Hong Kong Market Misconduct Tribunal rejects Hong Kong SFC case in CITIC Pacific case and rules on the meaning of the statement: “no material adverse change”

April 10, 2017

Introduction

The Market Misconduct Tribunal (MMT) delivered its delivered its decision in CITIC Limited (formerly CITIC Pacific) case on April 10, 2017. The MMT found that none of the executive directors at the relevant time were engaged in misconduct and provisionally awarded costs against the SFC.

Significantly, the MMT determined that under s.277(1) of the Securities and Futures Ordinance:

- material adverse change is a concept distinct from price sensitive information which would be judged objectively independent of perceptions of the investing public;
- a material adverse change was a change in the company’s financial position of such significance that it undermined the company’s financial integrity in all the circumstances for an enduring period; and
- decisions made by executives must be judged within their relevant temporal framework and that judgments calls made by executives are entitled to a margin of appreciation.

As the first case decided by the MMT on the meaning of the term ‘no material adverse change’, this decision provides clarification on the scope of this term, being a legal and regulatory requirement for announcements under Chapter 14A of the Listing Rules, and indicates how the MMT would likely distinguish between ‘material adverse change’ and ‘price sensitive information’ in the future.

Background

This case concerned a no-MAC disclosure by CITIC Pacific in a circular published on the Hong Kong Stock Exchange on 12 September 2008.

CITIC Pacific was the holding company of a number of subsidiaries including Sino Iron Pty Limited and CITIC Pacific Mining Management Pty Limited. In July 2008, CITIC Pacific decided to hedge its exposure to AUD500 million which CITIC Pacific required for its iron-ore mining project in Australia owned by these two companies. In July and August 2008, CITIC Pacific entered into various Target Redemption Forward contracts (“**TRF Contracts**”) to hedge the fluctuations of AUD, Euro, and Renminbi against the US dollar.

Between July and September 2008, the AUD/USD spot rate dropped significantly. By October 2008, the mark-to-market loss of the outstanding TRF Contracts was HK$14.7 billion, which was significantly in excess of the AUD 500 million exposure which the TRF Contracts were intended to hedge for the Sino Iron Project.

On 20 October 2008, CITIC issued a Profit Warning Announcement (the “**Announcement**”) in respect of losses primarily linked to the TRF Contracts. The Announcement also stated that CITIC “*became aware of the exposure arising from [the TRF Contracts] on 7 September 2008*”.

It was discovered by the Hong Kong SFC that on 12 September 2008, a circular had been issued concerning a discloseable and connected transaction involving another subsidiary, Dah Chong Hong, stating that the “*Directors are not aware of any material adverse change in the financial or trading position*

of the Group since 31 December 2007, the date to which the latest published audited accounts of [CITIC] were made up".

If it was a fact that CITIC Pacific's executive directors had become aware of its exposure arising out of the TRF Contracts on 7 September, so the question was whether this may have contradicted no-MAC confirmation in the circular. The MMT was asked by the SFC to determine whether the fact that the circular contained a no material adverse change statement as of 7 September 2008 had a false or misleading impact on the market.

MMT Decision

Under section 277(1) of the Securities and Futures Ordinance, market misconduct would be committed if:

(i) a person disseminates the information (in this case, this was the publication of the circular with the no-MAC statement);

(ii) the information is likely to induce dealing in securities or is likely to maintain, increase, reduce or stabilise the price of securities in Hong Kong (in this case, the SFC argued that the markets was re-assured by the no-MAC statement which maintained the price of CITIC) (the "**Market Effect Element**");

(iii) the information is false or misleading as to a material fact (in this case the SFC argued that the exposure to TRF Contracts was of such a magnitude that it constituted an actual material adverse change in the Group's financial position) (the "**False or Misleading Element**"); and

(iv) the person in question knows that or is reckless or negligent as to whether the information is false or misleading.

Addressing each element in turn, the MMT found that:

(i) it was not disputed that each of the specified persons in their capacity as directors authorised the publication of the circular;

(ii) in the context where the Dah Chong Hong circular related to an entirely mundane transaction that was of no real consequence for CITIC Pacific, where there had been no particular news about CITIC Pacific, and no particular motivation therefore to discover whether there was a material change in CITIC Pacific's financial position, there was no evidence to draw the inference that the market was relying on assurances that setbacks would not materially affect CITIC Pacific's financial position. It has not been demonstrated that the no-MAC statement had the effect of maintaining or stabilising the price of CITIC Pacific's securities;

(iii) whilst the data available between 7 and 9 September demonstrated a real danger of a material change in CITIC Pacific's financial position at some point in the future, that data was not capable of demonstrating that there was already in existence an actual material adverse change. The SFC had not proven that the no-MAC statement was false or misleading; and

(iv) it was unnecessary to determine the *mens rea* issues given its conclusions on the Market Effect Element and the False or Misleading Element.

