - costs which have to be borne by shareholders of funds or users of trust arrangements ultimately. They further represented that for groups with diverse business interests, removal of the exemptions would give rise to “*onerous*” group level monitoring and compliance burden.

Should the current exemptions given to locally registered investment managers and trust companies be removed, respondents suggested the following alternatives to replace the exemptions:

- (i) ***Relaxed disclosure regime for investment managers and trustees***

Of the 35 respondents, 11 requested the SFC to consider providing a more relaxed disclosure regime for investment managers and trustees generally. They suggested that Hong Kong should follow the U.S. or the U.K. model, i.e. either to provide a longer notification period or a to impose a less stringent initial disclosure threshold for investment managers and trustees.<sup>(25)</sup> These respondents cited the following reasons for their proposal:

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<sup>(25)</sup> *ibid*, see notes (5) and (7) above.

- ***No influence on “control”*** - Respondents represented that U.K. and U.S. regulators had considered it “*unnecessary*” or “*counter-productive*” to require more complete and immediate disclosure from investment managers and institutional investors. According to these respondents, the main purpose of the U.S. and U.K. regimes was to ensure that investors had information about an impending takeover. As trustees and fund managers did not normally engage in takeovers or seek to influence control of listed companies, information on interests in shares held by them was unlikely to be of significant value to investors.
- ***Flexibility to conduct business*** - Respondents considered that a more relaxed disclosure regime would give investment managers, trustees, entities engaged in securities business and other professionals who did not seek to influence the control of listed issuers a sensible degree of flexibility to deal in securities in the ordinary course of their business without subjecting them to onerous reporting obligations.

(ii) ***Clarification of the bare trustee exemption***

A number of respondents considered it necessary that the scope of the existing exemption given to “*bare trustees*” under section 14(1)(a) of the Ordinance be clarified. They queried whether that exemption would also apply to other persons, such as custodians and nominees, who act only on the instructions of interest holders and who make no discretionary decisions. They requested the SFC to extend the scope of that exemption to include:

- All trustees whose role was passive, in particular, trustees holding funds which were managed by separate fund managers; and
- Brokers and nominees with no discretionary powers, for example, brokers and nominees who held securities for clients, but who did not have any discretion on dealings in securities, regardless of whether a formal trust relationship existed.

(iii) ***Disaggregation of group interests***

Some respondents believed that if the current exemptions were removed, provisions should be introduced to allow “*disaggregation*” of group interests - for example, by amending the “*one-third rule*” to expressly allow members of the same group of companies not to aggregate interests arising from investment management or trust operations where these businesses were conducted independently from other group members.

### ***The Final Proposals***

For the reasons stated in the Consultation Paper,<sup>(26)</sup> the SFC takes the view that the current exemptions given to locally registered investment managers and trust companies should be removed.

The SFC is not inclined to adopt a less stringent disclosure threshold or notification period for substantial shareholders who are involved in investment management or trust business. In the SFC's view, it is important that a level playing field is created for all participants.

However, the SFC acknowledges that substantial shareholders whose interests in shares are derived from their business of managing the investments of other persons, or safeguarding the assets of other persons, should be treated differently from those who control, or seek to influence the control of, interests in shares. The former type of substantial shareholders is broadly represented by professional investment managers, custodians and trustees. It is not uncommon that these persons carry on more than one kind of business - for example, a custodian may also be a trustee in relation to the same interest in shares.

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<sup>(26)</sup> *ibid*, see note (25) above.

(1) ***The “bare trustee” exemption***

If a person is a “bare trustee”, then it can take advantage of the existing exemption under section 14(1)(a) of the Ordinance. No interest in shares held by it in such capacity need to be disclosed.

Whilst the SFC cannot give authoritative guidance on how the courts will interpret the Ordinance, in practice, the SFC would regard a “bare trustee” as someone whose interest in shares is entirely “passive”, i.e. a person who holds property in trust for the absolute benefit and at the absolute disposal of other persons, and who has no present beneficial interest in the property and no duties to perform in respect of it, except to convey or transfer it to persons entitled to hold it, or in accordance with such persons’ directions.<sup>(27)</sup> The exemption is accordingly, very narrow. A bare trustee has no power or discretion in relation to the acquisition or disposal of an interest in shares, and has no power to vote or exercise any other rights with respect to any share. In the SFC’s view, a formal trust arrangement is not necessary to determine whether or not a person is a bare trustee, an implied trust relationship is probably sufficient.

(2) ***Disaggregation of group interests***

For professional investment managers, custodians and trustees who have the power to deal in interests in shares which they manage or safeguard on behalf of others, the SFC is inclined to allow their interests to be “disaggregated” from interests held by other members of the same corporate group for the purposes of disclosure under the Ordinance.

Under the existing *one-third rule*, any notifiable interest held by a company acting as an investment manager, for example, should be attributed to its holding and intermediate holding companies if they are aware of the interests held by the investment manager. Therefore, in determining the interests held by the holding and intermediate holding companies, interests of the investment manager have to be aggregated with those held by them, if any.

Under the current proposal, where the organisational structure of the holding and related entities of a corporate group is such that the voting and investment powers over the interests in shares held by the investment manager are exercised independently by it from its holding and related entities, then (i) attribution of interests held by the investment manager to its holding and related entities, and (ii) the aggregation of interests of the investment manager with those held by the holding and related entities, is not required, even if such entities are

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<sup>(27)</sup> *Halbury’s Laws Volume 48 at paragraph 641.*

aware of the investment manager's interests in shares. It is suggested that the same should apply to corporate groups which have within their structures companies which carry on the business of a custodian or a trustee.

The determination of whether voting and investment powers are exercised independently should be based on the facts and circumstances of each case. The practical question to be asked is who actually makes decisions regarding the interests in shares. The existence of informational barriers ensuring the independent exercise of voting and investment powers would be one factor indicating independence. Whilst the existence of some common directors, officers and employees between related entities may be an indication that they are not independent of each other, it is not a determining factor negating independence.

It is proposed that "*investment manager*", in this connection, means a person authorised to manage investments belonging to another pursuant to an agreement.

As the meaning of "*custodian trustee*" under section 14(1)(a) of the Ordinance is unclear and appears redundant in light of the above proposals, it is suggested that the reference to "*custodian trustee*" in that section be deleted. For the purpose of disaggregation of group interests, the SFC suggests that "*custodian*" be defined as "*custodian (whether by trust or by contract)*".

To apply the disaggregation rules, an investment manager, custodian or trustee need not be registered or authorised as such in Hong Kong. This would create a level playing field for all participants in the Hong Kong market.

The SFC believes that including the above proposals in the revised Ordinance would reduce the compliance burden.

(3) ***Clarification on "interest which subsist by virtue of any authorised unit trust and mutual fund corporation"***

Section 14(1)(b)(i) of the Ordinance provides that for the purposes of disclosure, "*an interest which subsists by virtue of*" any unit trust or mutual fund corporation authorised under section 15 of the Securities Ordinance is to be disregarded. Market participants considered that such wording was vague and uncertain. Questions were raised on whether this have the effect of exempting interests held by trustees and fund managers of collective investment schemes authorised by the SFC under section 15 of the Securities Ordinance.

