GIBSON DUNN

Hong Kong's SFC Consults on Market Sounding Guidelines

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The Proposed Guidelines set out for the first time the specific regulatory requirements and the SFC's regulatory expectations in respect of market soundings in Hong Kong. On October 11, 2023, Hong Kong's Securities and Futures Commission ("**SFC**") published a consultation paper (the "**Consultation Paper**") on the proposed guidelines for market soundings (the "**Proposed Guidelines**").[1] The Proposed Guidelines are noteworthy since it sets out for the first time the specific regulatory requirements and the SFC's regulatory expectations in respect of market soundings in Hong Kong. This client alert will explore the SFC's proposals in greater detail. **I. Why introduce the Proposed Guidelines?** To understand the rationale of the requirements in the Proposed Guidelines, it is helpful to understand why the SFC has decided that it is the appropriate time to introduce the Proposed Guidelines. Firstly, the SFC observed an increasing number of persons trading ahead of placings and block trades, which suggested that some intermediaries may have unfairly taken advantage of non-public information received during market soundings to make unjustified profits. This led the SFC's thematic review of market sounding practices and controls adopted by intermediaries in 2022, where the SFC noted a divergence of practices among intermediaries in designing their risk controls over market soundings, which suggested that more clarity on the SFC's regulatory expectations was required to deter substandard conduct and to assist intermediaries in upholding market integrity during market soundings. Secondly, in light of the determination of the Securities and Futures Appeals Tribunal ("**SFAT**") on September 27, 2022 (the "**SFAT Determination**") in the Aarons case,[2] the SFC considered it appropriate to provide both sell-side and buy-side market participants with additional clarity on complying with the general principles in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "**Code of Conduct**") during market soundings. In summary, the case involved a hedge fund manager who entered into short swaps (which can be used for short selling) after the manager received non-public information about an intended block sale (a large, privately negotiated sale of securities) of shares in a listed Korean company from one of the underwriters of the block sale. The communication was made by the underwriter (a sell-side broker) to the hedge fund manager (a buy-side participant) as part of a market sounding to see if the manager would be interested in participating as a buyer on the block sale. After news of the block sale became public, there was a material drop in the share price of the listed Korean company, and the short swaps entered into by the hedge fund manager generated a profit for the fund he managed. The SFAT upheld the finding by the SFC that the hedge fund manager's conduct was such that he was not a fit and proper person to continue to be licensed, having regard to General Principles 1 (*Honesty and fairness*) and 7 (*Compliance*) of the Code of Conduct. In doing so, the SFAT determined that a two years suspension of the hedge fund manager's licence was the most appropriate sanction. It is relevant to note that the hedge fund manager was *not* charged with the offence of insider dealing under the Securities and Futures Ordinance (Cap. 571) ("**SFO**"). The reason is likely because the civil and criminal insider dealing regimes[3] under the SFO have a regulatory lacuna with respect to insider dealing committed in Hong Kong with respect to overseas listed securities. This regulatory lacuna will be addressed when amendments to the insider dealing provisions under the SFO are introduced (please see our earlier client alert[4] for further details). As such, in hearing the appeal, it was *not* necessary for the SFAT to determine whether or not the communication made to the hedge fund manager constituted "inside information" as defined in the SFO. Rather, the issue to be determined by the

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SFAT was whether the hedge fund manager's conduct breached the Code of Conduct (namely, General Principles 1 and 7).[5] The SFAT ultimately agreed with the SFC's findings that the hedge fund manager's deceitful conduct after receiving "material non-public information" about an impending block sale meant that he failed to adhere to principles of honest and fair conduct, and hence failed to act with the integrity that the market required, and in conclusion failed to comply with General Principles 1 and 7 of the Code of Conduct. **II. What communications are subject to the Proposed Guidelines?** The Proposed Guidelines would apply to the communication of non-public information – *irrespective* of whether or not it is price-sensitive "inside information"[6] – with potential investors prior to the announcement of a securities transaction, to gauge their interest in a potential transaction or assist in determining the specifications related to a potential transaction (such as private placements and large block trades) ("**Market Sounding**"), by intermediaries who:

- *Disclose* non-public information during the course of a Market Sounding ("**Disclosing Person**"), such as a sell-side broker acting on behalf of an issuer or an existing shareholder selling in the secondary market ("**Market Sounding Beneficiary**") in a potential securities transaction; and
- *Receive* non-public information during the course of a Market Sounding, such as a buy-side firm that is sounded out by a Disclosing Person as a potential investor in a potential securities transaction(collectively, a "**Market Sounding Intermediary**").[7]

