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7 June 2002

Our Ref SMXF

Your Ref

The Securities and Futures Commission
(Disclosure of Interests)
12th Floor, Edinburgh Tower
The Landmark
Hong Kong

Dear Sirs

Consultation on the Securities and Futures (Disclosure of Interests - Exclusions) Regulation

On behalf of the financial institutions named in the attached paper, we enclose some comments on the draft Regulation. In summary, we propose that the opportunity be taken to include a number of additional exemptions in the Regulation from the disclosure requirements in Part XV of the Securities and Futures Ordinance.

One of the proposals in the attached paper relates to disclosure obligations that could arise for the managers of a securities offering in connection with the offering itself, and permitted stabilization activities. This is an area of considerable complexity. We are copying this letter and the attached paper to the Executive Director of Corporate Finance at the SFC, and would welcome a discussion with the Corporate Finance Division on this aspect.

In reviewing the changes to systems and controls needed to comply with the disclosure requirements in Part XV, the financial institutions concerned have encountered a number of practical difficulties and uncertainties. While no specific exemption is sought in the Regulations, written guidance from the SFC on a number of topics would be useful. For example:

- where an institution finds that it is not practicable to make the changes to systems and controls that would be needed to rely on the “de minimis” provisions and/or one or more of the exemptions in Part XV, and therefore its reporting systems may “over-report” its interests, we assume that it would not be the SFC’s policy to prosecute or take disciplinary action against the institution concerned.
- can the SFC confirm its view (expressed in a meeting last September) on the interpretation of Sections 316(2)/313(10) i.e. that it is not necessary, when calculating the discloseable interest of a holding company, to “double count” when more than one wholly-owned subsidiary of the holding company has an interest in the same stock.

The financial institutions concerned would be grateful for a discussion with the SFC on various issues arising from the implementation process and please contact Stephen Fletcher at Linklaters if you wish to arrange a meeting.

Yours faithfully

Linklaters

cc: Ashley Alder, Executive Director of Corporate Finance
Mark Dickens, Executive Director of Supervision of Markets
Anthony Wood, Legal Department

COMMENTS ON THE SECURITIES AND FUTURES (DISCLOSURE OF INTERESTS - EXCLUSIONS) REGULATION

These comments are submitted on behalf of the financial institutions named below.

1 Introduction

Under Section 376 of the Securities and Futures Ordinance (the "Ordinance"), the Chief Executive in Council can make regulations, among other things, to:

" … provide for exclusion from the requirement to give notification under any provision of [Part XV of the Ordinance]".

The draft Regulation, which will be made under Section 376, prescribes a number of "interests" in shares which can be disregarded for the purposes of the disclosure regime established under Part XV of the Ordinance. The draft Regulation reflects some (but not all) of the exemptions currently set out in the existing Securities (Disclosure of Interests) (Exclusions) Regulations.

We have no comments on the text of the exemptions contained in the Regulation. In view of the policy conclusions reached by the SFC (and reflected in Part XV of the Ordinance) on the application of the disclosure regime to trustees, custodians and investment managers, we have no comments to make in respect of the exemptions contained in the existing Regulations but which are not replicated in the Regulation.

However, we consider that there are a number of areas, not presently covered in the Regulation, where an interest or short position may technically arise under Part XV, but where an exemption from disclosure would be justified. Some proposals for additional exemptions to be included in the Regulation are therefore set out below. In each of these cases, we consider that creating an exemption would not be contrary to the policy conclusions reached in the SFC's Consultation Conclusions Paper of April 1999, and as reflected in Part XV of the Ordinance.

2 Exchange-traded options and futures contracts

Where a dealer buys or sells shares for its client, it is arguable that the dealer acquires an "interest" in the shares pending settlement (although we believe that it has not been the practice under existing law to treat the dealer as having an "interest" in these circumstances). For the avoidance of doubt, an exemption has been introduced in Section 323(1)(i) of the Ordinance to exempt the dealer from any duty of disclosure in such circumstances.

However, this exemption will not apply where a dealer which is an Exchange participant is entering into transactions in Exchange-traded stock options or stock futures relating to underlying shares in a Hong Kong listed corporation. In summary, when an Exchange participant opens a position for a client, this involves two contracts, one buy and a matching sell, being entered into:

- between the Exchange participant and (by novation) the clearing house, and
- between the Exchange participant and the client.

Stock options and stock futures are equity derivatives, and a "long" position in stock options or futures creates an interest in the underlying shares (Section 311(2) and Section 322(8) of

the Ordinance). Under the matching contract with the client, the Exchange participant would also have a "short position" (which could not be netted off for disclosure purposes against the "long" interest).

Under the Exchange Rules, all transactions effected by an Exchange participant in options and futures will be clearly designated as either being for the account of a client or for the Exchange participant's own account. Where transactions are effected for clients, the Exchange participant has no "economic" interest in the positions created. The role of the dealer is analogous to that of an agency broker in the cash market, even though (because of the way in which the clearing system operates) the transactions are effected as back to back principal positions.

Furthermore, under the Securities and Futures (Contract Limits and Reportable Positions) Rules, significant positions held or controlled by an Exchange participant or a client will need to be reported to the relevant Exchange, and there are limits on the amount of open contracts that an Exchange participant and/or a client may have at any time.

