



By Email (marketsounding_consultation@sfc.hk)

8 December 2023

The Securities and Futures Commission
54/F One Island East
18 Westlands Road
Quarry Bay, Hong Kong

Dear Sir/Madam,

Re: Consultation Paper on the Proposed Guidelines for Market Soundings

CFA Society Hong Kong (the **Society** or **we**) appreciates the opportunity to respond to the Securities and Futures Commission (the **Commission**)'s consultation paper on the Proposed Guidelines for Market Soundings (the **Proposed Guidelines**). As an organization committed to promoting fair and transparent capital markets and safeguarding investors' interests, we are pleased to provide our comments and suggestions in alignment with our mission. Unless otherwise defined herein, capitalized terms used in this letter shall have the same meanings as those defined in the Proposed Guidelines.

First and foremost, we welcome the Commission's proposal to introduce a set of specific guidelines for market soundings. The Proposed Guidelines aim to provide clarity on regulatory expectations, deter substandard conduct, ensure a level playing field in the industry and assist intermediaries in upholding market integrity during market soundings. We agree with the Commission's view that a well-defined market soundings regime is essential for maintaining market integrity and investor confidence.

Enhancing market efficiency through market soundings

Market soundings play a vital role in enhancing market efficiency. Empirical research has demonstrated that effective market soundings associated with block trades contribute to enhancing liquidity and facilitating price discovery, particularly for stocks with low liquidity in on-exchange limit-order book (HKEX research 2019¹) which, therefore, minimize price impact and uncertainty for both active and passive asset managers. With the asset management industry experiencing significant growth, there has been an increased demand for block trading¹. In particular, Hong Kong's position as the premier asset and wealth management hub in Asia² further emphasizes the importance of efficient block trading with effective market soundings.

¹ Chief China Economist's Office, Rising Demand for Block Trading in the Mainland and Hong Kong Securities Markets, HKEX Research Report (October 2019)

² https://www.fstb.gov.hk/fsb/en/business/policy_highlights/asset-and-wealth-management.htm





Insights from major jurisdictions

Drawing upon the experience of major jurisdictions, the spirit of the market soundings regime seeks to balance the benefits of board-investor dialogue with the core ideal of market egalitarianism. Market egalitarianism asserts that all investors should have equal access to information in marketplace (J. Payne 2022³) and is catered to by insider dealing regime, a framework established to prevent privileged access to information for undue economic advantage.

However, the insider dealing regime poses practical challenges when it comes to market soundings, which involve selective disclosure of inside information to gauge the interest of potential investors in private placements or block trades. This creates a dilemma in ensuring fair treatment of investors while maintaining market efficiency. To address this, the European Union first introduced an EU-wide market soundings regime⁴ to protect companies and other actors from disseminating certain non-public material information under the insider dealing regime. The objective is to promote the efficient functioning of the market⁵.

Our perspectives

We believe that the Proposed Guidelines should strike a balance between the interests of issuers, market intermediaries, and investors. In addition, it should take into account the practices of major financial markets while considering Hong Kong-specific nuances. Consistent with the above principles, CFA Code of Ethics & Standards of Professional Conduct⁶ strictly require that all Society members and CFA candidates must not act or cause others to act on material nonpublic information (refer to **Appendix II** – Summary of the CFA Institute's Standard of Professional Conduct II(A)—Material Nonpublic Information). To ensure adherence to this crucial requirement, we have developed an extensive array of training resources and case study materials, such as those related to market sounding (refer to **Appendix I** - Extract of the CFA Institute's Ethics in Practice – Ethics in Investment Management Casebook⁷). These educational tools support our members in understanding and adhering to the obligations associated with handling inside information and market soundings.

³ Payne, Jennifer, Market Soundings Rules: The Challenges and Opportunities for Board-Shareholder Engagement (December 13, 2022). Forthcoming in Board-Shareholder Dialogue: Policy Debate, Legal Constraints and Best Practices (Luca Enriques & Giovanni Strampelli eds, Cambridge University Press)

⁴ Market Abuse Regulation, Article 11

⁵ Market Abuse Regulation, Recital 32

⁶ CFA Institute, Standard II(A) Material Nonpublic Information: <https://www.cfainstitute.org/en/ethics-standards/ethics/code-of-ethics-standards-of-conduct-guidance/standards-of-practice-II-A>

⁷ CFA Institute, Ethics in Practice – Ethics in Investment Management Casebook (October 2019): <https://www.cfainstitute.org/-/media/documents/ethics-in-practice/ethics-in-practice-casebook-2nd-edition-web.pdf>



**CFA Society
Hong Kong**

Thank you for your consideration of our views and perspectives. We welcome and appreciate the opportunity to meet and provide you with more details on our letter and the appendices. We have set out our detailed comments and suggestions in the response section of this letter. Should you have any questions or seek further elaboration on our responses, please contact Mr. Matthew Chan, the Managing Director of the Society at matthew.chan@cfahk.org.

