

Hong Kong Market Misconduct Tribunal's CITIC Ruling: The Implications

May 2017

Key points

- The Market Misconduct Tribunal's ruling clarified the meaning of "material adverse change in the financial...position of the Group". A statement of any such change (or an appropriate negative statement) is required to be contained in certain company circulars under the Hong Kong Listing Rules (the **Listing Rules**).
- The concept of a material adverse change in a company's financial position (**MAC**) is distinct from price sensitivity. Information that is price sensitive may not necessarily constitute a MAC. A MAC in this context - being in relation to a company's financial position - involves an actual change with a deeply significant and enduring impact on the financial integrity of a company.
- Although directors and officers of listed companies can be comforted by this high threshold, they must remain vigilant that a less dire situation than a MAC will often constitute inside information that is required to be disclosed as soon as reasonably practicable. The statutory inside information regime was implemented after the relevant events of the CITIC case. The same fact pattern if repeated today would likely constitute a late disclosure of inside information under the SFO.
- A different, and broader, interpretation of what constitutes a MAC may be applied by the Hong Kong Stock Exchange in the context of IPO prospectuses.
- In the context of commercial agreements, material adverse change provisions are often drafted more broadly than the language considered by the Market Misconduct Tribunal, in particular by including references to "business" and "prospects".

