

HK profit announcements: to warn or not to warn?

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The SFC's profit warning guidelines are not crystal clear. Here's best practice on how to comply

Since Hong Kong's statute-backed inside information disclosure regime saw the light of day on January 1 2013, the market has been trying to acclimatize to it. Senior managers of Hong Kong-listed companies are now required, as a matter of law, not only to refrain from dealing while in possession of 'price-sensitive information' (now renamed 'inside information'), but to take positive steps to disclose the information, unless a safe harbor applies.

This is an important development. Now that the disclosure obligation is part of legislation, as opposed to a listing rule of the Hong Kong Stock Exchange (Stock Exchange), non-compliance constitutes a breach of law and attracts civil liability and other forms of penalty. In clear cut cases, the Securities and Futures Commission (SFC) might even consider exercising their newly-clarified powers under section 213 of the Securities and Futures Ordinance (SFO). This allows the SFC to bring civil claims for damages against directors personally, on behalf of investors who bought shares prior to an announcement of inside information being made, where the SFC's view is that the announcement was materially late.

In reality, determining whether something is or is not inside information may be a tall order for company directors, most of whom are not financial market experts.

Profit warnings

Under the new section 307B SFO, a listed company must, as soon as reasonably practicable after any inside information has come to its knowledge, disclose it to the public.

In reality, directors and officers will almost always possess information about their company at least a short time ahead of the market. What must they do in relation to internal accounts and management updates? According to the Guidelines on Disclosure of Information (Guidelines) issued by the SFC:

'Generally the mere knowledge of the content of draft annual or interim accounts prior to their publication or internal management accounts would not be [inside] information. However, knowledge of substantial losses or profits made by a corporation even though the precise magnitude is not yet clear ... may be inside information.' (paragraph 31)

Directors may breathe a sigh of relief here – we now have assurance that not all internal financial records are price-sensitive, only those which show 'substantial losses or profits'.

So what does 'substantial' mean? The SFC's view is:

'The facts and figures in every case will be different and every case turns on its own facts. To constitute inside information the difference between the results which the market might predict and the results that directors or officers know must be significant.' (paragraph 31 of the Guidelines)

Market sentiment

This is less helpful than one would hope. The SFC says a director or officer is expected to find out what the market might predict about the company.

In this day and age, a perfect or near-perfect grasp of market sentiment is probably a feat beyond even the most sophisticated investment analysts and market specialists. Those specialists are often wrong. How does one assess the market?

The SFC, again, tries to lend a helping hand:

'In assessing what results the market might predict for a corporation, account must be taken of information previously disclosed by the corporation ... References should also be made to profit projections by analysts and the availability of data and information about the corporation in financial journals and publications from which a sophisticated investor may logically deduce the corporations results.' (paragraph 33 of the Guidelines)

In short, the SFC suggests that directors and officers look at:

1. what they have told the market in the past; and
2. what market analysts and financial journalists are saying.

What the company has told the market

The first limb seems straightforward at first glance. The company should know what it has told the market and how much that diverges from the actual results. The problem, though, is the magnitude of divergence.

Is a profit warning called for when the company's profit shows an unexpected drop of six percent from last year? Or 10%, or indeed any other figure? Where do we draw the line? A line must be drawn if the director is to have any certainty about his company's compliance status.

Must the company issue a warning if its revenue has dropped, but its profit remains stable (or vice versa)? Or if one of the material accounting line items has deteriorated, but the company's overall financial health is not significantly worse off?

There is an almost infinite possibility of variety, and the position tends to become less clear the more complex the business of the listed group.

Are certain line items more price-sensitive than others (for surely they cannot all have the same effect)?

The SFC is almost totally silent on these issues, and maintains that the directors are best placed to decide. Let us call this the directors' judgment rule.

What the market thinks: a matter of evidence

The second limb in the SFC's two-prong test is more problematic.