Yours faithfully,
For and on behalf of
CFA Society Hong Kong

Matthew Chan
Managing Director



**CFA Society
Hong Kong**



Response Section

Questions 1 to 3

- *Do you agree with the scope of application of the Proposed Guidelines? If not, please explain.*
- *Do you consider the definition of “market soundings” to be clear and appropriate? If not, please explain.*
- *Do you have any comments on the examples of factors to consider when determining the level of certainty of the corresponding potential transaction materialising in connection with a market sounding?*

We have the following comments on the proposed scope, definition and the “level of certainty” test. We observed that the notable difference in the Proposed Guidelines as compared to the practices in other major jurisdictions, including the European Union and the United Kingdom, is the inclusion of non-price sensitive information and pre-engagement market activities of sell-side brokers under regulatory purview (referred to as the **Additional Scope**), which may create unnecessary regulatory complexities.

As such, we suggest refining the definition and scope of the Proposed Guidelines to align with international market practices, focusing on the communication and disclosure of price sensitive information (i.e., inside information⁸ under the laws of Hong Kong). This approach would leverage the existing inside information regime, provide clarity to market participants, and minimize confusion and regulatory burdens.

Set out below are our observations on the findings of the thematic review and the recent determination of the Securities and Futures Appeals Tribunal (i.e., SFAT Application No. 1 of 2021) (the **SFAT Determination**), as well as the basis for our suggestions.

a) **The SFAT Determination and the Need for Guidance on Inside Information Provision**

We acknowledge that the Additional Scope aims to address the findings in the thematic review that some market intermediaries have expressed difficulty in determining inside information, and the SFAT Determination. However, we believe that these findings do not fully justify the Additional Scope.

⁸ Defined under Section 307A(1) of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (**SFO**): “Specific information that –

(a) is about –

(i) the corporation;
(ii) a shareholder or officer of the corporation; or
(iii) the listed securities of the corporation or their derivatives; and

(b) is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but would if generally known to them be likely to materially affect the price of the listed securities.”



- The Additional Scope covers all non-public information, regardless of whether it is material or price sensitive or not, so that market intermediaries may skip their inside information assessment in connection with market sounding. Nevertheless, the Proposed Guidelines introduces a new "level of certainty" test (outlined in paragraph 1.2(a) of the Proposed Guidelines) which remains subjective and complicated for market participants. We are uncertain about its effectiveness in addressing the issue of inaccurate inside information determination.

Furthermore, under the Additional Scope, even if the information involved is not considered material or price sensitive, the market intermediaries bear costs to go through the formalities under the Proposed Guidelines and will be restricted from dealings with the relevant securities. The Additional Scope in effect tightened the existing Code of Conduct⁹, which only captures non-public information expected to materially affect prices. This may impede market efficiency while its effectiveness in enhancing market integrity is questionable.

- Regarding the SFAT Determination, we understand that the case involved a SFC licensed person who dealt with overseas-listed securities after receiving price sensitive information from a market sounding call. That case highlighted a loophole¹⁰ arising from the limitations of inside information provisions on overseas-listed securities. In response, the Commission has proposed legislation amendments in August this year to fill the loophole by expanding the scope of inside information provision to cover overseas securities¹¹. Therefore, we believe that similar issues will be adequately addressed in the revised SFO without the need for the Additional Scope.

b) Well-established inside information and insider dealing regimes

The inside information and insider dealing regimes are fundamental to market integrity and have been widely recognized by market participants. For those market intermediaries who have difficulty determining what information constitutes inside information, we believe that they should adopt a more conservative approach in their assessments and seek necessary professional training and guidance. We believe that the Additional Scope and the additional "level of certainty" test do not address the root causes of such issue.