Market Effect Element

The MMT explained that the mischief under the Market Effect Element lies in the fact that it is probable that such information would have a causative effect in that it would induce the investing public to deal in securities of the listed company and thereby undermine and/or distort the open and honest workings of the market.

The SFC had initially advanced its arguments on the basis that CITIC Pacific's failure to put the true financial position into the no-MAC statement had falsely reassured the market. The MMT disagreed with

this interpretation. The Market Effect Element requires consideration of the information actually published and whether that is likely to maintain, increase, reduce or stabilise the price of securities; it is not the information that should have been published. The SFC accepted this and proceeded to rely on a realistic and common sense approach as to the tightening liquidity at the time of the announcement, the extraordinary market circumstances in September 2008 and the assurance in the no-MAC statement that the directors were not aware of any material adverse change in CITIC Pacific's financial position.

The MMT observed that the Market Effect Element tests is a predictive test as to whether at the time of publication of the no-MAC statement, it was probable that there would have been an effect sufficient to maintain the price. This question though cannot be answered in the abstract and must be answered by reference to specific facts or the lack of them.

In circumstances where there was a complete absence of evidence as to actual influence occasioned by the publication of the no-MAC statement, and an almost complete absence of primary evidence upon which to draw inferences, the MMT decided that the SFC has not demonstrated that it had any influence on the market.

The False or Misleading Element

The False or Misleading Element required the SFC to demonstrate that the information contained in the 'no material adverse change' statement was (i) false or misleading as to a material fact or was false or misleading through the omission of a material fact and (ii) that the specified persons were aware of this fact as at 9 September 2008 (the latest practicable date in the circular).

The MMT found that:

- the purpose of the no-MAC statement was primarily to assure the shareholders that there had been no material adverse change in CITIC Pacific's financial position by reason of the connected transaction which was subject of the circular, and to assure them more generally that there had been no change since the last published audited accounts;
- a no material adverse change statement was not a requirement simply to advise shareholders of whether the directors had knowledge of price sensitive information or to give some assurance of general financial 'good health', but was a more specific requirement of whether there had been a change in CITIC Pacific's financial position of such significance that it undermined CITIC Pacific's financial integrity in all the circumstances for an enduring period; and
- material adverse change was to be determined objectively in looking at the financial information and other information; it is a concept distinct from price sensitive information, which depends on perceptions of the investing public.

Accordingly, whatever the apparent magnitude of the mark-to-market losses on 9 September 2008, the losses under the TRF Contracts were such that they were unrealised and dependent on the AUD/USD exchange rate remaining constant throughout the tenure of the contracts. There was no question of an actual imminent crystallisation of capital loss.

Bearing in mind that all losses were prospective, that no losses were imminently to be crystallised and the real strength of CITIC Pacific in meeting any cash flow stress, there was insufficient objective evidence of any actual material adverse change in CITIC Pacific's financial position.

Further, the MMT decided that until the specified persons as a body of senior executives were capable of understanding the true nature of the threat that was being faced, they could not know how to deal with it, nor could they know at the time whether CITIC Pacific faced not merely the threat of a significant and enduring change in its financial position but that such a position was an existing fact. As highly experienced business executives, their judgment calls made at the time are entitled to a margin of appreciation.

Costs

The MMT found that the specified persons are entitled to payment of their legal costs by the SFC to be agreed or taxed.

Conclusion

In signing and approving standard no material adverse change statements in announcements, business executives should be aware that the material adverse change would be determined objectively by reference to the company's financial statements and not by reference to perceptions of the investing public. For there to be a material adverse change, there has to be a change in the company's financial position of such significance that it undermined the company's financial integrity in all the circumstances for an enduring period.

This decision is also helpful in acknowledging that decisions made by highly experienced executives are entitled to a margin of appreciation, and would not be judged with hindsight but within their relevant temporal framework.

Davis Polk represented Mr. Henry Fan, the former CITIC Pacific Group CEO.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Martin Rogers	**852-2533-3307**	**martin.rogers@davispolk.com**
James Wadham	**852-2533-3309**	**james.wadham@davispolk.com**
Linh Lieu	**852-2533-3317**	**linh.lieu@davispolk.com**
Erwin Yau	**852-2533-1039**	**erwin.yau@davispolk.com**