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HKCGI Securities Law and Regulation Guidance Note (Ninth Issue) – SFC's Initiatives to Address Cross-Border Insider Dealing

SFC's Initiatives to Address Cross-Border Insider Dealing

Governance professionals must stay abreast of the most recent enforcement-related regulatory reforms. The purpose of this guidance note is to keep them well-informed. In June 2022, the Hong Kong Securities and Futures Commission (**SFC**) consulted the market on proposals to broaden certain enforcement-related sections of the Securities and Futures Ordinance (**SFO**) referred in this guidance note. In response to the expansion of the territorial reach of the SFO's provisions on insider dealing, which is most directly related to listed issuers of all the proposals made, our Institute submitted that:

'In relation to the proposal to extend insider dealing in Hong Kong to securities or derivatives listed overseas, we need more clarity on the scope of the proposed legislation to comment further. For example, would insider dealing be determined by reference to Hong Kong or the law of the overseas jurisdiction? How would our mutually exclusive criminal or civil regime work if there are no corresponding regimes in the overseas jurisdictions, or if the regimes are mutually inclusive? Concerning criminalising this type of conduct, would this amount to a 'thought crime' meaning taking steps to commit insider dealing being the yardstick to find criminal liability, or would there be a need to have actual insider dealing committed in the overseas jurisdiction? From the governance perspective, we recommend more guidance and investor education if a change is made to the SFO's reach beyond Hong Kong.'

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On 8 August 2023, the SFC released its consultation conclusions. In light of industry feedback, the SFC will move forward with the proposed amendments to the insider dealing provisions within the SFO, empowering the SFC to address instances of cross-border insider dealing. Clarification has been provided in the consultation conclusions regarding the scope and applicability of the suggested amendments raised by some of the respondents. The industry will have the opportunity to review the draft amendments to the SFO during the legislative process. This will provide clarity and ample time for organisations to revise their internal compliance policies and manuals, eliminating the need for a transition period.

The constraints with the SFO's insider dealing provisions

The SFO currently covers insider dealing in (a) Hong Kong-listed securities and their derivatives; and (b) securities dual-listed in Hong Kong and another jurisdiction, along with their derivatives. Nevertheless:

- It does not explicitly encompass instances of insider dealing occurring outside Hong Kong that involve Hong Kong-listed securities or their derivatives.

- Additionally, the SFC has been constrained in addressing suspected insider dealing of securities listed overseas. While it can share intelligence with overseas securities regulators, such regulators may, for various reasons, not consider it appropriate to take action in their jurisdictions, particularly if much of the evidence required to substantiate the misconduct is in Hong Kong. The SFC has also sought to combat insider dealing of overseas-listed securities perpetrated in Hong Kong by pursuing civil remedies under section 213. In such cases, the SFC demonstrated that the activities contravened section 300, which forbids fraudulent or deceptive conduct in transactions involving securities.

These limitations contrast with other major common law jurisdictions. Hence, the SFC proposed expanding the insider dealing regime to encompass:

- insider dealing occurring in Hong Kong involving overseas-listed securities or their derivatives; and

- insider dealing occurring outside Hong Kong involving any Hong Kong-listed securities or their derivatives.

Clarification provided in the consultation conclusions

The SFC garnered broad support for this proposal and will proceed with the amendments outlined in the consultation paper. The SFC also addressed requests for clarification by the Institute and other respondents in the consultation conclusions:

- The revised provisions will specify that the misconduct must also be unlawful in the relevant overseas jurisdiction (the consultation paper noted that a new subsection would be introduced under section 282 for the civil regime and section 306 for the criminal regime to this effect). Given that the primary objective of the proposal is to empower the SFC to combat cross-border insider dealing, the SFC will not narrow the scope of this power by prescribing a list of selected overseas markets to which the revised provisions will apply.

- The present definition of 'derivatives' and the applicability of the insider dealing framework to over-the-counter transactions in listed debt securities will remain unchanged. The expanded insider dealing framework will encompass such transactions involving both Hong Kong-listed and overseas-listed debt securities unless one of the statutory defences applies. In essence, it's the territorial scope that is being changed.

No transition period will be provided upon the implementation of the revised insider dealing provisions. The SFC has expressed confidence that those affected will have sufficient time to revise their internal compliance policies and manuals during the period between the publication of the legislative amendments and the passing of such amendments by the Legislative Council.

The governance professional working for licensed firms should be mindful that the requirement to report breaches under the Code of Conduct for Persons Licensed by or Registered with the SFC will apply to the updated insider dealing provisions, including insider dealing of overseas-listed securities. They are required to submit a report upon becoming aware of any suspected breaches. In relation to concerns over cross-border data transfer restrictions, the SFC responded that firms should use their best endeavours to obtain any data that is located overseas (for example, where there is suspected insider dealing in overseas-listed securities) to submit in their report to the SFC.

Other proposed amendments deferred

The governance professional should also know that the following proposals were put on hold in light of the concerns and complexities highlighted by most respondents:

- Amending section 213 to expand the grounds on which the SFC can seek court orders, including compensation orders, after exercising its disciplinary powers under sections 194 or 196 against a regulated person.

- Narrowing the professional investor (**PI**) exemption to section103(1) (offence to issue advertisements, invitations or documents relating to investments in certain cases) under section 103(3)(k), along with corresponding modifications to section 103(3)(j) to align with the original intended purposes of section 103.

With regard to section 213, the SFC will conduct further evaluations of the effectiveness of existing avenues for seeking financial redress by or for aggrieved investors and explore a full range of other options to achieve the policy objective of enhancing the prospects of investors receiving fair compensation in cases of intermediary misconduct, including strengthening the SFC's disciplinary framework. This might mean that the SFC's objectives can be achieved without primary legislation.

Concerning section 103, the SFC has chosen not to proceed with the proposal in its current form, but will continue to monitor the necessity of introducing new policies over the long term. It is possible that the SFC may engage the industry in further consultations.

Additional comments on PI exemption under section 103

The governance professional (**PI**) should also note the SFC's reminder in the consultation conclusions that anyone seeking to invoke the PI exemption must be able to demonstrate a clear intention to distribute the investment product exclusively to PIs. To demonstrate this intention, the issuer of an advertisement should, at a minimum, ensure that it is plainly apparent from the face of the advertisement that the investment product is intended only for distribution to PIs. The SFC considers that the clear display of an appropriate message or warning on all advertising materials would significantly contribute to establishing this intent.

It is worth noting that in the Pacific Sun case, the Court of Final Appeal concurred with the appellants' argument that section 103(3)(k) does not require that it be made apparent on the advertisement itself that it is made in respect of PIs. It only requires a person invoking the exemption to demonstrate that the relevant investment is in fact intended solely for PIs. Although the current market practice is arguably sufficient to guard against the sale of complex and risky products to retail investors, issuers of advertisements should still carefully consider how best to demonstrate and evidence a genuine intention to distribute an

investment product only to PIs, especially in light of the SFC's most recent comments.

The SFC is contemplating providing additional guidance to the market on this subject.

Overall comment

The SFC will continue to evaluate the effectiveness of existing avenues for seeking financial redress by or for aggrieved investors and explore a broad range of alternatives to achieve its policy objective, including bolstering its disciplinary framework.