In the SFC's view, the Ordinance should be amended to clarify that holders of authorised collective investment schemes are exempted

from disclosure as they do not normally have any influence on how the schemes are managed.<sup>(28)</sup> Further, as authorised schemes are usually managed by separately appointed fund managers, trustees of the schemes only occupy a “*passive*” position in practice. Accordingly, it is proposed that interests held by trustees of authorised collective investment schemes should also be expressly disregarded for the purpose of disclosure.<sup>(29)</sup> As the real “*operator*” of such schemes, however, fund managers appointed to manage the schemes should, for transparency reasons, be required to disclose their interests in shares under the Ordinance, except that the disaggregation rules mentioned in paragraph (2) above should also apply to these fund managers as they are proposed to apply to other investment managers.<sup>(30)</sup>

**(4) *Summary of position***

To sum up, therefore, the SFC proposes that:

- Interests in shares held by bare trustees will continue to be disregarded from disclosure under the Ordinance;
- Companies which carry on the business of an investment manager, a custodian, or a trustee, wherever incorporated or registered, may take advantage of the disaggregation rules; and
- Interests which a person has by being a trustee of an authorised collective investment scheme or a holder of such a scheme are disregarded from disclosure under the Ordinance.

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<sup>(28)</sup> *The position is the same in the U.K. Please refer to section 209(1)(b) of the U.K. Companies Act, 1985.*

<sup>(29)</sup> *The position is the same in the U.K. Please refer to section 209(1)(h)(i) of the U.K. Companies Act 1985.*

<sup>(30)</sup> *In the U.K., operators of authorised collective investment schemes have to disclose their interests at the 10% threshold - section 199(2A) of the U.K. Companies Act, 1985.*

## 11. Derivatives

### *Derivatives in respect of Unissued Shares*

#### *The Proposed Changes*

The Ordinance currently covers derivatives in respect of issued shares only. The Consultation Paper proposed that the Ordinance be amended to cover also derivatives with respect to unissued shares.

#### *Public Comments*

The comments generally supported the proposal that the Ordinance be amended to cover derivatives with respect to unissued shares. Of the 35 respondents, 10 (29%) agreed, 3 (9%) agreed impliedly or with reservations and 4 (11%) disagreed.

One respondent commented that “*disclosure should be required of all derivatives instruments whether listed or not and whether exercisable into the underlying shares*”. Another respondent believes that this would add transparency value and be beneficial to the investing public.

The only concern raised in this respect is that requiring disclosure of interests by Euro-convertible bond holders may be impracticable given the anonymity of the market. It is however believed that normally the size of Euro-convertible bonds is limited to just 10% to 20% of the issued share capital of the listed company. If that is the case, only a person holding 25% to 50% of the total convertible bonds would become a 5% substantial shareholder if he does not hold other interests in shares. This would seem to be reasonable. Regarding the anonymity of the overseas holders, this is an enforcement concern which already exists at the moment as there are many overseas funds holding 5% or more of shares in a Hong Kong listed company. Placing agents and listed companies are expected to educate substantial Euro-convertible bond holders on the implications of the Ordinance during marketing of the bonds.

#### *The Final Proposals*

As the Consultation Paper said it is difficult to justify the policy reason why the current Ordinance includes derivative warrants but excludes subscription warrants. Given the general support from the respondents, no change is made to the original proposal.



## **Calculation of Derivatives Interests**

### ***The Proposed Changes***

The Consultation Paper proposed that the last known total number of issued shares be taken as the denominator as basis for calculating the percentage of derivative interests.

### ***Public Comments***

The respondents generally supported this proposal. Of the 35 respondents, 9 respondents (26%) agreed, 1 (3%) agreed with reservations and 5 (14%) disagreed.

Most of the respondents agreed that this calculation method is comparatively simple and user-friendly, although it may result in minor distortions. Some respondents also thought that this calculation method is unlikely to materially lower the disclosure threshold since there are limits imposed by the Stock Exchange in respect of the size of subscription warrant issues and share option schemes.

There were no better alternatives suggested by other respondents. One respondent suggested using the denominator the sum of the last known share capital plus the unissued shares relating to the derivatives held by the person making the notification.

### ***The Final Proposals***

The SFC has considered this alternative. This method would have the problem that, although it may reduce the distortions (which are normally immaterial) of the percentage calculation of derivatives, it may create similar distortions with respect to shares held by the same derivatives holder (e.g. if a person holds 5% shares and 1% derivatives). This is because the substantial shareholder may or may not exercise the derivatives. Further, a substantial shareholder would need to change the denominator whenever there is a change of his derivative interests. No change is made to the original proposal.

## **Short Positions of Derivatives**

### ***The Proposed Changes***

The Consultation Paper proposed that disclosure of short positions of derivatives (e.g. the writing of a call option and the holding of a put option) be required.

### ***Public Comments***

The respondents had divergent views on this proposal, although there were more respondents who supported the proposal. Of the 35 respondents, 12 respondents (34%) agreed with this proposal (including 4 or 11% who agreed impliedly or with reservations) and 10 (29%) disagreed.

The major argument against this proposal was that short positions are not “*interests*” in shares.

### ***The Final Proposals***

Some respondents said that it is difficult to argue that some derivative holdings should be disclosed and others should not. Disclosure of only long positions but not short positions would reduce the informational value of the disclosures.

The SFC agrees with this view. For example, a derivatives trader of an investment bank writes a call option with respect to 6% of the issued shares of a listed company. As part of his hedging activities it also holds 5.5% of the shares of the same listed company and becomes a substantial shareholder. Public investors may then be misled in that they may believe that the investment bank has taken 5.5% proprietary position, without noticing that these are purely hedging activities. As discussed later in this paper, the SFC believes that there have been possible manipulation schemes or activities involving derivatives. Part of the reasons for the “*success*” of these possible manipulation schemes is that the hedging activities of buying underlying shares might have misled some public investors and helped push up the price of the underlying shares.

The SFC has considered the counter arguments. It is believed that the disclosure of long positions only but not short positions may distort the true picture of derivative trading activities and may give an inaccurate or misleading view of the interests disclosed.

### **Netting-off between Long and Short Positions**

#### ***The Proposed Changes***

The Consultation Paper proposed that there should not be any netting-off between long and short positions.

#### ***Public Comments***

Of the 35 respondents, 8 (23%) agreed, 3 (9%) agreed impliedly or with reservations, and 8 (23%) disagreed.

The only major argument raised in this respect was that “*the most logical method to aggregate the interests is to net-off the long and short positions*”.

### ***The Final Proposals***

Firstly, the SFC believes that to allow netting-off of short and long positions may lead to easy circumvention of the Ordinance. For example, a 5% shareholder may avoid a disclosure by taking a 0.01% put option. Secondly, to allow netting-off may reduce the informational value of a disclosure and sometimes, may even distort the true picture of an investment or trading activity. To quote the example mentioned in the section headed “*Short Positions of Derivatives*” above, if netting-off is allowed, a substantial shareholder writing 6% call options and holding 5.5% underlying shares for hedging purposes would then be regarded as holding -0.5% interests. He would then not be required to make any disclosure. No change is made to the original proposal.

### **Stock futures and Purely Cash-settled Derivatives**<sup>(31)</sup>

#### ***The Proposed Changes***

It is proposed that stock futures and purely cash-settled derivatives be covered by the Ordinance. It should be clarified that the current Ordinance already covers unlisted derivatives and derivatives with cash option (i.e. there is a possibility that settlement be made by either cash or shares). The current Ordinance also covers derivatives with respect to a single stock but not derivatives with respect to a basket of underlying shares. Except for the proposed changes there is no intention to make changes on these areas.