The Exchanges, the clearing houses and the SFC are already in a position to monitor the size of open positions effected by Exchange participants for their clients. Treating the Exchange participant as having an interest/short position in the underlying shares for the purposes of Part XV will not enhance the regulators' ability to monitor activities in the market. Furthermore, to include such interests/short positions in disclosures made to the relevant listed corporation and the market would, we believe, serve no purpose and potentially give a misleading picture as to the true size of the position held by an Exchange participant and the group of which it is a member.

We therefore propose an exemption to enable an Exchange participant to disregard for disclosure purposes interests and short positions arising from transactions effected, for the account of clients, in stock options and stock futures traded on a recognized exchange company in Hong Kong. We would be happy to propose the wording for such an exemption.

3 "Client facilitation" transactions

When a dealer receives an order from a client to buy or sell Hong Kong shares, or a basket of shares, the dealer may commit to achieve a particular standard of execution (for example, no worse than the value-weighted average price for transactions in the market on the trading day). While the dealer will effect the purchases or sales as the client's agent, if this does not achieve the agreed execution price, part of the trade will be rebooked as a principal trade, to achieve that price. Similarly, a dealer may buy a block of shares from a client at an agreed price for immediate on-sale into the market, or may "go short" in order to fill an order from a client or from the market (for example, when acting as a liquidity provider in respect of structured products).

To the extent that the dealer is not acting as agent, the "agency brokerage" exemption in Section 323(1)(i) will not apply. However, we consider that an equivalent exemption from Part XV should be available in respect of interests/short positions temporarily arising in the course of effecting a transaction resulting from the instructions of a client, where the transaction is effected in the ordinary course of the dealer's business, and the interest or short position is held for no more than 3 business days and ceases on settlement of the transaction with the client.

4 IPOs and follow-on offers

In the context of an IPO, or a new issue of shares or convertible/exchangeable bonds by a listed issuer, the offering will normally be underwritten, and the issuer may grant a greenshoe option to the lead manager. There may also be arrangements for the syndicate to borrow stock from a substantial shareholder. There will be various legal agreements entered into, including among the managers themselves. As a result of the Securities and Futures (Price Stabilizing) Rules to be made by the SFC, stabilisation activities in connection with new issues will also be permitted.

The analysis of when the lead manager and/or the other syndicate members are to be regarded as having an interest/short position/change in nature of interest arising through their underwriting commitments, the greenshoe option, stock borrowing and stabilisation activities, is a matter of great complexity. The problems will be exacerbated in the case of a new issue by an already-listed corporation. Under the Ordinance, an interest includes an interest in unissued stock of a Hong Kong listed corporation. Therefore, as soon as the underwriting agreements and greenshoe option are entered into, this is likely to trigger disclosure.

In the context of a new issue, to report the interests/short positions of the syndicate members prior to the offering taking place, and during the stabilisation period, could be very onerous. There could be a large element of "double counting" among the various syndicate members, and the information provided to the market could give a misleading picture as to the success of the offering. Where stabilising activities are being conducted, disclosures under Part XV could make it more difficult to carry out legitimate stabilising activities and undermine the maintenance of an orderly market.

Under the Securities and Futures (Keeping of Records) Rules, the Price Stabilisation Rules and the Corporate Finance Adviser Code of Conduct, the syndicate members already have extensive obligations to keep records in relation to the offering. It is also necessary to announce the results of the offering, and we understand that the SFC may also require an announcement at the end of the stabilising period, in respect of stabilising activities that have taken place. Further disclosures under Part XV are not needed to achieve "transparency" or to provide the regulators with information on market activities. . As noted above, disclosure could be misleading, and could conflict with the policy of allowing stabilising activities to be conducted during the stabilization period with disclosure of such activities only being made after the end of the stabilising period.

We propose an exemption from Part XV for interests/short positions of the managers of an issue of securities potentially arising as a result of activities carried out for or on behalf of the syndicate of managers, during the period up to and 30 days after the date of the offering. (This 30 day period would tie in with the stabilization period permitted under the Stabilization Rules). Such an exemption would cover:

- underwriting commitments (this would not, of course, apply if an underwriter in fact has to take up any of the shares);
- greenshoe options;
- agreements among managers;
- stock borrowing to cover over-allocations;
- stabilising activities, including ancillary stabilising activities.

We would welcome the opportunity to discuss these issues further with the SFC. If it is not considered appropriate to include a blanket exemption for the above activities in the Regulation, another possibility might be for the SFC to grant exemptions, on a transaction by transaction basis, under Section 309 of the Ordinance.

If the SFC would like to discuss the issues raised in this paper collectively with the institutions referred to below, please contact Stephen Fletcher at Linklaters, 10/F Alexandra House, Hong Kong. Tel: 2901 5350.

Listing of financial institutions

Credit Suisse First Boston (Hong Kong) Limited

Goldman Sachs (Asia) L.L.C.

Morgan Stanley Dean Witter Asia Limited

Salomon Smith Barney Hong Kong Limited

Deutsche Securities Asia Limited

J.P. Morgan

Merrill Lynch (Asia Pacific) Limited

UBS Warburg