⁹ Paragraph 9.3 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, under which "a licensed or registered person should have procedures in place to ensure that its employees do not deal ... in securities or futures contracts where the employee concerned effects the dealing in order to "front-run" pending transactions for or with clients, or on the basis of other non-public information which would be expected to materially affect prices of those securities or futures contracts and which is to be released to the market."

¹⁰ The SFAT Determination involved a licensed person who was found guilty of insider trading in Korea. The defendant had engaged in share transactions (listed on the Korea Exchange) based on inside information obtained during a market sounding call in 2016. At that time, the insider dealing provision of the SFO did not apply to overseas-listed securities or their derivatives. As a result, the SFAT Determination was made solely based on the Code of Conduct.

¹¹ Consultation Conclusions on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance (August 2023) <https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=21CP3>



Given the above, we suggest that the Commission provides guidance on inside information provision in the context of market soundings through the publication of a frequently asked questions document (FAQ). The FAQ would aim to provide clarity on the definition and examples of inside information, mirroring the definitions and examples provided in international standards (refer to Appendix II, which summarized CFA Institute's standard and guidelines on inside information). This would not only offer practical insights to assist market sounding intermediaries in better understanding of and effectively applying the Proposed Guidelines, but also ensure a more consistent and streamlined regulatory framework.

c) The Code of Conduct – Client priority

The Code of Conduct already sets out requirements for handling of non-public material information, restricting "front-run" for transactions involving clients or based on inside information. It adequately expressed the general principle and our expectation of licensed persons in handling non-public material information during market soundings. Based on our experience, the Code of Conduct, as a set of general principles, is best served by a principles-based approach rather than in the form of specific guidelines. As such, we suggest that the Proposed Guidelines should be specific implementation guidelines under the inside information provision rather than guidelines in the Code of Conduct.

d) Unduly burdensome

The Additional Scope may place undue burdens on market soundings, potentially causing confusion and impairing the efficiency of price discovery. Given that the confidentiality of non-public information (price sensitive or not) may be already bound by the contract between the issuers and the market intermediaries (if applicable), as well as the Code of Conduct, the Additional Scope creates additional costs and formalities that might hinder legitimate market sounding process. For instance, under the Additional Scope, the person who would receive the information (even preliminary or non-price sensitive) is not allowed to engage in certain behavior, such as buying or selling securities of the issuer. In addition, empirical researches shows that there is little evidence that institutional investors want to receive inside information, since this then constrains their behavior in the markets very significantly¹². As such, we recommend a balanced approach that carefully considers the impact on market efficiency and explores ways to mitigate any unintended consequences.

¹² Strampelli, Giovanni, Knocking at the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor Engagement in Law and Practice (September 6, 2017). Virginia Law & Business Review, Forthcoming, Bocconi Legal Studies Research Paper No. 3044278, Available at SSRN: <https://ssrn.com/abstract=3044278> or <http://dx.doi.org/10.2139/ssrn.3044278>



In short, we appreciate the Commission's efforts but have concerns about the proposed scope, definition and the "level of certainty" test. We propose refining the definition and scope to align with international market practices, focusing on inside information under the inside information provision, and providing clear guidance to market participants. This approach would ensure clarity, consistency, and efficiency in the regulatory framework.

Questions 4 to 5

- ***Do you agree that a Market Sounding Intermediary has a duty to maintain the strictures of confidentiality of non-public information passed or received during market soundings? If not, please explain.***
- ***Do you agree that, from the standpoint of the Code of Conduct, a Market Sounding Intermediary should not trade on or use any non-public information passed or received during market soundings for its own or others' benefit or financial advantage? If not, please explain.***

We strongly agree that market sounding intermediaries should adhere to strict confidentiality requirements regarding non-public information obtained during market soundings. This duty arises from the contractual relationship between issuers and market intermediaries (if applicable), the requirements outlined in the Code of Conduct - Client Priority⁹, and the legal obligations under inside information provision⁸.

In accordance with the above principles and law, a market sounding intermediary shall not trade on or use any non-public information passed or received during market soundings for its own or others' benefit or financial advantage. In practice, the requirement may inevitably involve an assessment of whether there is an action for personal or others' benefit or financial advantage (**Benefit Test**).

As such, for sake of clarity, we suggest that the Commission aligns the Benefit Test with the threshold set by the inside information provision, as highlighted in our responses to Questions 1 to 3. This approach is also in line with the practices in other major markets (i.e., European Union) to protect companies and other actors from disseminating certain non-public material information under the insider dealing regime with an objective is to promote the efficient functioning of the market⁵.