#### ***Public Comments***

This was one of the most controversial issues with respect to derivatives. Of the 35 respondents, 5 (14%) agreed, 2 (6%) agreed impliedly or with reservations, and 10 (29%) disagreed.

The arguments against the proposal included:

- It is not clear how entering into a purely cash-settled derivative can give rise to an interest in shares.
- Such disclosure obligation is not required under the laws of the U.K., the U.S. or Australia.
- Some purely cash-settled derivatives are highly complex and it may be difficult to determine the value of the economic interest in the underlying shares.
- The proposal may involve intrusion into privacy of market participants.

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<sup>(31)</sup> *The discussions regarding purely cash-settled derivatives in this Paper does not carry any implications regarding the legality of purely cash-settled derivatives under the Gambling Ordinance.*

## *The Final Proposals*

The arguments supporting the proposal included:

- As some respondents commented, there is no reason why some derivative interests should be disclosed and others should not.
- A substantial purely cash-settled OTC derivative position may affect the market price of the underlying shares, especially if it is close to the expiry date and the gap between the strike price and the market price is narrow. These derivative activities are highly price-sensitive. As discussed below, disclosure of purely cash-settled derivatives may also reduce the misleading picture arising out of some hedging activities, in particular in those involving possible manipulation of share prices.
- The proposed requirement will provide more transparency in the OTC derivatives market. These derivative trading activities in some recent cases seriously affected the financial resources of a number of intermediaries and listed companies.
- The London and Hong Kong Takeovers Codes already cover purely cash-settled derivatives. The SFC conducted consultation in relation to such amendment to the Takeovers Code earlier this year but did not receive any objections from the market.

In recent years, the SFC has observed that there have been possible manipulation activities or schemes involving the use of derivatives. The common features of these cases are:

- The scheme involves an intermediary (with or without the support of a substantial shareholder) which engages in possible manipulation of the market price of an underlying stock.
- OTC derivatives (whether or not purely cash-settled) are used to assist the intended manipulation.
- These intermediaries normally use derivative techniques involving the taking of a call option and the writing of a put option. Their counterparties (writer of a call option and holder of a put option) then buy shares in the market for delta hedging. Public investors are misled and they believe that there has been strong buying demand for the stock. The market price of the underlying stock may be pushed up.
- In many cases the share interests involved in the transactions are higher than 5% and in some cases are close to 10% of the total issued share capital.

- A sudden drop of the market price of the stock triggers substantial selling of the shares under delta hedging which then leads to the collapse of the stock price, and may then lead to the collapse of the intermediaries.

Currently, the market does not know the true picture with respect to these derivative activities. Very often public investors are misled by the appearance of heavy buying activity, or sometimes by (partial) share interests disclosed pursuant to the Ordinance. These investors suffer financial losses. Although no change is made to the original proposal, as discussed below, an exemption power is proposed to be provided with the SFC. In that case, if a derivative participant considers that a particular purely cash-settled derivative (or any other derivative) should be exempt from the Ordinance, he may apply to the SFC for an exemption from the disclosure requirements.

### **The Three Options relating to Aggregation of Derivatives Interests**

#### ***The Proposed Changes***

The details of the three options are set out in *Appendix B*.

#### ***Public Comments***

The respondents generally preferred Option 3. Of the 35 respondents, 13 (37%) preferred Option 3, 1 (3%) preferred Option 1, 2 (6%) preferred Option 2, and 5 (14%) disagree with all three options.

The overall comment was that Option 3 strikes a balance between providing adequate market transparency on the one hand and meaningful information to the market on the other. Some respondents thought that this option provides a less distorted and opaque information than the other options. The major criticism of Option 3 was that it is complicated.

#### ***The Final Proposals***

It was proposed that Option 3 as set out in *Appendix B* be taken as the basis for aggregation of derivative interests. To clarify one respondent's query, the de minimis exemption will apply separately to both long and short positions of derivative interests.

### **Consideration and Agreements of Derivatives**

#### ***The Proposed Changes***

It was proposed that disclosure of the consideration with respect to all derivative transactions and the agreements with respect to OTC derivative transactions be required.

### ***Public Comments***

Generally the respondents objected strongly to a full disclosure of an OTC derivative agreement. Of the 35 respondents, 11 (31%) disagreed, 4 (11%) agreed and 2 (6%) agreed to disclose principal terms but disagreed with providing a copy of the derivative agreement.

The major arguments against the proposal were:

- The proposal may involve the disclosure of commercially sensitive information or financing techniques.
- The requirement would constrain the derivative participant's ability to effect hedging transactions and put them at a competitive disadvantage.
- Such information may be used by persons to disrupt trading strategies or hedging activities.
- Some respondents said this proposal would significantly reduce OTC equity derivative transactions in Hong Kong.

### ***The Final Proposals***

The SFC shares some of the above concerns. In particular, full disclosure of all principal terms of a derivative agreement may put the derivative participant in a difficult position. It is therefore proposed that an exemption be created for derivative agreements so that only the transaction date, the exercise period (e.g. whether of American or European style), the expiry date and the number of underlying shares in the notifiable interest that are held through the derivatives or the interest which is derived from the derivatives are required to be disclosed. The proposal would not require disclosure of the consideration, the strike price, the option premium or the option price.

### ***Changes in the Nature of an Interest***

#### ***The Proposed Changes***

The Consultation Paper proposed that disclosure be required with respect to all changes in the nature of an interest, whether resulting from an exercise or expiry of a derivative or otherwise, even if the percentage of interests remains unchanged. It should be clarified that this proposal would not cover changes in the terms of the same derivative transaction resulting from a change in the underlying share capital, e.g. a change of the strike price resulting from a consolidation of shares.

### ***Public Comments***

Of the 35 respondents, 6 (17%) supported this proposal and 4 (11%) disagreed.

As one respondent said, the proposal would clarify disclosure obligations in relation to the assignment, exercise or expiry of options held by a director and would bring substantial shareholders under the same disclosure duty as directors.

One respondent commented that this requirement is unnecessary as the expiry date of the derivative would have been notified to the market on initial disclosure, and if the derivative is not exercised then the market can assume that it has expired. This respondent has not considered the cases where a holder of a derivative interest may exercise the derivative prior to the expiry date and his percentage interest may remain unchanged. The market should be entitled to know when such person starts to hold shares instead of derivatives. No change is made to the original proposal.

It should, however, be noted that the proposed changes will affect a stock lender's disclosure obligation. Please see the discussion under paragraph 14 below.

### **Exemption of a derivative transaction**

In view of the complexity, the novel and esoteric nature of some derivative products, it is proposed that an exemption power be given to the SFC to exempt a particular derivative transaction from disclosure requirements under the Ordinance. The SFC believes that such exemption is helpful to the market in light of expeditious development of derivative products in recent years.

### **Current position under the Ordinance applicable to derivatives**

Two respondents sought clarification of the legal views expressed in page 39 and Appendix 1 of the Consultation Paper. After considering the respondents' views, a revised summary is now set out in **Appendix C** of this Paper.

