Davis Polk

SFC releases consultation on proposed guidelines for market soundings

October 16, 2023 | Client Update | 12-minute read

On October 11, 2023, the SFC released a consultation paper proposing guidelines for market soundings (the "Proposed Guidelines"). The Proposed Guidelines apply to both sell-side and buy-side firms, and would require intermediaries to implement a specific market sounding control framework and procedures and to adhere to certain core principles when engaged in market soundings. The consultation also proposes that market sounding requirements apply whether or not insider dealing law is engaged.

The SFC has, for some time, voiced concern over potential information leakage in the market sounding process that, according to the SFC, provides some market participants with an unfair information advantage over the rest of the market. This concern led the SFC to conduct a thematic review in 2023 in which the market practices and views of industry participants were surveyed. The present consultation and the Proposed Guidelines are the product of this thematic review.

The stated purpose of the Proposed Guidelines is to provide clarity on the SFC's expectations, deter substandard conduct, ensure a level playing field, and to assist intermediaries in upholding market integrity.

We outline here key aspects of the Proposed Guidelines and potential issues that may be addressed in the consultation process, and then summarize the full Proposed Guidelines below:

- **Formalizing regulatory guidance and expectations on market soundings** – Prior to the consultation, the SFC had not issued formal guidance to intermediaries concerning market soundings. Market Misconduct and Securities and Futures Appeal Tribunal precedents provided some guidance, but those decisions were necessarily focused on the facts being considered by the Tribunal. The Proposed Guidelines are intended to ensure more uniform compliance processes, at least in certain respects, and enable the SFC to investigate possible deviations from the guidance.
- **Comprehensive internal control framework surrounding market soundings** – The Proposed Guidelines will require all intermediaries engaged in market soundings, on both the sell- and buy-side, to implement an internal control framework that includes (i) governance and senior management oversight, (ii) policies, procedures, and training; (iii) information barrier and management controls; (iv) surveillance; and (v) record keeping and use of authorized communication channels. Implementing such a control framework for market soundings may involve additional compliance requirements, particularly on the buy-side.
- **Focal point is disclosure of any non-public information** – The scope of the Proposed Guidelines extends to all communications gauging investor interest in a potential transaction where non-public information is disclosed, regardless of whether such information is price sensitive or would be considered "inside information," as defined in the Securities and Futures Ordinance (SFO). While this appears to be designed to eliminate potentially divergent views on the sell-side as to whether certain information is price sensitive, the scope of the Proposed Guidelines would correspondingly exceed current insider dealing law in Hong Kong. This focus may also result in divergent approaches where the disclosure or use of non-public information in the market sounding context will be subject to different regulation than if the exact same information had been obtained in a different context.

- **Carve out for transactions with no level of certainty** – The Proposed Guidelines carve out from their scope, and the definition of a market sounding, transactions that are "without any level of certainty of such transactions materializing." The Proposed Guidelines also provide certain factors a sell-side firm may consider in determining whether there is "any level of certainty" based on their interactions with a seller. The consultation process provides the opportunity to consider whether or not this approach will increase regulatory clarity, including taking into account that there may be differences in the extent and scope of communications between, on the one hand, a seller and, on the other hand, different sell-side intermediaries.
- **Record keeping** – The Proposed Guidelines expand record keeping obligations for both the buy- and sell-side beyond what is currently required and even what is required in other contexts. For example, although many market participants may already conduct market soundings and other investor outreach on recorded lines, the Proposed Guidelines will expand the scope of conversations that must be recorded and require that they be kept for at least seven years.

Proposed guidelines on market sounding

The Proposed Guidelines set out the SFC's principles and regulatory expectations in relation to market soundings. Whilst the Proposed Guidelines will not carry the force of law, they will assist the SFC in determining whether a licensed person has complied with their obligations under the Code of Conduct for Persons Licensed or Registered with the SFC in regard to honesty, fairness, and operating in the best interests of clients and market integrity, in sum, whether a licensed person continues to be fit and proper.

The Proposed Guidelines apply to "Market Soundings," which is defined to mean the communication of non-public information, irrespective of whether it is price-sensitive inside information[1] or not, 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 its potential size, pricing, structure and selling method, by a licensed or registered person acting as either:

- A "Disclosing Person," i.e., the person disclosing information during a Market Sounding, which will typically be a sell-side broker acting on behalf of a seller (whether the seller be a client, an issuer, or an existing shareholder) (Market Sounding Beneficiary); or
- A "Recipient Person," i.e., a person receiving information during a Market Sounding, which will typically be a buy-side investor.

