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NEW SFC GUIDANCE ON INSIDE INFORMATION AND LISTING DOCUMENT DISCLOSURE AND APPROPRIATENESS OF IPO INCENTIVE SCHEMES

The Securities and Futures Commission's (the **SFC's**) latest Corporate Regulation Newsletter (Issue No. 2 of April 2015)¹ includes guidance on:

- Aspects of listed companies' obligation to disclose inside information under Part XIVA SFO including:
 - disclosure of inside information generated by internal developments and investment portfolio performance; and
 - the announcement of previously disclosed inside information; and
- Listing applicants' disclosure of customer identities; and
- IPO incentive schemes.

LISTED COMPANIES' INSIDE INFORMATION DISCLOSURE OBLIGATION

1. Previously Disclosed Inside Information

Companies should not make repeated disclosure of the same set of facts unless changes in the facts and circumstances would have a material impact on their share price and thus warrant the issue of a further inside information announcement.

¹ SFC Corporate Regulation Newsletter Issue no. 2 of April 2015 available at http://www.sfc.hk/web/EN/files/ER/Reports/CRN/CR_201504.pdf

An example given by the SFC is profit warning announcements issued by companies shortly after listing stating that significant listing costs were a main reason for profit decline. Since listing costs are required to be published in a company's prospectus, they are already known to the public and thus the amount of the costs is not normally considered to be inside information. Announcement of information that has already been disclosed is unnecessary and may cause confusion.

The following provides a summary of the SFC's advice regarding the announcement of inside information in respect of previously disclosed matters.

If companies believe that repeated disclosure regarding the same event should be made, they should make clear the extent to which the information in the new announcement differs from the information previously disclosed. An inside information announcement should be published where there has been a significant change in the facts and circumstances previously published.

Specific new information

The SFC states that clear, thorough and measurable disclosure made in the prospectus generally need not be repeated in an inside information announcement. Inside information announcements may however be required in respect of 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. A subsequent work stoppage is likely to be specific information which is not generally known to the public. The company would then have to consider whether the disclosure of the information would have a material effect on its share price. If it considers that it would, it would need to issue an inside information announcement under the SFO. The company cannot rely on its previous prospectus disclosure since this contains only vague references to possible future events and would not fulfil the company's disclosure obligation if the events subsequently materialise.

One-off events

The SFC notes that confusion is sometimes caused by the repetition of information in profit alerts and warnings. For example, the absence of a one-off gain which was included in the prior year is often cited as a reason for the decline in profits for the current year. By definition, one-off, extraordinary, discontinued and other similar items are not expected to reoccur; the fact that they do not reoccur will therefore not normally constitute inside information which needs to be announced.

Repeated disclosures

Some companies announce an event as inside information more than once in the same year, for example in profit alerts or warnings for both the interim and year-end results. For example, a gain from the sale of a building which is announced in respect of a company's interim results does not need to be disclosed again as a factor resulting in increased profits for the year-end results. The danger of repeated disclosure is that if the announcement is vague or unclear, investors may be misled into believing that two separate events occur during the financial year and thus misjudge the company's financial position.

2. Information Generated By Internal Developments

Trading Performance

The definition of inside information in section 307A of the Securities and Futures Ordinance (**SFO**) is broadly specific information about a company that, if made public, would be likely to materially affect the price of its listed securities.

The SFC Guidelines on Disclosure of Inside Information contain a non-exhaustive list of events or circumstances where a company should consider whether an obligation

arises to disclose inside information. Many of the examples involve transactions such as takeovers, major restructurings, the acquisition or disposal of major assets, or the signing (or cancellation) of a major sales contract.

There are however other circumstances which may give rise to the creation of inside information. The trading performance of a company is an example of inside information which is not directly related to specific events. When determining whether trading performance is inside information that must be disclosed a number of factors need to be considered, many of which are likely to be company-specific. The SFC recommends that companies take into account at least the following three factors:

i) Certainty

It is not necessary for a company to know the exact figures for profit for a period before deciding that its trading performance amounts to inside information. Care needs to be taken in assessing whether an apparent change in results is a short-term effect rather than indicative of a longer term trend. However, increased profits resulting from strong customer demand should not be ignored merely because there is no absolute certainty that customers will continue to place orders at the same rate in the future.

ii) Expectations

Companies should consider making inside information announcements if there is a mismatch between market expectations of the company's results and the actual results. Thus while a drop in trading profits compared to the previous period would normally be inside information, if the company has already warned investors that profits are likely to drop because of loss of a major contract, it is less likely that the information is inside information.