## 12. Disclosure Forms

### *The Proposed Changes*

The Consultation Paper proposed that two sets of statutory disclosure forms should be adopted for use in relation to the revised Ordinance: one set for substantial shareholders and a separate set for directors. Further, for administration and clarity purposes, substantial shareholders and directors would be asked to complete different forms depending on the circumstances under which their duty of disclosure arises. The purpose was to streamline the notification process as far as possible.

A draft substantial shareholder form was included in the Consultation Paper for comment. The Consultation Paper also provided illustrations on how the draft form was intended to be completed.

### *Public Comments*

Quite a number of respondents said that they had not reviewed the draft notification form because the proposed changes were not yet finalised. They would, however, want to review the draft in detail at a more advanced stage. Others provided us with detailed comments on the draft form.

Some respondents found the draft form to be complex, although others considered it to be “*self-contained*”, “*user-friendly*” and “*relatively easy to use*”.

Respondents supported the use of plain language in the draft form and welcomed the illustrations provided on how to complete the form.

A number of respondents questioned the need to use mandatory forms. They preferred the use of recommended sample forms as is currently the case. These respondents considered that the existing practice allowed users more flexibility in fulfilling their disclosure obligations depending on the complexity and circumstances of each case.

### *The Final Proposals*

As some proposed changes included in the Consultation Paper have been revised, the SFC will have to amend the draft substantial shareholder form included in the Consultation Paper, and to design all the other forms for use by substantial shareholders and directors by reference to the circumstances in which their duty of disclosure arises. The new notification forms will be included as part of the package accompanying the draft Bill of the revised Ordinance.



It is the SFC's intention to make the forms as self-contained and user-friendly as possible. So far as possible, the SFC will also provide illustrations on how the final forms are intended to be completed.

The SFC takes the view that the final forms should be adopted as prescribed forms and not as sample recommended forms. Given the increased information to be included, the use of prescribed forms is necessary to enable the SEHK to extract information for public dissemination accurately and efficiently. This would minimise the circumstances under which the SEHK finds itself interpreting the information provided. The SFC also notes that although the existing sample forms are not prescribed forms, nearly all disclosures are made in the recommended forms. Accordingly, the SFC does not foresee that the use of prescribed forms would create many practical difficulties for the market. Whilst it is the responsibility of substantial shareholders and directors to ensure that information included in the notifications is accurate and legible, the SFC will design the forms with a view to allow flexibility for completion as far as possible.

### **13. Disclosure of Share Pledges**

#### *The issues raised*

In light of the sharp fall in the share price of several listed companies during the recent financial turmoil caused by creditors rapidly selling shares pledged by substantial shareholders in the market, the Consultation Paper asked the market to comment on whether more transparency was required with respect to pledges of listed shares or interests in shares created by substantial shareholders in favour of their creditors.

The Consultation Paper explained that substantial shareholders who pledged shares as security for loans were not normally required to disclose interests subject to the pledges unless they had defaulted on the loans, lenders had enforced the security under the pledges, and such actions had resulted in a change in the interest of substantial shareholders in a listed company. With respect to lenders, the Consultation Paper explained that currently, authorised banks and licensed stockbrokers were exempted from disclosure if shares were pledged to them and held as "*exempt security interests*" under sections 14(1)(d) and 14(4) of the Ordinance. However, if they enforced the security and the relevant shares constituted a notifiable interest, then they would be required to make a disclosure under the Ordinance. For lenders who could not take advantage of the section 14 exemption, interests in shares that were subject to pledges had to be disclose at the creation of the pledge if the shares constituted 10% or more of the issued shares of a listed company. The Consultation Paper raised the following questions:

- (a) Should banks be required to disclose interests under the Ordinance when substantial listed shares are pledged to them?

- (b) Should substantial shareholders be required to disclose share pledges and mortgages?<sup>(32)</sup>

### ***Public Comments***

#### **Regarding authorised banks and licensed brokers**

Of the 35 respondents, 15 (43%) considered that banks and licensed stockbrokers should not be required to disclose pledges of shares made by substantial shareholders before the enforcement of security. Some respondents, however, suggested that the Ordinance should clarify the circumstances under which lenders would be regarded as having enforced security under share pledges, or the circumstances under which they would be taken as having acquired an absolute interest in pledged shares.

#### **Regarding substantial shareholders**

The market had mixed views on whether substantial shareholders should be required to disclose pledges of shares prior to enforcement of security by lenders. Of the 35 respondents, 6 (17%) considered that substantial shareholders should be required to do so, and another 6 (17%) took the opposite view.

Respondents who considered that substantial shareholders should not be subject to additional disclosure obligations on share pledges gave the following reasons in support:

- They believed that disclosure of the creation of a share pledge itself, without information on the full financial position of a substantial shareholder, would not serve any useful purpose.
- Respondents argued that the financing arrangements between a substantial shareholder or director and a lender was a private matter between the parties. Although a pledge created a legally binding obligation on the shareholder, the shareholder, nevertheless, retained control over the shares as long as he was not in default of his loan. Accordingly, until the shares came under the control of the lender, the existence of the pledge should remain a private matter between the shareholder and the lender.
- Respondents were concerned about the possible effects that a disclosure of this nature might have on a company's share price, in particular, in cases where a controlling shareholder disclosed that it

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<sup>(32)</sup> Pages 50 and 51 of the Consultation Paper.

had borrowed funds and had pledged substantial shares in the company to a third party.

On the other hand, respondents who took the opposing view cited the recent financial turmoil as an example to show how pledges could affect the “control” of a listed company.

These respondents stressed that in the recent financial turmoil, it had become apparent that a massive amount of lending was made against listed securities and that for many small to medium sized companies, the effective control was passed, or could have been passed, to such lenders. Most of these loan arrangements allowed lenders to realise security quickly so that there had been many instances where lenders dissipated a controlling interest by rapid and successive market sales without having to make any disclosures. These respondents pointed out that if a primary purpose of the Ordinance was to improve the information available to investors, then investors ought to know whether large shareholdings were pledged and the rights that lenders might have over the shares. They should also know when there were changes to the lending agreements, for example, when loans were in default (which normally would result in voting rights attached to pledged shares being passed to lenders), and when a lender foreclosed. In view of the scale of lending and the rapid changes in the control of many listed companies that had occurred during the recent economic downturn, respondents considered that it would be difficult to sustain the argument that information regarding share pledges made by substantial shareholders was not important to the market.

## ***The Final Proposals***

### **Regarding authorised banks and licensed brokers**

In the SFC’s view, imposing a duty on banks and licensed brokers to disclose share pledges before enforcement of security would create undue burden on their normal business activities. It is not the SFC’s intention to remove or revise the exemption currently available to them under sections 14(1)(d) and 14(4) of the Ordinance.

The SFC notes the public’s comment regarding the lack of certainty on when a lender is regarded as having enforced security on a pledge or exercised its rights as pledgee. The SFC proposes that express provisions should be included in the Ordinance to clarify the position. As suggested by one of the respondents, the SFC agrees that the circumstances under which lenders are deemed to have acquired an absolute interest in shares under a pledge should include the following:

- (i) when loans have been declared in default which result in the lender being entitled to exercise 5% or more of the voting rights of the shares of a listed company;
- (ii) when a mortgage over a substantial shareholding has been determined;

- (iii) when the lender takes steps to exercise its power of sale over a substantial shareholding; or
- (iv) when a foreclosure order has been granted over a substantial shareholding.