In addition, we suggest that the Commission refines the scope of Core Principle 1 – Market Integrity to "trade on any material non-public information" instead of "trade on and use any non-public information", so as to align the scope with (i) the definition of insider dealing under Sections 270 and 291 of the SFO, and (ii) Article 11(5)(b) and (c) of the EU Market Abuse Regulation, which limits to trade on the information instead of using the information. An extract of the SFO and the EU Market Abuse Regulation are as follows:



- Sections 270 and 291 of the SFO set out that “insider dealing in relation to a listed corporation takes place, amongst others, when a person who has information which he knows is inside information and which he receives, directly or indirectly, from a person who he knows is connected with the corporation and whom he knows or has reasonable cause to believe held the information as a result of being connected with the corporation, deals in or counsels or procures another person to deal in the listed securities of the corporation, its derivatives, or those of a related corporation.
- Article 11(5)(b) and (c) of the EU Market Abuse Regulation states that (i) the person receiving the market sounding is prohibited from using that information, or attempting to use that information, by acquiring or disposing of, for his own account or for the account of a third party, directly or indirectly, financial instruments relating to that information; and (ii) the person receiving the market sounding is prohibited from using that information, or attempting to use that information, by cancelling or amending an order which has already been placed concerning a financial instrument to which the information relates.

Questions 6 to 7

- ***Do you have any comments on the Core Principles in the Proposed Guidelines as outlined above?***
- ***Are there any other areas which you think the Core Principles in the Proposed Guidelines should cover? If so, please provide examples.***

We agree that the Core Principles provide a common set of controls and practices for the Market Sounding Intermediaries to follow. We believe that the Proposed Guidelines do not need to provide detailed specifications regarding internal policies and procedures, but rather allow the Market Sounding Intermediaries to establish their own policies and procedures appropriate and proportionate to the scale, size and nature of their business activities.

Questions 8 to 12

- ***Do you agree with the proposal for Disclosing Persons to adopt the use of a standardised script? If not, please explain.***
- ***Do you have any comments on the minimum content and sequence of information set out in the standardised script?***
- ***Do you agree that Disclosing Persons should not provide specific information that may allow the Recipient Person or potential investor to identify the subject security before receiving relevant consent from the Recipient Person or potential investor? If not, please explain.***



- ***Do you agree that Disclosing Persons have an obligation to determine if non-public information disclosed by them during market soundings has been cleansed? If not, please explain.***
- ***Do you agree with the proposed periods of record keeping and details of the records to be kept by Disclosing Persons? If not, please explain.***

We agree with the specific requirements for Disclosing Persons. It is important to have uniform guidance to enhance accountability and market integrity.

Question 13 to 14

- ***Do you agree that a Recipient Person should designate a properly trained person(s) to receive market soundings? If not, please explain.***
- ***Do you agree with the proposed periods of record keeping and details of the records to be kept by Recipient Persons? If not, please explain.***

We agree with the specific requirements for Recipient Persons. Designating a consistent and properly training person(s) for each Recipient Person helps to limit the possibilities for dissemination of potential inside information. In addition, following our response to Questions 1 to 3 above, which suggest refining the definition and scope of the Proposed Guidelines to focus on inside information, we believe that the proposed record keeping requirements on Recipient Persons would not be unduly burdensome.

Question 15

- ***Do you think a six-month transition period is appropriate? If not, what would be an appropriate transition period? Please set out your reasons.***

We agree as the implementation and compliance of the final Proposed Guidelines primarily involves updating internal procedures and controls, rather than requiring extensive system changes that may require a longer transition period.



Appendix I:

Extract of the CFA Institute's Ethics in Practice – Ethics in Investment Management Casebook

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**ETHICS IN PRACTICE:
Investments and Trading – Case 2**

CASE STUDY

Hwang is the founder and lead portfolio manager of Tiger Asia Partners (TAP) and Park is a trader for the firm. TAP is participating in private placements for both Bank of China and China Construction Bank stock, and the placement agents shared confidential information with Hwang and Park about both companies. In the days prior to the private placement, Hwang directed Park to make short sales in each stock. TAP earned \$16.2 million by using the discounted private placement shares they received to cover the short sales. Park's actions were

- A. acceptable because he was following the orders of his superior.
- B. acceptable because he used a short position rather than trading in the bank stock itself.
- C. acceptable if the placement agents did not require a confidentiality agreement covering information about the private placements.
- D. unacceptable because the trade was based on material nonpublic information.

