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SFC releases consultation conclusions on guidelines for market soundings

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On October 31, 2024, Hong Kong's Securities and Futures Commission released its consultation conclusions on the proposed guidelines for market soundings. A final version of the guidelines was gazetted the following day. This client update outlines key aspects of the consultation conclusions, the guidelines and the accompanying FAQs, and provides a summary of the full guidelines.

On October 31, 2024, the Securities and Futures Commission (SFC) of Hong Kong released its consultation conclusions on the proposed guidelines for market soundings (Consultation Conclusions). A final version of the Guidelines for Market Soundings (Guidelines) was gazetted the following day. In response to market reaction, the Consultation Conclusions make significant revisions to the original guidelines proposed by the SFC in October 2023. The SFC has refined the scope of the Guidelines to apply only to the sharing of confidential information entrusted by a Market Sounding Beneficiary,[1] which the SFC refers to as "Market Sounding Information". However, the Guidelines still apply irrespective of whether the Market Sounding Information is material or price sensitive. The SFC also materially scaled back the internal control and record keeping obligations, particularly for buy-side firms. The SFC largely excluded debt capital markets (DCM) transactions.

As a refresher, the SFC has long expressed concern over substandard conduct in the market sounding context, which, according to the SFC, may result in information leakage and impact the integrity of the market. The SFC's concerns have been punctuated in recent years by the disciplinary action taken in the *Aarons* SFAT case,[2] and the ongoing criminal prosecution of Segantii Capital Management and two of its licensed personnel, including its founder, for insider dealing arising out of a market sounding.[3]

Against this backdrop, on October 11, 2023, the SFC launched a consultation on its proposed guidelines for market soundings. The SFC's stated objectives in issuing the consultation was to formalize regulatory guidance and expectations on market soundings and require intermediaries to establish comprehensive internal control structures surrounding this process.

The original proposed version of the guidelines was expressed to apply to any disclosure of non-public information during a market sounding, regardless of whether such information is price sensitive or would be considered "inside information", as defined in the Securities and Futures Ordinance (Cap. 571) (SFO). The SFC also proposed a complex set of carve-outs that would have excluded transactions with no level of certainty, that were ordinary day-to-day trade executions, or were public offerings.

The consultation generated a strong reaction with a majority of respondents objecting to this proposed scope. The SFC has now finalized a revised version of the Guidelines that the SFC suggests addresses these concerns.

In addition to the Consultations Conclusions and the final version of the Guidelines for Market Soundings, the SFC also released a series of FAQs to provide further guidance to the market.

We outline here key aspects of the Consultation Conclusions, the Guidelines, and the accompanying FAQs, and then summarize the full Guidelines, which will come into effect in 6 months' time on May 2, 2025.

Scope of application to "Market Sounding Information" – As noted above, the SFC has limited the applicability of the Guidelines to a new definition of "Market Sounding Information" that is disclosed during a market sounding. The key elements of Market Sounding Information are that it is:

1. confidential information;
2. provided by a Market Sounding Beneficiary; and
3. that an intermediary has a duty to safeguard.

Notably, Market Sounding Information need not be material or price sensitive for the Guidelines to apply. The SFC identifies the following types of information, which may qualify as Market Sounding Information:

- the name of the subject security (or specific information that would allow the name of the subject security to be deduced);
- the identity of the Market Sounding Beneficiary or their intent to pursue a possible transaction; and
- the terms of or specifications related to the possible transaction, such as its potential timing, size, pricing, structure, and trading method.

– **Purpose of the Guidelines** – The SFC clarified that the Guidelines are intended to address regulatory issues unrelated to insider dealing under the SFO. As such, the Guidelines apply to any dissemination or use of Market Sounding Information irrespective of whether insider dealing law is engaged. In other words, it is not necessary that the Market Sounding Information emanate from a "connected person" or that such information is price sensitive. Under the Guidelines, a Market Sounding Intermediary is required to:

- protect Market Sounding Information and safeguard its confidentiality; and
- ensure there is an effective system of functional barriers to prevent inappropriate disclosure, misuse and leakage of Market Sounding Information.

