

Welcome to the second edition of the SFC's *Corporate Regulation Newsletter*. This series of newsletters highlights specific issues related to disclosures by listing applicants and listed companies.

In this edition we discuss disclosure of inside information generated by internal developments and investment portfolio performance. We advise taking care with information that has previously been announced and, lastly, talk about some issues relating to listing applications.

We hope that these articles will be of use to companies, sponsors, market practitioners and others interested in listed company disclosures. We would be grateful for your comments and feedback, including suggestions for topics you would like us to address in the future.

Please send your comments to CRnews@sfc.hk.

We look forward to hearing from you.

Previously disclosed inside information

In 2014, there was a burst of press interest when some companies issued profit warning announcements shortly after listing which stated that significant listing costs were among the main reasons for the profit decline. These costs were required to be published in the company's prospectus and so were already known to the public. As such, the existence or size of these costs would not normally be considered inside information. An announcement to repeat previously disclosed facts is not necessary and may even cause confusion.

If a company feels that it needs to make an announcement about matters previously disclosed in its prospectus, it should clarify the extent to which the information in the announcement differs from previously disclosed information. Clearly, if there has been a significant change in the facts and circumstances since the prospectus was issued, then an inside information announcement is warranted.

Highlights

- Previously disclosed inside information
- Disclosure of information generated by internal developments and investment portfolio performance
- Dual Filing Regime: customers' identities and IPO incentive schemes

Specific new information

Making an announcement repeating information, which in the prospectus is detailed, unambiguous and quantifiable, is rarely required under the statutory regime for disclosure of inside information, Part XIVA of the Securities and Futures Ordinance (SFO). However, this would not apply to some of the more general comments in a prospectus, such as the risk disclosures.

For example, potential work stoppages at a factory might be disclosed as a risk factor. In such a case, a subsequent suspension of factory operations is likely to be specific information which is not generally known to the public. The company would have to consider whether the disclosure of the information would have a material effect on its share price and hence whether an inside information announcement under the SFO was required. The company could not rely on its previous disclosures in the prospectus, as vague references to possible future events do not fulfil a company's disclosure obligations if any of those events come to pass.

One-off events

There have been other instances of confusion caused by the repetition of information in announcements described as profit warnings or alerts. For example, the absence of a one-off gain which was included in the prior year is commonly cited as a reason for the decline in profits in the current year. By definition, one-off, extraordinary, discontinued or other similarly described items are not expected to reoccur, and therefore the fact that they did not reoccur would not normally be considered inside information. Where a company seeks to highlight the absence of a one-off event and this has the effect of masking the impact of other factors on its financial performance, it may be regarded as having made a misleading statement. For example,

- A company announces that its profits for 2015 will be substantially reduced from 2014's \$500 million due to the absence of the previous year's gain of \$300 million arising on the sale of a subsidiary.
- The company then issues the 2015 accounts showing a loss of \$50 million.
- Adjusting for the one-off gain in 2014, there was a shift from a profit of \$200 million in 2014 to a loss of \$50 million in 2015. Such a significant change in trading performance is likely to have been evident quite early on and needs to be considered independently from the previous year's one-off gain.

Repeating disclosures

Similarly, some companies announce an event more than once in the same year. This is sometimes seen in profit alerts or warnings where the same disclosures are repeated in both the interim and year-end reports. For example,

- A company announces that its profits for the six-month period increased due to a gain arising from the sale of a building.
- It then issues a profit alert at the end of the year stating that its yearly profits increased substantially due to the significant gain from the sale of a building.

There is no statutory requirement to refer specifically to the gain on the property sale as a factor in the increased profits for a second time. The gain arising on the sale of the building has been made known to the public and so the company is not obliged to disclose such information again under the SFO.

Some companies may feel that repeating the details helps investors to put the property sale and resulting gain into perspective when considering the results of the full year. But, if the two announcements were sufficiently vague or unclear that they might cause some investors to think that there were two separate transactions resulting in gains, then the company may be regarded as having made a misleading announcement.

Inside information generated by internal developments

Inside information is defined in section 307A of the SFO. In broad terms, it includes specific information about a company that, if made public, would be likely to materially affect the price of its listed securities. This definition does not include any reference to how the information might be created.

The SFC's Guidelines on Disclosure of Inside Information set out a non-exhaustive, indicative list of events or circumstances where a company should consider whether a disclosure obligation arises. Many of the examples given in the list involve transactions such as takeovers, major restructurings, the acquisition or disposal of major assets, or the signing (or cancellation) of a major sales contract.

However, there are other circumstances which give rise to the creation of inside information. As mentioned in paragraph 85 of the aforementioned guidelines, the trading performance of the company is an example of inside information generated within a company which may not be directly related to specific events. The determination of when trading performance is inside information that needs to be disclosed can be a difficult judgment. A number of factors, many of which are likely to be company-specific, have to be taken into account. Although it is impossible to provide an exhaustive list, companies would need to consider at least the following:

Certainty – Companies are rightly cautious about providing the market with precise figures for expected long-term earnings. However, that does not mean that the company needs to know the level of profit for a period to the nearest dollar before deciding that its trading performance amounts to inside information. Some care needs to be taken in assessing whether an apparent change in results is merely a short-term effect or indicative of a longer-term trend. But increased profits arising from strong customer orders should not be ignored solely because there is no absolute certainty that the customers will place orders at the same rate in the future.

Expectations – Companies should consider how results match market expectations. Under normal circumstances, if trading profits for the period were substantially lower than the previous period, this would very likely be inside information. But if the company has already warned investors that such an outcome is expected due to the loss of a significant contract, then it is much less likely to be inside information.