**Regarding substantial shareholders**

**Disclosure of Share Pledges**

The Commission notes that the question of whether substantial shareholders should be required to disclose pledges of shares before the enforcement of security by lenders is a particularly controversial issue in light of the events that took place during the financial turmoil, where sudden forced sales of pledged shareholding of substantial shareholders adversely affected share prices. The Commission has considered the arguments for and against imposing such a requirement. There is a need to balance a substantial shareholder's right to privacy in relation to his personal financial affairs against the usefulness to the market of disclosure of share pledges. On balance, the Commission does not favour requiring all substantial shareholders to disclose pledges before enforcement of security or at the time of creation of pledges due to the following principal reasons:

- (i) The recent publication of Practice Note 19 to the Listing Rules would have the effect of providing the market with information on share pledges made by controlling shareholders in cases where their shares are used to secure loans or other obligations of listed companies, or where pledges of shares may affect funds or credit provided to listed companies, such as in circumstances where facilities provided to listed companies are conditional upon controlling shareholders maintaining a certain level of shareholding in the listed company.
- (ii) Although Practice Note 19 does not deal with cases where substantial shareholders pledge shares to secure their own obligations, a general requirement that all substantial shareholders be required to disclose pledges would increase the compliance burden on them. Unless the market is also aware of the financial position of such shareholders during the term of a share pledge, disclosure of the pledge itself would not provide meaningful information on the likelihood of a forced sale.
- (iii) The suggested provisions to clarify the circumstances under which lenders are regarded as having enforced security or acquired an absolute interest in the pledged shares would mitigate the problem.

## 14. Stock Lending and Borrowing

### *The Legal Position - the Stock Borrower*

The Consultation Paper discussed the current legal position regarding stock lending and borrowing. Stock lending in Hong Kong, in common with other developed markets, involves a change of title. A better degree of standardization has also been achieved by the common use of the Overseas Securities Lending Agreement (“OSLA”) for most transactions. The OSLA clearly establishes transfer of ownership and ensures that the borrowed stocks do not constitute “collateral” held by the lender so that the stocks are free from incumbrances. Accordingly, under the current Ordinance the stock borrower is regarded to have acquired an interest in the borrowed shares, and as a result, would need to disclose his interest as a substantial shareholder if his interest in shares exceeds the disclosure threshold.

### *Public Comments*

On the question whether the reduction of the disclosure threshold from 10% to 5% would cause any particular practical problem, 24 respondents (69%) did not express comments on this issue. Of the 35 respondents, 5 (14%) took the view that an exemption should be introduced to exclude temporary “borrowed” interests. One respondent said that strict application of the disclosure requirements with respect to “borrowed” interests might create a problem of double counting of the shares. Another five respondents took the view that disclosure requirement with respect to borrowed shares should be imposed. One respondent said it was not aware of any reason why a 5% disclosure threshold should not also apply to a borrower of stock. Another said that where stocks being borrowed are discloseable for the purposes of the Ordinance, similar requirements should apply, i.e. the reporting threshold and the notification period should be the same as those applied to other cases. Others said the reduction of the initial disclosure threshold should not create any particular obstacles for bona fide stock borrowing and lending activities. The SFC has considered the above views and it is not proposed to make any changes to the current disclosure requirements applicable to a stock borrower.

### *The Stock Lender*

However, a lender of stock is not required to disclose the share loan transaction under the current Ordinance. As discussed above, a stock lender actually disposes of the “loaned” shares but at the same time his right under the stock lending agreement constitutes a right to call for delivery of the same number of shares and so the stock lender’s *percentage* interest in shares remains unchanged and disclosure is not required. For example, if a 10% shareholder lends 2% shares to a third party, his interests in the shares will become 8% shares and 2% “call option”. This is a change in the nature or the legal form of share interests. Under the proposed changes mentioned in the section headed “Changes in the Nature of an Interest” in paragraph 11 above, disclosure will

then be required as there is a change in the nature of interests held by a substantial shareholder. Such disclosure will also address one respondent's concern about "*double counting*", since investors may then know that the disclosed "*borrowed*" share interests are "*acquired*" from another substantial shareholder who is the stock lender by reference to his interest in the "*call option*". The SFC does not see any policy reason why specific exemption from the "*change in nature proposal*" should be created with respect to stock lenders.

## **OTHER SPECIFIC COMMENTS**

This section sets out the principal additional comments raised by respondents. The more technical issues are not included. It is the SFC's intention to consider the more technical issues when drafting the Bill for the revised Ordinance.

### **1. Application of the Ordinance to issuers of listed debt securities and derivatives warrants**

At present, the Ordinance imposes continuing disclosure obligations on substantial shareholders and directors of "*listed companies*". A "*listed company*" is defined to mean any corporation which has any of its securities listed on the SEHK. Accordingly, the definition is wide enough to cover issuers who only have debt securities and derivative warrants listed on the Exchange.

In practice, these issuers apply to the SFC for an exemption exempting them, their substantial shareholders and directors from complying with the Ordinance. The SFC usually grants such exemptions. In obtaining an exemption, however, issuers have to pay a fee of \$24,000 pursuant to the Securities and Futures Commission (Fees) Rules.

A number of respondents considered that the Ordinance should only apply to equity securities listed on the SEHK. They believed that disclosure of interests was of a primary concern to equity investors, but not to investors of debt securities or derivative warrants. Respondents also argued that the need to obtain an exemption under the Ordinance for each listing of debt securities or derivative warrants on the SEHK rendered the documentation and procedure of listing in Hong Kong cumbersome and expensive. In their view, this affects Hong Kong's attractiveness as a centre for listing selectively marketed debt securities.

The SFC has considered the above representations. In the SFC's view, the suggested amendment would leave no flexibility in applying the provisions of the Ordinance to listed issuers who may wish to list new products on the SEHK in future where disclosure implications may arise. Therefore, the SFC does not recommend that the Ordinance be revised in the manner as suggested.

### **2. Notice under Section 18 of the Ordinance**

Section 18 of the Ordinance gives listed companies a right to require persons whom they know, or have reasons to believe, to be interested in their shares to obtain further information regarding their shareholding in the company. This ability of listed companies to require information from a shareholder was

regarded as one of the principal functions of the Ordinance identified by the Securities Review Committee in 1988.<sup>(33)</sup> The objective of section 18 is to provide listed companies with a legal channel to carry out “*investigations*” on persons who may have interests in their shares.

However, respondents pointed out that some recipients of section 18 notices (including major nominee companies) had refused to respond to such notices on the ground that either they were not required to do so or that it was administratively difficult or inconvenient for them to do so. Respondents were concerned that nominee companies were not fully aware of the importance of responding to section 18 notices speedily. They pointed out that in the context of a hostile takeover offer, slow responses to such notices could effectively frustrate the whole purpose of section 18 in circumstances where it was most needed to work.

The SFC notes the above concern and wishes to remind the public that listed companies are entitled to send out notices under section 18 to obtain information on persons who they have reasonable cause to believe to be interested in their shares. The notice should be complied with within a reasonable period. The Ordinance does not exempt any person or any particular category of persons from complying with section 18 notices. A person who fails to comply with a section 18 notice commits an offence and is liable on summary conviction to a fine, and on conviction upon indictment, to imprisonment. Further, if a person fails to comply with such a notice, listed companies are entitled to apply to the courts for an order directing that the shares in question be subject to a restriction notice.<sup>(34)</sup>

### **3. Netting-off of Interests**

A respondent raised the question of whether the Ordinance should allow the “*netting off*” of trades made within one day so that a disclosure obligation would arise only if there was a change in the interest in shares held by a substantial shareholder after taking into account or “*netting off*” all trades made during the day regardless of whether any single trade would result in a change in interest. As one of the principal objectives of the Ordinance is to increase market transparency, the SFC is not inclined to introduce changes to the Ordinance which would allow intra-day netting of interests in shares.