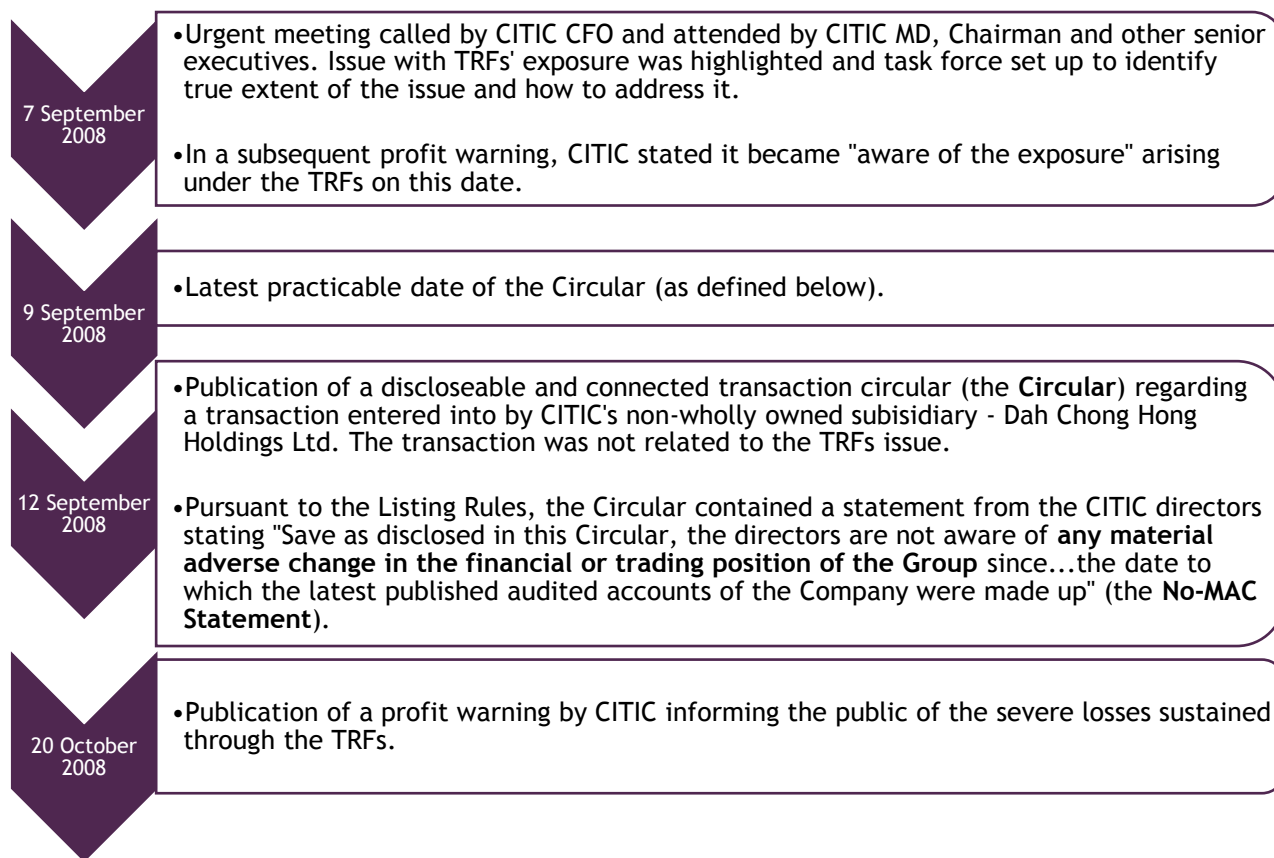
Background

CITIC Limited (formerly CITIC Pacific Limited) (**CITIC**) is a Hong Kong listed company with mining rights to an iron ore site in Australia.

The estimated capital expenditure of the iron project was denominated in US dollars for budget purposes, but a substantial portion of the capital expenditure was required to be paid in Australian dollars. To hedge the forex risk, CITIC made use of derivative instruments including highly complex target redemption forward contracts (**TRFs**).

Triggered by the global financial crisis, the Australian dollar lost about 37% of its value from late July 2008 through to late October 2008. This brought "dire financial consequences that was to bring CITIC to a state of crisis" (to quote the Market Misconduct Tribunal (**MMT**) report). The collapse of the Australian dollar meant CITIC was obliged under the TRFs to buy increasing multiples of Australian dollars at prices significantly higher than prevailing market rates. When CITIC released its profit warning in October 2008, the mark-to-market loss arising from its TRFs was estimated to be around HK\$14.7 billion.

A timeline of key events is as follows:



It can be seen from the timeline that the directors made the No-MAC Statement in the Circular after certain of them became aware of the TRFs issue during the 7th September meeting. The MMT's mandate was to determine if CITIC and those directors who attended the meeting committed market misconduct under section 277(1) of the Securities and Futures Ordinance (the **SFO**).

The offence is committed if all of the following elements are satisfied:

1. a person disseminates the information (the **Publication Element**);
2. the information (i.e. the No-MAC Statement) is likely to induce dealing in securities in Hong Kong or is likely to maintain, increase, reduce or stabilise the price of securities in Hong Kong (the **Market Effect Element**);
3. the information is false or misleading as to a material fact or through the omission of a material fact (the **False or Misleading Element**); and

4. the person knows or is reckless / negligent as to whether the information is false or misleading.

It is important to note the question of whether CITIC should have released its profit warning earlier (pursuant to its then obligation under the Listing Rules to release price sensitive information as soon as reasonably practicable) did not form part of the MMT's mandate.

Ruling

In April 2017, the MMT ruled no market misconduct had been committed under section 277(1) of the SFO. The only element of the offence that was satisfied was the Publication Element (by virtue of the directors having authorised the publication of the Circular).

The following elements were not satisfied:

1. Market Effect Element - the No-MAC Statement was unlikely to have influenced the market.

The Market Effect Element requires there to have been a real degree of probability the statement actually published (alone or in

conjunction with other information) was likely to have influenced the actions of ordinary reasonable investors. This element does not deal with the information that should have been published (which falls to the False or Misleading Element). In short, a communication that is not likely to influence the market, even if found to be false or misleading in a material way, does not fall within section 277(1) of the SFO. Here, there was no evidence the market was looking for assurance from CITIC at the time of publication, such that the No-MAC Statement was likely to have influenced the market by giving that assurance; and

2. False or Misleading Element - the No-MAC Statement was not false or misleading as to a material fact or through the omission of a material fact.