Likewise, a property investment company may believe that because property prices in the relevant market had dropped 10%, the expectation would be that their portfolio had dropped a similar amount. However, if the company had a track record of consistently beating the market or the consensus of analyst comments were more favourable, then it should still consider making an announcement. Also, if the local press does not closely follow the relevant market (for example, an overseas property market), the company should still consider making an announcement, even if its performance is in line with analyst expectations, as the public may not be equally well informed about the property market concerned.

Materiality – Just because one month's trading results are higher than expected, this might not be sufficient to justify an announcement. But if that month's sales figures are of particular importance (eg, December sales in the run up to Christmas) then the performance in that month can be the difference between a good year and a bad year. A single-month figure can be of such significance that a trading update would be appropriate.

Disclosure of investment portfolio performance

Similarly, these three aspects may be just as relevant when considering making disclosures in connection with investment gains or losses on investment portfolios.

Certainty – Gains or losses arising from disposals of listed investments do not need to be confirmed by an auditor before they can be announced. Nor do fair value adjustments of listed investments which can easily be marked to market. If the gains or losses are sufficiently material to be considered as inside information, the company should consider whether an announcement is appropriate.

Expectations – If the investment portfolio of listed shares held by a company has been previously disclosed – such details often form part of the interim and annual accounts – then, if there have been no significant changes to the portfolio, investors can gauge the changes in value of such a portfolio and the significance to the finances of the company. However, if the portfolio has changed and now has a very different valuation from an unchanged portfolio, the company should consider whether an announcement is necessary.

Materiality – If part of a company's business is trading in shares, then there is no requirement to inform the market of normal fluctuations in portfolio valuation on a daily basis. However, if in early January such a company disposes of an investment at a significant gain over the previous book valuation, or the market valuation of a listed investment held, but not previously disclosed, increases enough to materially affect projected profits for the period, it is unlikely to be reasonable to only disclose that fact in the interim results announcement for the period to June.

Where an investment portfolio may significantly affect a company's finances, it is worth considering disclosing the portfolio's details at least on a half-yearly basis.

Dual filing regime

Under the new sponsor regime, a sponsor should come to a reasonable opinion that the application proof of the draft listing document is “substantially complete” except in relation to matters that by their nature can only be dealt with at a later date. The available evidence suggests that practitioners have generally complied with this requirement, and it appears that the requirement has had the positive effect of speeding up the listing process.

Due diligence is the sponsor’s job

Disclosure alone is not enough to protect investor interests. The sponsor should also ascertain the accuracy of the information disclosed. It is the sponsor’s responsibility to conduct reasonable due diligence on the listing applicant and its listing document and to bring to the regulators’ attention any fundamental issues which might adversely affect the sustainability and legality of the applicant’s business. Similar to securities regulators in other leading jurisdictions, the SFC is not in a position to verify all statements in listing documents. It is unacceptable for sponsors to rely on the regulators’ enquiries to uncover disclosure deficiencies.

A listing document is the applicant’s document for which its directors and advisers take responsibility. While the SFC reviews listing documents in parallel with The Stock Exchange of Hong Kong Limited (SEHK) under the dual filing regime¹, the SFC’s objective is mainly to assess whether investors are given sufficient information to make an informed assessment of a listing applicant’s business, prospects and risks and whether the listing would be in the interest of the investing public or in the public interest. As such, the SFC’s commenting process focuses on disclosures regarding issues of material importance, rather than examining every single detail in a listing document.

Disclosure of customers’ identities in marketing documents

Where a significant portion of an applicant’s revenue is derived from a few customers, customer identity information is useful for investors to properly understand the applicant’s business. We strongly encourage applicants to disclose the identities of their major customers in listing documents. If customer identities are not disclosed in the listing document, the applicant and the sponsor are obliged to take reasonable steps to ensure that this information is not included in any marketing communication provided to analysts or investors.

IPO incentive schemes

From time to time companies come forward with proposals for initial public offerings (IPOs) which include an incentive scheme. Such schemes can be constructed in many different ways. For example, they may be related to the purchase of shares in the IPO itself or to the continued holding of IPO shares as a means to reward shareholder loyalty. The actual incentive may be set at a flat rate so that any investor receives the incentive whatever amount of shares are held, or it may be directly related to the total holding either at IPO or after some time has passed.

Some apparent incentives can be easily priced and understood. A buy-one-get-one-free promotion might persuade someone to buy more of something at the supermarket. It is easy to understand that this is the same as buying each item at half price. The effective price can be compared to the price of the same item at other shops (or the previous price at the same shop) and when the items are bought the incentive effect is effectively finished.

¹ The Securities and Futures (Stock Market Listing) Rules require a listing applicant to file its listing application with both SEHK and the SFC for review.

However, incentive schemes relating to IPOs can be constructed in many different ways and may involve incentives which are only distantly related to the shares being offered, and in such circumstances it may be hard to understand the value of the incentive. The conditions relating to the grant of the incentive, or its withdrawal, can also affect the decision to buy shares in the IPO and having bought them, whether to continue to hold them in light of the changing market price.

Making an investment decision based on the expected future value of a company is not a simple exercise, even for a straight forward IPO. The addition of an incentive scheme creates additional complications to the investment decision.

Any incentive scheme that may unduly influence the investment decision will always raise questions concerning its appropriateness and is likely to be carefully scrutinised by the SFC. Where there are sufficient concerns that an incentive would unduly influence the investment decision, the SFC may use its powers under Rule 6 of the Securities and Futures (Stock Market Listing) Rules to object to the listing. An issuer considering the use of such an incentive scheme is advised to discuss the matter with SEHK and the SFC at an early stage in the listing process.

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