– **Application to ordinary sales and trading activity** - The SFC confirmed that the Guidelines are not intended to apply to routine daily sales and trading activities. While the SFC did not offer guidance as to how sales and trading activity should be distinguished from market soundings in all cases, it appears that one factor will be whether an actual client order has been received.

– **Application to DCM transactions** – Generally, the Guidelines will only apply to transactions involving shares that are listed on an exchange, i.e., ECM transactions. However, a DCM transaction, or a transaction involving any other type of security, may still fall within the scope of the Guidelines if the transaction is likely to materially affect the prices of shares that are listed on an exchange.

– **Cleansing** – The SFC has withdrawn any affirmative obligation for Disclosing Persons to cleanse Market Sounding Recipients, acknowledging the practical difficulties with such an obligation given the scope previously proposed. Instead, the SFC has clarified that Market Sounding Intermediaries may (but are not obliged to) agree on the length of time that a duty of confidentiality with respect to any Market Sounding Information may apply, after which it will be appropriate to regard the information as stale.

– **Record keeping** – The Consultation Conclusions remove any obligation for Recipient Persons to conduct market soundings through authorized and recorded communication channels. The obligation of Disclosing Persons to use recorded channels is confirmed. However, the SFC included language allowing for some flexibility where authorized and recorded communication channels could not be accessed. In addition, the retention period for telephone recordings of Disclosing Persons has been reduced from seven years to two years.

Guidelines for Market Soundings

The Guidelines set out the principles and requirements applicable to intermediaries when conducting market soundings. The Guidelines are intended to be read in conjunction with General Principles 1 (Honesty and Fairness), 2 (Diligence), and 6 (Conflicts of Interest), and paragraph 9.3 (Front-running) of the Code of Conduct, and paragraph 1.3 (Functional barriers) of the Fund Manager's Code of Conduct.

A "Market Sounding" refers to the communication of information with potential investors prior to an announcement of a transaction, to gauge their interest in a possible transaction and assist in determining the terms and specifications relating to it, such as its potential timing, size, pricing, structure and trading method. The Guidelines apply to market soundings by intermediaries in connection with a possible transaction in (i) shares that are listed on an exchange, whether in or outside of Hong Kong; and (ii) any other securities transaction, e.g., DCM, which is likely to materially affect the price of shares that are listed on an exchange.

The Guidelines apply when an intermediary is in possession of, disseminates or receives Market Sounding Information. Information entrusted to a Disclosing Person constitutes Market Sounding Information if the Disclosing Person has a duty of confidentiality with respect to that information. It remains unclear whether a Market Sounding Beneficiary can modify the application of the Guidelines by modifying whether or to what extent a duty of confidence arises.

A non-exhaustive list of examples of Market Sounding Information (where a duty of confidentiality is considered by the SFC to exist) includes: (i) the name of the subject security (or specific information that would allow the name to be deduced); (ii) the identity of the Market Sounding Beneficiary or their intent to pursue a possible transaction; and (iii) the terms or specifications of a possible transaction, such as its potential timing, size, pricing, structure, and trading method.

A Recipient Person will also have a duty of confidentiality in respect of Market Sounding Information that it receives following its confirmation that it will safeguard and not misuse such information.

The Guidelines do not carry the force of law. A failure to comply with any provision of the Guidelines will not render a person liable in any judicial or other proceeding, but the Guidelines may be admissible in evidence in any proceeding and may cause the SFC to consider whether any such failure adversely reflects on a person's fitness and properness. The Guidelines will apply in addition to relevant laws and regulations concerning insider dealing.