It is important to highlight that the Proposed Guidelines apply to communications on all "non-public information", irrespective of whether the same information constitutes "inside information" under the SFO. It is also noticeable that, despite referring to the SFAT Determination, the Proposed Guidelines do not use the potentially narrower term "material" non-public information, as found in the SFAT Determination, and instead adopt the much broader term "non-public information". This appears to be intentional, as the Consultation Paper explains that one of the SFC's concerns was that intermediaries may run the risk of potential misconduct from an inaccurate determination of what constitutes "inside information", as it often involved complex judgment and interpretations and that it was not uncommon for parties to arrive at different conclusions)[8] – and presumably similar concerns apply to the determination of whether or not non-public information is "material" or not. Adopting the broader term "non-public information" therefore reduces the risk of inaccurate determinations. **III. What communications are not subject to the Proposed Guidelines?** According to the Consultation Paper, the Proposed Guidelines will *not* apply to communications regarding:

- Speculative transactions or trade ideas shared by a Disclosing Person without consulting with the potential Market Sounding Beneficiary or without any "level of certainty" of such transactions materialising. The Proposed Guidelines provides guidance on the factors to consider in determining whether there is some "level of certainty", such as the extent to which the Market Sounding Beneficiary has expressed an interest with the Disclosing Person in proceeding with a possible transaction, among other factors[9];
- Transaction in such size, value, structure or selling method, that are commensurate with "ordinary day-to-day trade execution", such as a sell-side broker sourcing potential buy-side participants to execute an ordinary size trade (in relation to the average trading volume or market capitalisation) after receiving an actual order instruction placed by the sell-side broker's client with a genuine intention for execution; and
- Public offering of securities.

The above carve-outs will be important in light of the wide range of Market Sounding communications that are likely to contain some form of "non-public information". However, internal procedures and controls will need to be carefully designed and

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implemented, or else intermediaries run the risk of potential misconduct from an inaccurate determination of whether a particular communication falls within the above carve-outs, and therefore failing to comply with the regulatory requirements in the Proposed Guidelines. The Proposed Guidelines also make clear that they may apply even *before* a formal mandate from the Market Sounding Beneficiary is received, i.e. as soon as the Disclosing Person starts to conduct any form of market sounding (soft or otherwise) on behalf of a Market Sounding Beneficiary. **IV. Core Principles of Market Sounding** The Proposed Guidelines contain a set of Core Principles ("**CP**"), which all Market Sounding Intermediaries should comply with in conducting Market Soundings. The CPs are briefly summarised below[10]:

- ***CP 1. Market Integrity***: Market Sounding Intermediaries should maintain confidentiality and not trade on or use non-public information passed or received during Market Soundings for the benefit of themselves or others until the information ceases to be non-public.
- ***CP 2. Governance***: Market Sounding Intermediaries should implement robust governance and oversight arrangements over its Market Sounding activities. This includes: (i) senior management are responsible for oversight of Market Soundings; (ii) establish governance arrangements for Marketing Soundings; (iii) designate a committee or person(s) independent from the "front-office" to monitor Market Soundings in support of senior management oversight; and (iv) develop and implement appropriate reporting lines and escalation processes to ensure any Market Sounding issues are promptly reported to senior management and the designated committee or person(s) for review and follow-up action.
- ***CP 3. Policies and Procedures***: Market Sounding Intermediaries should establish and maintain effective policies and procedures specifying the manner and expectations in which its Market Soundings should be conducted. The written polices and procedures should cover, among other matters: (i) when they become applicable and the timing and procedures of Market Soundings; (ii) allocation of roles and responsibilities among staff involved in Market Soundings, taking into account the "three lines of defence" and ensuring proper staff training; (iii) personal dealing restrictions; (iv) escalation protocols; (v) consequences for non-compliance with the Market Sounding requirements; (vi) categorisation, identification and handling of information during the course of Market Soundings; and (vii) record-keeping requirements.
- ***CP 4. Information Barrier Controls***: Market Sounding Intermediaries should implement adequate and effective physical and electronic information barrier controls to prevent inappropriate disclosure, misuse or leakage of non-public information during the course of Market Soundings. This includes, but is not limited to: (i) physical segregation; (ii) system user access controls; (iii) information sharing policies and procedures (e.g. Market Sounding information should be restricted to authorised personnel on a "need-to-know" basis and disclosed only through authorised communication channels); and (iv) maintaining a list of internal and external recipients of non-public information as well as "Restricted List" to prohibit trading on non-public information.
- ***CP 5. Review and Monitoring Controls***: Market Sounding Intermediaries should establish effective procedures and controls to monitor and detect suspicious behaviour, unauthorised disclosure, or misuse of information from Market Soundings. This includes periodic reviews of trading and communication surveillance controls, voice and electronic communications, and unauthorised access to information.
- ***CP 6. Authorised Communication Channels***: Market Sounding Intermediaries should only use recorded and firm-authorised communication channels to conduct Market Soundings, until the information ceases to be non-public.