Collectively, the Proposed Guidelines refer to a Disclosing Person and a Recipient Person as a "Market Sounding Intermediary."

Importantly, the definition of Market Sounding, and therefore the scope of the Proposed Guidelines, would apply to all communications where non-public information is conveyed, regardless of whether such information would constitute "inside information" under Hong Kong law. This extends beyond the parameters of insider dealing law under the SFO, where the information conveyed must be information from a connected person,[2] that is specific, about a corporation, a shareholder or officer of the corporation, or the listed securities of the corporation or their derivatives, and likely to materially affect the price of the listed securities.

The Proposed Guidelines do, however, carve out three categories of communications from the definition of Market Sounding. These are communications relating to:

- Speculative transactions or trade ideas put forward by a Disclosing Person without consulting with the potential Market Sounding Beneficiary or without any level of certainty of such transaction materializing;
- Transactions, in such size (e.g., in relation to average trading volume or market capitalization), value, structure, or selling method, that are commensurate with ordinary day-to-day trade execution; and
- Public offerings of securities.

In regard to the first category above, the SFC has advised that determining whether there is a "level of certainty" for a potential transaction will require a case-by-case analysis of the facts and circumstances, including the extent to which the Market Sounding Beneficiary has (i) expressed an interest to the Disclosing Person in proceeding with a possible transaction; (ii) shared any particulars with the Disclosing Person in relation to the possible transaction (e.g., timing, size, price, or structure); or (iii) mandated, requested or consented to the gauging of investor appetite.

The Proposed Guidelines proceed to identify six core principles, applicable to all Market Sounding Intermediaries, and specific requirements and procedures that are dependent on a party's role in the Market Sounding as either a Disclosing or Recipient Person.

Core principles

- **CP1 Market Integrity** requires that Market Sounding Intermediaries maintain strict confidentiality and not trade on or use any non-public information obtained during Market Soundings for the benefit of themselves or others until such information ceases to be non-public.
- **CP2 Governance** requires that Market Sounding Intermediaries establish a robust governance and oversight framework that includes (i) senior management assuming ultimate responsibility; (ii) surveillance of Market Soundings conducted by a person(s) or function sufficiently independent from the front office; and (iii) internal controls and escalation processes to ensure that issues are promptly brought to the attention of senior management.
- **CP3 Policies and Procedures** requires implementation and maintenance of effective policies and procedures that set forth (i) prescribed procedures for Market Soundings; (ii) allocation of roles and responsibilities amongst relevant staff; (iii) personal account dealing policies; (iv) escalation protocols; (v) an appropriate consequence / discipline framework for non-compliance; (vi) information management systems in respect of non-public information received; and (vii) record keeping requirements. Appropriate training for staff on the policies and procedures is also required.
- **CP4 Information Barrier Controls** requires Market Sounding Intermediaries to implement effective information management controls, including (i) segregation between private side and public side staff; (ii) system segregation and user access rights; (iii) information sharing policies implementing the "need-to-know" principle; and (iv) maintenance of both a restricted list and a list of wall-crossed internal and external individuals who possess non-public information arising out of Market Soundings.
- **CP5 Review and Monitoring Controls** requires appropriate surveillance controls to monitor and detect suspicious trading behavior, misconduct, or misuse of non-public information, including surveillance of personal account dealing, voice and electronic communications, and unauthorized information access.
- **CP6 Authorised Communication Channels** specifies that Market Sounding Intermediaries should only use recorded, firm approved communication channels when conducting Market Soundings.

Specific requirements for disclosing persons

Pre-Sounding Procedures. The Proposed Guidelines require that a Disclosing Person adhere to certain procedures prior to conducting a Market Sounding. These procedures include (i) determining a standard set of information to be disclosed during the Market Sounding process and an assessment, subject to review by senior management or an independent control function, of that information; and (ii) obtaining consent from the Market Sounding Beneficiary to engage in the Market Sounding. The Proposed Guidelines also require that a Disclosing Person determine in advance the timing of a Market Sounding (preferably after trading hours and as close as practicable to the deal launch) and a suitably limited number of potential investors for Market Sounding as is necessary to gauge investor interest.