Core principles

- **CP1 handling of information** requires that a Market Sounding Intermediary protect Market Sounding Information and safeguard its confidentiality. It should ensure there is an effective system of functional barriers to prevent inappropriate disclosure, misuse and leakage of Market Sounding Information. In this connection, a Market Sounding Intermediary should implement and maintain:
  - appropriate standards of conduct expected of its staff in handling Market Sounding Information;
  - clear and robust information sharing principles and processes to be adhered to by the staff, e.g., restrictions of Market Sounding Information on a need-to-know basis and disclosed through authorized and recorded communication channels; and
  - physical and functional segregation of incompatible duties (e.g., between public and private sides) and system segregation with user access controls in compliance with the need-to-know principle.
- **CP2 governance** requires a Market Sounding Intermediary to establish a robust governance and oversight frame work that includes (i) senior management assuming overall responsibility; (ii) appropriate governance arrangements; (iii) surveillance of market soundings by a committee or persons with adequate knowledge of the internal policies and procedures relating to market soundings; and (iv) internal control and escalation procedures to ensure that issues are promptly brought to the attention of senior management.
- **CP3 policies and procedures** requires implementation of effective written policies and procedures relating to market soundings that set forth (i) prescribed procedures for market soundings; (ii) allocation of roles and responsibilities amongst relevant staff; (iii) firm and personal account dealing policies to prevent inappropriate disclosure, misuse or leakage of Market Sounding Information; (iv) escalation protocols; (v) an appropriate consequence / disciplinary framework; and (vi) record keeping requirements.
- **CP4 review and monitoring controls** requires appropriate surveillance controls to monitor and detect suspicious trading behavior, misconduct or inappropriate or unauthorized disclosure, misuse or leakage of Market Sounding Information, and non-compliance with internal policies.

Specific requirements for Disclosing Persons

Procedures before conducting market soundings. A Disclosing Person must obtain agreement or consent from a Market Sounding Beneficiary to engage in market soundings and determine in advance:

1. a standard set of information to be disclosed in each market sounding;
2. appropriate timing to conduct market soundings; and
3. a suitable number of Recipient Persons to contact, such that market soundings are limited to as few investors as necessary for the purpose of gauging interest in the transaction.

Use of authorized communication channels. A Disclosing Person should only use authorized and recorded communication channels to conduct market soundings. The use of other formats to record market soundings (e.g., written minutes) should only be allowed if other authorized and recorded communication channels are not accessible.

Standardized script. Disclosing Persons are required to adopt the use of a standardized, pre-approved script during market soundings. The SFC has established minimum standards for the standardized scripts, which include the following information and sequencing:

1. an opening statement that discloses the purpose of the call is a market sounding and a confirmation that the individual is authorized by the Recipient Person to receive market soundings;
2. a request for consent to record the conversation; and
3. a request for consent to receive, safeguard and prevent misuse or leakage of Market Sounding Information (effectively a form of undertaking).

If these consents are not obtained, the Disclosing Person should not provide the Market Sounding Information.

In addition, any preliminary information provided by the Disclosing Person to enable a recipient to assess whether they wish to provide consent must be on a no-name basis and must be sufficiently broad, limited and vague to prevent a reasonable person from deducing the name of the subject security.

After obtaining consent, a Disclosing Person should provide a written confirmation to the Recipient Person confirming and summarizing the contents of the market sounding.

Record keeping. Finally, the Guidelines require a Disclosing Person to retain records relating to its market soundings for at least two years. The records that a Disclosing Person must retain include:

1. the agreement or consent obtained from a Market Sounding Beneficiary to engage in market sounding;
2. a list of Recipient Persons or other potential investors who have declined a market sounding;
3. audio, video or text records of market soundings conducted through recorded communication channels;
4. written minutes of any market soundings conducted through unrecorded channels; and
5. a list of all internal and external persons (including legal and natural persons) who possess the Market Sounding Information, including details of the date and time such information was disclosed.

Specific requirements for Recipient Persons

Handling of market sounding requests. A Recipient Person is required to authorize a person with adequate knowledge of its internal policies on the receipt and handling of market soundings to receive market soundings on its behalf. A Recipient Person is further required to notify Disclosing Persons of its arrangements upon being contacted for a market sounding. Recipient Persons are also required to inform Disclosing Persons whether they wish to receive market soundings or not in relation to all or particular types of transactions. Finally, in circumstances where a Disclosing Person does not specify whether a communication is a market sounding or whether certain information is Market Sounding Information, a Recipient Person must use its reasonable best effort to verify whether it is in possession of Market Sounding Information or not.

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

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[1] A "Market Sounding Beneficiary" is defined as "a client, an issuer or an existing shareholder selling or buying in the secondary market."

[2] *Christopher James Aarons v SFC* (Decision of the Securities and Futures Appeals Tribunal dated 27 September 2022).

[3] See announcements issued by the SFC on (i) May 2, 2024; (ii) June 12, 2024; (iii) July 2, 2024; and (iv) October 15, 2024.