### **4. Application of the 5% threshold under the Listing Rules**

At present, the Listing Rules defines a “*substantial shareholder*” as a person who is entitled to exercise, or control the exercise of, 10% or more of the voting power at general meetings of a listed company. Some respondents

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<sup>(33)</sup> *ibid*, note (3) above

<sup>(34)</sup> Section 24 of the Ordinance.



raised the question of whether the definition of “*substantial shareholder*” under the Listing Rules would also be revised if the 5% threshold under the Ordinance were to be adopted. They pointed out that this issue should be considered carefully. The reason was that under the Listing Rules, the definition of substantial shareholders not only affected the application of connected transaction provisions, but also affected the level of public float for many listed companies. The SFC notes the market’s view and believes that the SEHK would consider the relevant implications before a proposal is made to amend the Listing Rules in this connection.

**5. The need for a Rule 33 disclosure under the Takeovers Code**

Briefly, Rule 33 of the Takeovers Code requires a person to disclose any acquisition or disposal if it results in his acquiring or disposing of any voting rights or rights over shares within the range of between 10% to 34.99%. Such disclosure must be made to the Takeovers Executive no later than 9:00 a.m. on the dealing day following the date of the transaction. If the initial disclosure threshold under the Ordinance was lowered to 5% and the notification period was reduced to two business days, some respondents considered that there would be no value in retaining Rule 33. The SFC notes the public’s view on this and will consult the Takeovers Panel on this issue.

## APPENDIX A

### *Profile of Respondents*

<u><i>Nature of Respondents</i></u>	<u><i>Number</i></u>
Listed Companies	5 <sup>(a)</sup>
Financial services groups	4
Asset management groups	3
Trust company	1
Stockbroker	1
Accountant	1
Lawyers	5
Regulators	3
Industry groups	12 <sup>(b)</sup>
Total	<hr/> 35

*Notes:*

<sup>(a)</sup> *Of the five listed companies, there are three groups with banking interests.*

<sup>(b)</sup> *Industry groups represented the following professions, businesses and other interests - company directors, company secretaries, corporate finance and investment banking practitioners, fund managers, financial analysts, trustees, stockbrokers, commercial banks, derivative users and dealers, accountants and lawyers.*

## *Summary of Responses*

<u><i>Issues for consultation</i></u>		<u><i>Responses</i></u>				
		<i>Agreed</i>	<i>Agreed with reservations</i>	<i>Disagreed</i>	<i>Mixed views</i>	<i>No comment</i>
1.	Reduce initial disclosure threshold to 5%	12 (34%)	8 (23%)	2 (6%)	-	13 (37%)
2.	Reduce notification period to 2 business days	4 (11%)	3 (9%)	18 (51%)	2 (6%)	8 (23%)
3.	Disclosure to be made to SEHK at the same time as to listed companies	19 (54%)	-	-	-	16 (46%)
4.	De minimus change exemption	10 (29%)	4 (11%)	7 (20%)	-	14 (40%)
5.	Remove requirements to disclose registered shareholders	18 (51%)	-	1 (3%)	-	16 (46%)
6.	Disclosure of consideration and agreements	4 (11%)	4 (11%)	16 (46%)	-	11 (32%)
7.	Disclosure of corporate substantial shareholders	7 (20%)	6 (17%)	6 (17%)	-	16 (46%)
8.	Disclosure of settlors of discretionary trusts	5 (14%)	2 (6%)	12 (34%)	-	16 (46%)
9.	Extend the scope of “concert party agreements”	11 (31%)	2 (6%)	3 (9%)	-	19 (54%)
10.	Remove exemptions for investment managers and trusts companies	9 (26%)	5 (14%)	4 (11%)	1 (3%)	16 (46%)

Total number of Respondents : 35

**Summary of Responses  
Regarding Derivatives**

	<b><u>Responses</u></b>				
	<i>Agreed</i>	<i>Agreed with reservations</i>	<i>Disagreed</i>	<i>No comment</i>	
1. Cover derivatives in respect of unissued shares	10 (29%)	3 (9%)	4 (11%)	18 (51%)	
2. Adopt last known total exercisable voting rights as the denominator for calculating percentage of interests	9 (26%)	1 (3%)	5 (14%)	20 (57%)	
3. Disclose short positions of derivatives	8 (23%)	4 (11%)	10 (29%)	13 (37%)	
4. No netting-off between long and short positions of derivatives	8 (23%)	3 (9%)	8 (23%)	16 (46%)	
5. Cover stock futures and purely cash-settled derivatives	5 (14%)	2 (6%)	10 (29%)	18 (51%)	
6. Disclose consideration and agreements of derivatives	4 (11%)	2 (6%)	11 (31%)	18 (52%)	
		(Agreed to disclose principal terms but not copy of contract)			
7. Disclose changes in the nature of an interest, whether resulting from an exercise or expiry of a derivative or otherwise, even if the percentage of interests remains unchanged	6 (17%)	--	4 (11%)	25 (72%)	
	<i>Preferred Option 1</i>	<i>Preferred Option 2</i>	<i>Preferred Option 3 (including those supporting any one of the 3 Options)</i>	<i>Disagreed with 3 Options</i>	<i>No comment</i>
8. The 3 options relating to aggregation of interests	1 (3%)	2 (6%)	13 (37%)	5 (14%)	14 (40%)

Total number of Respondents : 35

**Summary of Responses  
Regarding share pledges and stock lending/borrowing**

	<u><i>Issues for consultation</i></u>	<u><i>Responses</i></u>			
		<i>Agreed</i>	<i>Disagreed</i>	<i>Mixed view</i>	<i>No comment</i>
1.	Should additional obligations be imposed on banks to disclose pledges of shares.	-	15 (43%)	1 (3%)	19 (54%)
2.	Should additional obligations be imposed on substantial shareholders to disclose pledges of shares.	6 (17%)	6 (17%)	1 (3%)	22 (63%)
3.	Would the revised SDIO create obstacles for bona fide stock borrowing and lending activities.	1 (3%)	3 (8%)	-	31 (89%)

Total number of Respondents : 35

## Appendix B

### Particulars of the Three Options for Aggregation of Derivatives Interests

(i) Option 1

- (a) The holding of a call, writing of a put and taking of a long future (derivative interests which carry the characteristics of a “*buy*” or “*long*” position) will be deemed interests in shares and will be included for the purpose of calculating the percentage of shareholding.
- (b) If the aggregate of the above crosses over 5% or thereafter has 1% band movements, disclosure will be required.
- (c) The writing of a call, holding of a put and taking of a short future (derivative interests which carry the characteristics of a “*sell*” or “*short*” position) are not “*interests in shares*” and will not be included for the purpose of calculating the percentage of shareholding but will be required to be disclosed if a person is making disclosure under (b) above and at the time of disclosure is still holding such positions.
- (d) By way of example, if a person holds 2% shares in a listed company and 2% equivalent derivative call warrants in respect of such shares, and then holds 1.9% equivalent put stock options, he is not a substantial shareholder as the 1.9% holding of put options will not be included for such purpose. But equally this 1.9% holding of put options cannot be netted-off against any other interest in shares. However, if he then further acquires 1% shares (which makes him a 5% interest substantial shareholder), he is required to disclose the 1.9% holding of put options held by him at the time of disclosure.