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Appendix I (continued):

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ETHICS IN PRACTICE: Investments and Trading – Case 2

ANALYSIS

This case relates to trading based on material nonpublic information (MNPI). CFA Standard II(A): Material Nonpublic Information prohibits members who have MNPI that could affect the value of an investment from acting or causing others to act on that information. Hwang and Park received MNPI about the bank stocks from the placement agents as part of the offering process. Park is not exempted from the requirements of the standards simply because his boss directs that he violate laws or ethical standards, so Answer A is not correct. Park should have advised Hwang that the actions he was being asked to take were unethical and likely illegal and refused the directive to trade. The prohibition on using MNPI goes beyond the direct buying and selling of individual securities and extends to any related derivatives (e.g., swaps or option contracts), mutual funds, other alternative investments, so Answer B is not correct. It would have been advisable for the private placement agents to ask Hwang and Park to sign a confidentiality agreement, establish a "fire wall" around the disclosure of that information, and agree not to trade on the information. But even absent such an agreement, Park is prohibited from trading on MNPI, therefore C is incorrect. Because the trading was based on MNPI, the trade was improper and Park's conduct is unacceptable – Answer D.

This case is based on an enforcement action by both the US SEC and the Securities and Futures Commission of Hong Kong.

ABOUT CFA INSTITUTE

CFA Institute is a global not-for-profit organization and the world's largest association of investment professionals. We are dedicated to developing and promoting the highest standards of ethics, education, and professional excellence in the investment industry, for the ultimate benefit of society. Our goal is to create an environment where investors' interests come first, markets function at their best, and economies grow.

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Appendix II:

Summary of the CFA Institute's Standard II(A)—Material Nonpublic Information

The CFA Institute's Standard II(A)—Material Nonpublic Information¹³ (the CFA Standard) within the Code of Ethics and Standards of Professional Conduct requires all CFA charterholders and CFA Institute members “who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on that information”. This CFA Standard applies to professionals in investment firms with access to such information, as well as issuers engaged in market-sounding activities. The CFA Standard broadly encompasses activities that could disclose material non-public information. Furthermore, individuals who receive investment recommendations based on inside information or confidential company information while assessing investment interest are also prohibited from trading based on such information.

Under the CFA Standard, information is “material” if its disclosure would probably have an impact on the price of a security or if reasonable investors would want to know the information before making an investment decision. In other words, information is material if it would significantly alter the total mix of information currently available about a security in such a way that the price of the security would be affected. The specificity of the information, the extent of its difference from public information, its nature, and its reliability are key factors in determining whether a particular piece of information fits the definition of material. The Standard also cites examples of material information, including but not limited to:-

- Earnings;
- Mergers, acquisitions, tender offers, or joint ventures;
- Changes in assets or asset quality;
- Innovative products, processes, or discoveries (e.g., new product trials or research efforts);
- New licenses, patents, registered trademarks, or regulatory approval/rejection of a product;
- Developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
- Changes in management;
- Change in auditor notification or the fact that the issuer may no longer rely on an auditor’s report or qualified opinion;
- Events regarding the issuer’s securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits, changes in dividends, changes to the rights of security holders, and public or private sales of additional securities);
- Bankruptcies;
- Significant legal disputes;
- Government reports of economic trends (employment, housing starts, currency information, etc.);
- Orders for large trades before they are executed; and
- New or changing equity or debt ratings issued by a third party (e.g., sell-side recommendations and credit ratings).

¹³ <https://www.cfainstitute.org/en/ethics-standards/ethics/code-of-ethics-standards-of-conduct-guidance/standards-of-practice-II-A#nonpublic>



Appendix II (continued):

Under the CFA Standard, information is “nonpublic” until it has been disseminated or is available to the marketplace in general (as opposed to a select group of investors). “Disseminated” can be defined as “made known”.

We would also like to draw your attention to the “Mosaic Theory” under the CFA Standard. Under the Mosaic Theory, financial analysts may use significant conclusions derived from the accumulation and analysis of bits and pieces of public and non-material non-public information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. The Mosaic Theory recognizes the value of financial analysts' ability to gather and analyze diverse information sources to form a comprehensive understanding of an issuer's prospects, while still maintaining a distinction between material and non-material non-public information. This promotes the efficient functioning of the market while safeguarding against potential misuse of truly material non-public information.