Similarly, a property investment company may consider that if property prices in the market have dropped by 10%, the market's expectation would be that their portfolio had dropped by a similar amount. If, however, the company has a track record of beating the market, or if analyst comments were more favourable, the company should still consider making an announcement. If the local press do not closely follow the relevant market (e.g. 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 are unlikely to be equally well informed about the market concerned.

iii) Materiality

A single month's trading figure of particular importance, e.g. significant in determining whether it will be a good or bad year, warrants an inside information announcement.

3. Investment Portfolio Performance

Companies are recommended to consider at least the following factors when deciding whether to announce investment gains or losses on investment portfolios:

1. Certainty

Companies should consider whether to announce as inside information material gains or losses arising from disposals of listed investments and fair value adjustments of listed investments which can easily be marked to market. It is not necessary for the exact amount of the gain or loss to be confirmed by an auditor before announcement.

2. Expectations

Where an investment portfolio of listed shares has previously been disclosed – usually in the interim and annual accounts – no disclosure is necessary if there have been no significant changes to the portfolio. However, if the portfolio has changed and has a very different valuation, the company should consider whether an announcement is necessary.

3. Materiality

Companies who trade in shares as part of their business do not need to inform the market of normal fluctuations in portfolio valuation on a daily basis. However, if in early January the 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 will probably not be reasonable to only disclose that fact in the interim results announcement for the first half year. An announcement of inside information should therefore be considered.

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

Customer identities and IPO incentive schemes under the Dual Filing Regime

Sponsor due diligence

As required by the Hong Kong sponsor regime, sponsors should come to a reasonable opinion that the information in the Application Proof is substantially complete except for information that by its nature can only be finalised and incorporated at a later date. In addition to ensuring sufficient disclosure, sponsors are required to ascertain the accuracy of listing document disclosure through the conduct of reasonable due diligence. Sponsors are further required to alert the regulators to fundamental issues which might adversely affect the sustainability and legality of the listing applicant's business.

Under the Hong Kong dual filing regime², the SFC and the Hong Kong Stock Exchange (the **Exchange**) review listing documents in parallel. The SFC requires inclusion in the prospectus of information necessary to enable investors to make an informed assessment of the company's business, prospects and risks attached to its shares and whether the listing would be contrary to the interest of the investing public or in the public interest. The SFC's assessment process is therefore concerned only with issues of material importance.

Disclosure of major customers' identities

The SFC recommends applicants to disclose the identities of their major customers in their listing documents, especially if a few customers only are responsible for a large part of the company's revenues. If a listing applicant does not disclose customer identities in its listing document, the listing applicant and its sponsor must take reasonable steps to ensure that this information is not included in any marketing communication provided to analysts or investors.

IPO incentive schemes

The SFC notes that listing applicants sometimes offer incentive schemes to encourage purchase of shares in the IPO or the continued holding of IPO shares after listing, i.e. to reward shareholder loyalty.

² The Securities and Futures (Stock Market Listing) Rules

The actual incentive may be set at a flat rate so that all investors receive the incentive irrespective of the number of shares held, or it may be directly related to the total holding either at IPO or after some time has passed. Unlike normal sales promotion in stores, such as buy-one-get-one-free or half price of items, there are a number of different ways of structuring incentive schemes and the incentives provided may be only distantly related to the shares being offered, making it difficult for investors to properly evaluate the incentive.

The conditions relating to the grant and withdrawal of the incentive can also affect investors' decision to buy and hold. Any incentive scheme that may unduly influence the already complicated decision of whether to invest is likely to be carefully examined by the SFC, which may object to the listing if there are sufficient concerns that the incentive scheme will unduly influence the investment decision.³ Listing applicants who wish to offer incentive schemes in relation to their IPOs are therefore encouraged to discuss the matter with the Exchange and the SFC at an early stage.

³ Rule 6 of the Securities and Futures (Stock Market Listing) Rules sets out the SFC's powers to require further information and to object to listing

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