Market Sounding Intermediaries are expected to periodically review and update their

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governance and oversight arrangements, policies and procedures, and internal systems and controls, to ensure that they remain robust and effective. **V. Specific requirements for Disclosing Persons** As the party that initiates Market Soundings, Disclosing Persons bear the initial responsibility to ensure that any non-public information associated with Market Soundings is properly safeguarded and disclosed in accordance with the standards of conduct set out in the Proposed Guidelines. To this end, the specific requirements applicable to the Disclosing Persons are more extensive than for the Recipient Persons, and are summarised below.[11]

Stage of Market Sounding	Specific Requirements
Pre-Market Sounding procedures	Before the initial contact with Recipient Persons or other potential investors to conduct a Market Sounding, a Disclosing Person should: • Conduct assessments to determine whether the information disclosed during the Market Sounding would constitute non-public information; • Obtain consent from the Market Sounding Beneficiary to engage in the Market Sounding; and • Determine *in advance*, on a case-by-case basis taking into account the requirements in the Proposed Guidelines: (i) a standard set of informatio to be disclosed to Recipient Persons, (ii) an appropriate timing to conduc the Market Soundings, and (iii) a suitable number of Recipient Persons t contact for the Market Sounding.
During the Market Sounding communications process	A Disclosing Persons should adopt a standardised pre-approved script that is reviewed by senior management or independent functions, such as Legal and Compliance, during initial and subsequent Marketing Sounding communications. summary, the script should at a minimum include: • A statement that the communication is for the purpose of a Market Sounding and that the Recipient Person shall keep confidential the non-public information, and not trade or use such information for its own or others' benefit until the information ceases to be non-public; • A statement that the conversation is recorded and to request the Recipie Person's consent for recording; • Confirm that the individual is the person designated by the Recipient Person to receive Market Soundings; • A statement that the Recipient Person will receive information which the Disclosing Person considers to non-public and a request for their consen to receive such information; and • An estimate of when the information will cease to be non-public, where possible. After obtaining the above consents, a Disclosing Person should provide a written confirmation to the Recipient Person as soon as possible, summarising the contents covered in its Market Sounding communications. Prior to receiving the Recipient Person's consent (as explained above), a Disclosing Person should ensure that any preliminary information shared with th Recipient Person is sufficiently broad, limited, vague and anonymised to minimis the change of the Recipient Person guessing the name of the security involved. Greater caution should be exercised in determining the amount of non-public information to be shared where the subject security may be identified even with t provision of only limited information (e.g. for narrow industry sectors) – for exam the situation in the SFAT Determination as discussed above.
Cleansing	After non-public information has been disclosed during a Market Sounding, a Disclosing Person should: (i) conduct assessments to determine whether the information has ceased to be non-public (e.g. following the announcement of the

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	transaction, or if the transaction was called off); and (ii) inform the Recipient Person(s) as soon as possible in writing when the information ceases to be non-public according to the Disclosing Person's assessment.
Record keeping	A Disclosing Person should keep the records in relation to its Market Soundings a period of not less than seven years. These records must include: • Consents obtained from Market Sounding Beneficiaries to engage in Market Soundings; • A list of Recipient Persons who informed the Disclosing Person that they *do not* wish to receive any Market Soundings; • Audio, video or text recordings of Market Soundings conducted; • The Disclosing Person's assessment considerations, rationales, and discussions with the Market Sounding Beneficiary (if any), in determining whether the information disclosed would constitute non-public information and whether non-public information disclosed during Market Soundings h ceased to be non-public; • A list of all internal and external persons(s) who possess non-public information as a result of Market Soundings, including details such as the date and time of the Marketing Sounds, information and materials disclosed, etc.; • Notifications to inform Recipient Persons when the information ceases to be non-public.