(ii) Option 2

- (a) All derivative interests (including those carrying “*short*” or “*sell*” characteristics i.e. the writing of a call, holding of a put and taking of a short future) are “*interests in shares*” and will be aggregated for calculating the percentage of shareholding for disclosure purposes.
- (b) Accordingly there will be no netting-off between different positions of derivative interests.
- (c) By way of example, if a person holds 2% shares in a listed company and 2% equivalent derivative call warrants, and then writes 2% equivalent call options in respect of such shares, his aggregated interests in shares is 6% and he becomes a substantial shareholder (holding 5% or more) and disclosure is required. It should be noted that his holding of 2% call cannot be netted-off by his writing of 2% call.

(iii) Option 3

- (a) For the purpose of calculating whether a person's interests in shares hit the 5% threshold so as to determine whether he becomes a substantial shareholder, only his shareholding and derivative interests carrying the characteristics of a "long" or "buy" position (i.e. holding of a call, writing of a put and taking of a long future) will be aggregated; thereafter, every 1% band change of shareholding aggregating with these derivative interests requires disclosure. No netting-off is allowed.
- (b) A substantial shareholder is also required to disclose all his derivative interests carrying the characteristics of a "short" or "sell" position (i.e. writing of a call, holding of a put and taking of a short future) after he hits the 5% threshold under (a) above. Every 1% band change of these derivative interests carrying the characteristics of a "short" or "sell" position will be aggregated separately and require separate disclosure.
- (c) By way of example, if a person holds 2% shares in a listed company, and 2% call warrants and holds 1.9% put options in respect of such shares, he is not a substantial shareholder since the 1.9% holding of put options will not be included for such purpose. However, if he then takes a 2% equivalent long future in respect of such shares, he becomes a substantial shareholder and is deemed to have 6% interests in shares of the listed company. He is then required to disclose his 1.9% interest of the holding of puts separately. If he then further writes 0.2% call in respect of such shares, that will make his "short" or "sell" positioned derivatives 2.1% in aggregate and further disclosure is required due to the 1% band change (i.e. his "short" or "sell" positioned derivative interest crosses over "2%", from 1.9% to 2.1%).

On the whole, it seems Option 2 offers most transparency as it deems more interests discloseable. However, some people may think that it would be unfair to aggregate a shareholder's "short" or "sell" positioned derivative interests, i.e. writing of a call, holding of a put and taking of a short future, with his shareholding and other derivative interests. Option 1 is less complex and is relatively easier for a shareholder to understand and administer but it offers less transparency. The disclosure of a substantial shareholder's interests in "short" or "sell" positioned derivatives, i.e. writing of a call, holding of a put and taking of a short future, under this option will be piecemeal and may not reflect a full picture of dealings in derivatives by the substantial shareholder, because he may have actively dealt in these derivatives and then disposed of such derivative interests before a disclosure obligation arises. Amongst the three options, Option 3 offers more adequate transparency and more meaningful information to the market, but is complex in terms of drafting and understanding of the legislation.

## Appendix C

### Summary of Current Position under the Ordinance applicable to Derivatives

The analysis below applies to both derivative warrants and stock options. For the purpose of this Appendix, the word “*writer*” (of an option) includes an “*issuer*” (of a warrant), and the words “*taker*” or “*holder*” include “*warrant holder*”. The terms “*writing*”, “*taking*” and “*holding*” are to be understood accordingly.

In relation to a substantial shareholder a transaction or event involving a person becoming or ceasing to be interested in shares is only notifiable if, as a result of the transaction or event, the percentage level of his interest in shares crosses over a whole percentage level. To avoid repeating this point in each example in this Appendix we will assume that this requirement is met and we will focus simply on whether the transaction or event involves a person becoming or ceasing to be interested in shares.

#### *Calls*

(i) **The taking of a call by a person**

(a) *If the taker is a substantial shareholder:*

Under s. 13(5)(b) of the Ordinance, a person taking of a call is taken to have an interest in the shares the subject of the call which must be disclosed.

(b) *If the taker is a director or chief executive:*

The taking of a call by a director or chief executive is required to be disclosed under Paragraph 6(1)(b) of Part I of the Schedule of the Ordinance, which is identical to s. 13(5)(b).

(ii) **The assignment of a call by a holder**

(a) *If the holder is a substantial shareholder:*

As a person holding a call is taken to have an interest in the shares, and that person will cease to be interested in the shares following an assignment, the assignment of a call must be disclosed ( s.3(1)).

(b) *If the holder is a director or chief executive:*

As a person holding a call is taken to have an interest in the shares, and that person will cease to be interested in the shares following an assignment, the assignment of a call must be disclosed (s. 28(2)(a)).



(iii) **The exercise of a call by a holder**

(a) *If the holder is a substantial shareholder:*

If a holder of a call exercises a call and shares are delivered to him the percentage level of his interest in shares does not change – it is merely the nature of his interest in those shares which changes. This need not be disclosed.

Where the exercise of a call involves delivery of shares and a change of the identity of the registered holder, disclosure is required under s. 7(7) of the Ordinance. If shares are delivered from the writer to the holder in “street names” without changing the identity of the registered holder, disclosure will not be required.

(b) *If the holder is a director or chief executive :*

In the case where a director or chief executive exercises a call, disclosure is required Paragraph 12 of Part I of the Schedule. Paragraph 12 addresses the delivery stage of a contract ( as opposed to the point of formation of the contract ). Paragraph 12 states (so far as is relevant for the present purposes) -

*“Delivery to a person’s order of shares . . . in satisfaction of a right of his to call for their delivery . . . is deemed to constitute an event in consequence of the occurrence of which he ceases to be interested in them.”*

When a person exercises a call option the resulting delivery of shares clearly falls within the words of Paragraph 12. Under Paragraph 12 he is deemed to cease to be interested in them thus prompting a disclosure obligation under s.28(2)(a).

(iv) **The lapse of a call without exercise**

(a) *If the holder is a substantial shareholder:*

As the holder of a call is taken to have an interest in the shares the expiry of a call without exercise by a holder means that he has ceased to be interested in shares. Disclosure is therefore required under s.3(1).

(b) *If the holder is a director or chief executive:*

As the holder of a call is taken to have an interest in the shares the expiry of a call without exercise by a holder means that he has ceased to be interested in shares. Disclosure is therefore required under s.28(2)(a).

(v) **A person writes a call**

(a) *If the writer is a substantial shareholder:*

The writing of a call does not increase or reduce the writer's interest in the underlying shares, and as a result disclosure is not required. There is no provision in Part II of the Ordinance (applicable to substantial shareholders) which is similar to s. 28(2)(b) (applicable to directors and chief executives).

(b) *If the writer is a director or chief executive:*

Under Paragraph 6(1)(a) of the Schedule, a person who takes a call is taken to have acquired an interest in the shares. A director who writes a call option is therefore entering into a contract for the sale of that interest in shares which must be disclosed under s.28(2)(b). The fact that the sale is conditional on the holder exercising the option does not make it any less a contract for the sale of the shares.