Standardized Script. The Proposed Guidelines provide further guidance and requirements in respect of the script that Disclosing Persons must use when conducting Market Soundings. Specifically, they require that Disclosing Persons utilize a standardized, pre-approved script for all Market Sounding communications that is regularly reviewed by either senior management or an independent control function, like Legal or Compliance.

The Proposed Guidelines also set forth a specified sequence for a Market Sounding:

- The script must include a statement announcing the purpose of the communication and informing the investor that, if they are wall-crossed, the investor is required to restrict itself and keep confidential any non-public information it receives;
- The script must include a statement that the communication is recorded and the Disclosing Person must obtain the potential investor's consent for the recording;
- The Disclosing Person must obtain confirmation they are speaking with someone designated by the investor to receive Market Soundings;
- The script must also include a request by the Disclosing Person to obtain the potential investor's consent to be wall-crossed. In making this request, the Disclosing Person is able to provide preliminary information to the potential investor sufficient to allow them to determine whether they wish to be wall-crossed or not; however, the SFC cautions that such preliminary information must be sufficiently vague, limited, and anonymized so as to minimise the probability that the name of the relevant issuer would be easily identified by the investor. The SFC further counsels that specific information relating to the issuer should only be provided after a potential investor has consented to the wall-crossing;

and

- Finally, where possible, the Disclosing Person should provide an estimate of when the information disclosed will cease to be non-public.

The Proposed Guidelines also require that the Disclosing Person thereafter confirm in writing that the potential investor has received non-public information and summarize the contents of the Market Sounding communication.

Cleansing. A Disclosing Person is also required to conduct ongoing assessments and monitor to determine whether the non-public information disclosed in a Market Sounding ceases to be non-public (for this purpose, the Proposed Guidelines also refer to stale information, e.g., information relating to a deal that is not going forward, as information that has ceased to be non-public). Where the Disclosing Person has identified that the information ceases to be non-public, they should alert the potential investors they had wall-crossed as soon as possible in writing.

Record keeping. Finally, the Proposed Guidelines require a Disclosing Person to retain records relating to its Market Soundings for not less than seven years. The records that a Disclosing Person is required to retain include (i) consent from the Market Sounding Beneficiary to engage in Market Sounding; (ii) a list of all potential investors who declined a wall-crossing; (iii) records, including audio, video, or text recording of the Market Soundings; (iv) records of the assessment and discussions with the Market Sounding Beneficiary (if any) and conclusions as to whether information to be disclosed is non-public or whether such information ceases to be non-public; (v) a list of all internal and external persons who received or had access to the non-public information; and (vi) cleansing notifications to potential investors.

Specific requirements for Recipient Persons

Handling of market sounding requests. A Recipient Person is required to designate specific person(s) to receive Market Sounding requests, and to inform Disclosing Persons of their arrangements. A Recipient Person is also required to confirm for the Disclosing Person the appropriate designated person(s) upon being contacted for a Market Sounding. The person(s) designated by the Recipient Person should be adequately trained to receive Market Soundings as well. In addition, the Recipient Person must also inform the Disclosing Person whether they wish to receive Market Soundings or the types of potential transactions for which they may wish to Receive a Market Sounding. Individual consent would still be required before each Market Sounding.

Record keeping. A Recipient Person will be required to retain all records relating to Market Soundings for not less than seven years. The records required to be kept will include (i) notifications given to Disclosing Persons of the wish to receive Market Soundings or not; (ii) records of the Market Soundings, including audio, video, or text recordings; and (iii) a list of all internal and external persons who have received non-public information as a result of the Market Sounding.

What’s next?

The consultation paper kicks off a consultation period that will run until December 11, 2023.

At this early stage in the consultation period, we would note simply that there are a number of additional areas where clarification or additional guidance may be helpful. These areas include:

- The “level of certainty” carve-out;
- The carve out for “ordinary day-to-day trades”, particularly to the extent that block trades are crossed intra-day on the public side;
- Cleansing, including when information ceases to be non-public in the context of a stale transaction or a completed transaction by a non-issuer where no stock exchange announcement is required;
- The proposed record retention requirements, including the extent to which communications with Market Sounding Beneficiaries must be recorded.

The SFC has proposed a six month implementation period after finalization and publication of the Proposed Guidelines before they come into effect.

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.

Martin Rogers
+852 2533 3307
martin.rogers@davispolk.com

[1] The definition of "inside information" is provided for in sections 245 and 285 of the Securities and Futures Ordinance.

[2] As that term is defined under the SFO.