VI. Specific requirements for Recipient Persons The specific requirements for Recipient Persons are relatively lighter when compared with the Disclosing Person, and are summarised below.[12]

Stages of Market Sounding	**Requirements**
Handling of Market Sounding requests	A Recipient Person should: • Designate a properly trained specified person(s) inform the Disclosing Persons of such arrangem Disclosing Persons for Market Soundings; and • Inform the Disclosing persons whether it wishes from the Disclosing Persons.
Record keeping	A Recipient Person should keep the records in relation t not less than seven years. These records must include: • Any notifications given to the Disclosing Person Soundings; • Audio, video or text recordings of Market Soundi • A list of all internal and external persons(s) who result of Market Soundings, including details suc Sounds, information and materials disclosed, etc

VII. Conclusion The Consultation Paper containing the Proposed Guidelines is currently undergoing a public consultation. The SFC has indicated that it currently plans to provide a six-month transition period for the industry to update their internal procedures and controls after the Proposed Guidelines are finalised. Even prior to the finalisation of the Proposed Guidelines, intermediaries may still find it helpful to compare their existing internal procedures and controls with the requirements in the Proposed Guidelines, as it provides useful guidance on the SFC's regulatory expectations and areas which an intermediary may wish to consider updating. As demonstrated by the SFAT Determination, the SFC can still find an intermediary to be in breach of the General Principles in the existing Code of Conduct if the intermediary engages in substandard conduct in respect of market soundings. _____ [1]

"*Consultation Paper on the Proposed Guidelines for Market Soundings*", published by the

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SFC on October 11, 2023, available at: https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=23CP6 [2] *Christopher James Aarons v. Securities and Futures Commission*, SFAT Application No. 1 of 2021, Determination, September 27, 2022, available at: https://www.sfat.gov.hk/files/SFAT%202021-1%20determination.pdf [3] SFO, sections 270 and 291. [4] "*Hong Kong SFC Places Key Reforms to SFO Enforcement Provisions on Hold Following Industry Feedback*", published by Gibson Dunn on August 11, 2023, available at: https://www.gibsondunn.com/hong-kong-sfc-places-key-reforms-to-sfo-enforcement-provisions-on-hold-following-industry-feedback/. [5] SFAT Determination, paragraph 192. [6] "Inside information" is defined in sections 245 and 285 of the Securities and Futures Ordinance as "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. [7] The Consultation Paper, paragraph 24; and the Proposed Guidelines, paragraph 1.2. [8] The Consultation Paper, paragraphs 20 to 21. [9] According to the Proposed Guidelines, a case-by-case consideration of the facts and circumstances is needed to determine whether there is some "level of certainty" of a corresponding potential transaction materialising. The examples of factors to take into account when making such determination include the extent to which the Market Sounding Beneficiary has orally or in writing: (i) expressed an interested with the Disclosing Person in proceeding with a possible transaction; (ii) shared any particulars with the Disclosing Person in relation to the possible transaction (such as the timing, size, pricing or structure of the transaction); or (iii) mandated, requested or consented to the gauging of investor appetite by the Disclosing Person. It is important to note that these are only examples of some factors to take into account, and are not intended to be exhaustive. [10] The Consultation Paper, paragraphs 27 to 41; the Proposed Guidelines, paragraph 2. [11] The Proposed Guidelines, paragraph 3. [12] The Proposed Guidelines, paragraph 4.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Global Financial Regulatory team, including the following members in Hong Kong: William R. Hallatt – Hong Kong (+852 2214 3836, whallatt@gibsondunn.com) Emily Rumble – Hong Kong (+852 2214 3839, erumble@gibsondunn.com) Arnold Pun – Hong Kong (+852 2214 3838, apun@gibsondunn.com) Becky Chung – Hong Kong (+852 2214 3837, bchung@gibsondunn.com) **Jane Lu is a paralegal (pending admission) working in the firm's Hong Kong office who is not yet admitted to practice law.* © 2023 Gibson, Dunn & Crutcher LLP. All rights reserved. For contact and other information, please visit us at www.gibsondunn.com. Attorney Advertising: These materials were prepared for general informational purposes only based on information available at the time of publication and are not intended as, do not constitute, and should not be relied upon as, legal advice or a legal opinion on any specific facts or circumstances. Gibson Dunn (and its affiliates, attorneys, and employees) shall not have any liability in connection with any use of these materials. The sharing of these materials does not establish an attorney-client relationship with the recipient and should not be relied upon as an alternative for advice from qualified counsel. Please note that facts and circumstances may vary, and prior results do not guarantee a similar outcome.

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