Take the example of a director who knows that the company's profit for the first quarter of the year shows a six percent decrease compared to last year. Having considered all the circumstances, they believe this has no material effect on share price and decides not to issue a warning. Unfortunately, when the results are out weeks or months afterwards, the share price nose-dives and enforcement proceedings are brought against the director.

What will happen at court afterwards? Hopefully, the matter will not go to court. Hopefully, cases will only be brought in the most clear cut of circumstances.

If this sort of case does go to court, however, it's likely that there will be a war of expert witnesses. One side will argue that any reasonable director would have considered the drop in profit as price-sensitive – after all, did the price not go through the floor after the results were announced?

The other side will counter this with a whole host of factors – general market and industry conditions (which had been adverse and which the public knew about), trading patterns of the specific type of stock, regulatory developments, indeed any surrounding circumstances that could have driven the price down – to argue that any reasonable director would not have considered the profit drop as price-sensitive.

At the time, when the director has to decide, all this will be months or even years in the future. The outcome of this battle is no more and no less than a lottery for the director at the time when he is called upon to make a judgment. Is the safe way out for him to issue the announcement willy-nilly? This would be highly unsatisfactory, and probably an unintended, consequence of the directors' judgment rule.

What others are saying about the company

One of the most difficult questions companies and their advisers face is what to do with things that other people are saying about the company. As one of the most developed financial markets in the world with freedom of expression, Hong Kong has a vibrant local press and there are huge volumes of traffic daily on the information highway. How should a company react to items such as press reports, financial journalists' blogs, research reports, and even communications broadly circulated word of mouth?

The SFC's Guidelines helpfully clarify that, generally, listed companies are not expected to respond to these materials: 'If a corporation does not have inside information but media reports or market rumors carry false or untrue information, the corporation is not obliged to make further disclosure under the SFO.' (paragraph 80)

We should add here that under the Stock Exchange/SFC dual track regulation of part XIVA SFO, this is not necessarily the end of the story. This is because the Stock Exchange has reserved the right to request an announcement if a 'false market' is developing (potentially for any reason, including market rumors).

For now, however, let us take the SFC's word on its face value – that a listed company is not expected to track, check, confirm or refute third party reports, unless the presence of those reports indicates a leak of inside information which the company in fact possesses.

The irrational analyst and the quixotic journalist

Going back to profit warnings, we noted above the SFC's statement that the company should take into account how the market might predict its results and, to do that, consider what market analysts and financial journalists are saying. So perhaps the SFC does, after all, expect directors to track and check third party reports?

What, if any, conclusions are directors expected to draw from the views circulating in the market? The SFC admits 'it is not unusual that profit forecasts made by different analysts vary considerably and media reports contain inconsistencies.' (paragraph 34 of the Guidelines).

One concern is the hypothetical commentator who makes a fantastically optimistic prediction or target price for the company. What can the company realistically do about them, except to cross its fingers that the commentator does not have a wide readership and is not influential enough to generate expectations in the market?

In reality though, quixotic analysts and journalists are probably few and far in between. The more likely headaches are commentators who are not outrageously wrong, but just wrong enough to open a gap between market expectations and the actual results – a gap that directors will subsequently be called upon to close.

As an extension of this, would directors of a company be required to manage the expectations of the market? This would be troubling – hasn't the SFC stated that listed companies are not expected to respond to these materials?

False market and profit warning

Consider the situation of some people unrelated to the company writing a very attractive investment story quite divorced from the company's fundamentals. Is the company obliged to search out and review the reports? Could the directors be held negligent if they did not even know about their existence?

If the directors do know about the reports and are in possession of internal accounts that are much more sobering, is a false market developing? Should they issue an announcement to kill the false market?

More importantly, does the presence of such reports, and any market consensus they may be seen as having generated, in themselves turn the internal accounts into inside information? Must the directors now issue a profit warning, even though their lackluster, yet stable, results are actually not much different from last year's?

New trend for profit alerts / warnings?