(vi) **A writer of a call assigns the call**

It has been suggested that the assignment of a call option by the writer of the call would require novation as the writer of a call option cannot assign his obligation to deliver shares to the holder. In the event that the parties do actually novate the agreement, the transaction should be analysed as two separate events - the expiry of a call option without exercise, and the writing of a new call option ( see examples (iii) and (iv) above).

However, we understand that there is also a practice in the market of writers assigning obligations, without the consent of the holder of the call, either pursuant to express provisions of the contract or simply in accordance with market practice. Our comments below will address this practice.

(a) *If the writer is a substantial shareholder:*

Since the writing of a call does not mean that the writer ceases to be interested in the underlying shares, the assignment of a call imposes no disclosure obligation on the writer.

(b) *If the writer is a director or chief executive:*

A director or chief executive assigning a call has neither become or ceased to be interested in the shares he holds (within the meaning of s.28(1)(a)) and he has not entered into a contract relating to their disposal ( within the meaning of s.28(1)(b)) and there is therefore no disclosure obligation.

Under Paragraph 12, the lapse of a person's right to call for delivery of shares is deemed to constitute an event in consequence of the occurrence of which he (the person who has the right to call) ceases to be interested in them. This Paragraph does not apply as we are here concerned with the writer of the option, not the holder of the option.

(vii) **A writer has a call exercised against him**

(a) *If the writer is a substantial shareholder:*

When, following exercise of the option, a writer is required to deliver interests in shares to the holder of the option, the delivery of those interests in shares must be disclosed as the writer ceases to be interested in the shares.

(b) *If the writer is a director or chief executive:*

When, following exercise of the option, a writer is required to deliver interests in shares to the holder of the option, disclosure is required by virtue of section 28(2)(a), as that is an event in consequence of which he ceases to be interested in shares.

(viii) **A writer whose call option lapses upon expiry**

(a) *If the writer is a substantial shareholder:*

Since the writing of a call does not mean that the writer ceases to be interested in the underlying shares, the expiry of a call imposes no disclosure obligation on the writer.

(b) *If the writer is a director or chief executive:*

A director or chief executive assigning a call has neither become or ceased to be interested in the shares he holds (within the meaning of s.28(1)(a)) and he has not entered into a contract relating to their disposal ( within the meaning of s.28(1)(b)).

Under Paragraph 12, the lapse of a person's right to call for delivery of shares is deemed to constitute an event in consequence of the occurrence of which he (the person who has the right to call) ceases to be interested in them. This Paragraph does not apply as we are here concerned with the writer of the option, not the holder of the option.

***Puts***

(ix) **The taking of a put by a person**

(a) *If the taker is a substantial shareholder:*

A person taking a put does not acquire an interest in shares or cease to have an interest in shares and so no disclosure is required.

(b) *If the taker is a director or chief executive:*

Under Paragraph 6(1)(b) of the Schedule to the Ordinance, a person who writes a put is taken to have acquired an interest in the shares. We therefore take the view that a director who takes a put option is entering into a contract for the sale of shares under s.28(2)(b) which should be disclosed. The fact that the legal interest in the shares only passes if the director exercises the option does not make it any less a contract for the sale of the shares.

(x) **The assignment of a put by a holder**

(a) *If the holder is a substantial shareholder:*

A person taking a put does not acquire an interest in shares or cease to have an interest in shares, the subsequent assignment by the holder of a put does not have any disclosure implications.

(b) *If the holder is a director or chief executive:*

This is the same as a put expiring . The director has neither become or ceased to be interested in the shares he holds (within the meaning of s.28(1)(a)) and he has not entered into a contract to sell shares ( within the meaning of s.28(1)(b)). He has simply given up a right to sell shares . There is no duty of disclosure.

(xi) **The exercise of a put by a holder**

(a) *If the holder is a substantial shareholder:*

When, following exercise of a put, delivery of shares takes place, disclosure is required as the holder of the put option ceases to be interested in the shares he has delivered to the writer of the put (s.3(1)).

(b) *If the holder is a director or chief executive:*

Similarly, when, following exercise of the option, a holder delivers interests in shares to the writer of the put option, disclosure is required by virtue of section 28(2)(a), as that is an event in consequence of which the holder of the put ceases to be interested in the shares.

(xii) **The expiry of a put option without exercise by the holder**

(a) *If the holder is a substantial shareholder:*

On the expiry of a put option without exercise no disclosure is required as the holder of the put option has neither become or ceased to be interested in any shares.

(b) *If the holder is a director or chief executive:*

On the expiry of a put option no disclosure is required by a director or chief executive who is the holder of the put option as he has neither become or ceased to be interested in any shares (within the meaning of s.28(1)(a)) and he has not entered into a contract relating to their disposal ( within the meaning of s.28(1)(b)).

**(xiii) A person writes a put option**

(a) *If the writer is a substantial shareholder:*

The writing of a put is “an obligation to take an interest in shares” under section 13(5)(b) and constitutes “an interest in shares” which must be disclosed.

(b) *If the writer is a director or chief executive:*

Paragraph 6(1)(b) of Part I of the Schedule is identical with section 13(5)(b) and disclosure is therefore required.

**(xiv) A writer of a put assigns the put**

It has been suggested that the assignment of a put option by the writer of the put would require novation as the writer of a put option cannot assign an obligation. In the event that the parties do actually novate the agreement, the transaction should be analysed as two separate events - the expiry of a put option without exercise, and the writing of a new put option ( see examples (xi) and (xii) above).

However, we understand that there is also a practice in the market of assigning obligations without the consent of the holder of the put, either pursuant to express provisions of the contract or simply market practice. Our comments below will address this practice.

(a) *If the writer is a substantial shareholder:*

On the assignment of a put the writer ceases to be interested in the underlying shares and a duty of disclosure arises under s.3(1).

(b) *If the writer is a director or chief executive:*

A director or chief executive assigning a put ceases to be interested in the shares and a duty of disclosure arises under s.28(1)(a).

(xv) **A writer has a put exercised against him**

(a) *If the writer is a substantial shareholder:*

The previous disclosure of the writing of the put will mean that on exercise of the put (i.e. on delivery) there is no change in the notifiable percentage and no requirement to disclose under s. 4(4) or (5).

However, in the event that there is a change in the registered owner following exercise of the put that change must be disclosed under s.7(7).

(b) *If the writer is a director or chief executive:*

The exercise of the put option involves the delivery of shares in fulfillment of a contract for the purchase of those shares by the writer of the put within the meaning of Paragraph 12 of the Schedule. Paragraph 12 states (so far as is relevant for the present purposes) -

*“Delivery to a person’s order of shares . . . in fulfilment of a contract for the purchase of them by him . . . is deemed to constitute an event in consequence of the occurrence of which he ceases to be interested in them.”*

Under Paragraph 12 the director is deemed to cease to be interested in the shares and must disclose the transaction. The notification is of the shares acquired, not the shares deemed to be disposed of.

(xvi) **A writer whose put option expires without exercise**

(a) *If the writer is a substantial shareholder:*

On the expiry of a put the writer ceases to be interested in the underlying shares and that fact must be disclosed under s. 3(1).

(b) *If the writer is a director or chief executive:*

On the expiry of a put a director or chief executive ceases to be interested in the underlying shares and that fact must be disclosed under s.28(1)(a).