Let us look at what listed companies are doing about all this.

As at the end of June 2013, there were a total of 1,567 equity-listed companies on the Main Board and the Growth Enterprise Market of the Stock Exchange. Within the first seven and a half months of 2013, up to July 15 2013, there were no less than 697 profit announcements (including positive alerts as well as negative warnings) issued by companies listed on the two boards.

The Stock Exchange's statistics also reveal that during the year 2012 (with some 1,547 companies listed by the end of the year), there were more than 1,000 profit warnings or alerts issued.

Compare these figures with 2008. The whole of this year recorded a total of 334 profit warnings. At that time there were 1,262 equity-listed companies on the two boards combined.

Are we seeing a trend of listed companies being motivated to issue profit announcements to keep the market informed (and to stay on the right side of regulation)? If so, the market may be moving towards higher financial transparency, which is probably a good development.

However, it is also possible that companies and their directors are simply issuing these warnings as a knee-jerk reaction to the problems with the directors' judgment rule, made more acute since the beginning of 2013. This could be a worrying trend.

The shortcomings of frequent financial reporting (for example, management being pressured to pursue short-term goals to keep shareholders happy) are widely known. From directors' point of view, disclosing financial information more frequently brings its own problems. Firstly, these disclosures in turn create market expectations – including the expectation that any material deviations will be corrected – which the directors must continue to manage. Moreover, each public announcement is a potential liability document for the company and its directors.

If profit warnings become too routine, or the disclosure too vague or formulaic, they may be less meaningful to the market. Consider the earlier example of a director facing a six percent drop in his company's profit in a reference period. After much deliberation he decides, after all, to make an announcement stating that the company may suffer a drop, or substantial drop, in profits.

As the numbers are preliminary and unaudited at that stage, in line with Hong Kong normal practice, the company refrains from disclosing actual figures in the announcement. What, then, should shareholders and potential investors make of this announcement, especially if large numbers of listed companies issue such announcements routinely? A profit warning devoid of substance and issued primarily to avoid liability is unlikely to achieve the goal of a better-informed market.

The director/officer at a crossroads

Under the new regime, the danger for directors and officers is that an enquiry as to whether a market consensus did exist in relation to the company, and whether that means a piece of information should have been considered price-sensitive would always be conducted with perfect hindsight.

What the SFC has given in one hand – by stating that directors do not need to track, check and respond to third party reports – it may have taken away with the other by imposing requirements that in practice can only be complied with if directors do carry out such tracking, checking and responding.

Even if directors are willing and able to take these steps, that may not be the end of their problems if there is cacophony in the market. After all, a director or officer under the new regime is stuck with a 'yes' or 'no' decision on which they may be judged after the event, based on perfect information as to what the market consensus was supposed to have been at the relevant time.

Systems, controls, and the challenge for non-executive directors

Our discussion about when a profit warning is appropriate assumes, of course, that directors have at their fingertips up-to-date, reliable management information and are able to work out when that information, and revised forecasts for the full-year (or half-year) significantly deviate from market expectation.

However, this assumption may not be accurate. This is because accounting systems are weak, forecasting is not being updated, reviews of what the market is thinking are sporadic only, or executive management are not passing updates to non-executive directors on a timely basis. Non-executives need to be on top of this.

The danger for them is that officers of a company (which includes all directors plus senior management) are potentially personally liable for a breach if they have not taken all reasonable measures to ensure that the company has good internal control systems and procedures.

Non-executive directors need to ask themselves a series of questions. Is management accounting information reliable and timely? Are the auditors (internal and external) happy? Am I getting sufficient help from executive management to keep me abreast, on a monthly basis, of any significant changes in the market's expectation of the company's performance, both actual to date and forecasted? Are executive management telling us, regularly, what their view is as to whether or not a profits warning needs to be made?

Non-executives need to be able to answer 'yes' to all these questions.

**This article has also been published by [IFLR](#) in their July/August 2013 issue*

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