The precise wording of the No-MAC Statement has been mentioned in the timeline above. The MMT clarified the statement (which is required under the Listing Rules to be disclosed in the Circular) involved asking whether, objectively, there was in existence on 9 September 2008 (being the latest practicable date of the Circular) a MAC since 31 December 2007 of which the directors were aware.

As for the meaning of a “material adverse change in the financial position of the Group”, the MMT looked to cases in a commercial law context to conclude that such a change would require an actual change in CITIC’s financial position of such deep significance that it has undermined the group’s financial integrity in a manner that will endure. Not simply a threatened or likely change, but an actual change.

The concept of a MAC is therefore distinct from price sensitivity. The latter is a less profound issue and involves assessing whether the information might reasonably be expected to materially affect market activity concerning share price. Price sensitivity is assessed through the eyes of a reasonable ordinary investor; whilst a change in financial position is assessed objectively based on financial and any other relevant compelling information.

In the present case: (a) on the evidence available at the time, it was not demonstrated that a deeply significant change to the financial integrity of CITIC had already occurred. Unrealised loss (such as an

exposure to loss through derivative instruments) was capable of constituting an existing MAC only if the unrealised loss was of such magnitude and its crystallisation of such imminence that the loss was manifestly unavoidable - here, there was no question of actual imminent crystallisation at the material time; (b) in the context of CITIC (with its depth of assets and access to borrowings), the adverse change will have to endure a matter of months and not simply days in order to undermine its financial integrity; (c) given the fluctuations in the exchange markets at the time, it was not demonstrated that the change clearly would endure. If the Australian dollar rebounded, the potential losses would disappear or be greatly diminished; and (d) even if there were an existing MAC, it was not shown that the directors were aware of this at the material time - primarily because the data on anticipated cash flow was not yet available. The data available to them at the relevant time showed a real threat of a material change at some point, but not that one was already in existence.

In fact, with the benefit of hindsight, the threatened MAC did occur and it did endure. However, the MMT emphasised that such matters must be judged within their temporal frameworks rather than with the benefit of hindsight, and directors’ judgment calls should be given some margin of appreciation.

The MMT ruling did not expressly refer to the [guidance letter \(HKEX-GL41-12\)](#) (the **Guidance Letter**) issued by the Hong Kong Stock Exchange (the **Exchange**), in which the Exchange gave a broader interpretation of what constitutes a MAC in the context of IPO prospectuses. Similar to the Circular, the Listing Rules require a no-MAC statement (also by reference to a group’s financial and trading position) to be included in IPO prospectuses. The Guidance Letter states: “While we recognise that making this determination requires a degree of professional judgment on the part of the sponsors and listing applicants, we consider that in assessing whether a piece of information constitutes a material adverse change, sponsors and listing applicants should consider, as a minimum, whether there is any adverse change which has taken place *or is expected to take place in the near future, in the technological, market,*

economic, legal or operating environment in which the applicant operates” and any such changes should be disclosed if material (emphasis added). The Exchange’s interpretation of a MAC in a listing document context is therefore broader, not least as it includes changes that have not happened but are expected to happen in the near future. This is perhaps not surprising given the IPO context in which the guidance is given.

Implications

When authorising the publication of a no-MAC statement in circulars, directors of listed companies can take comfort that there is a high threshold for what constitutes a MAC in the context of financial position. It is to be assessed, objectively, whether at the latest practicable date, there existed an actual change in the group’s financial position of such deep significance that it has undermined its financial integrity in a manner that will endure.

Note that the MMT’s mandate was a narrow one – that is, whether giving the No-MAC Statement constituted a market misconduct offence under section 277(1) of the SFO. It was not part of the MMT’s mandate to determine whether the company breached its obligation to disclose inside information as soon as reasonably practicable by releasing its profit warning almost six weeks after the 7th September 2008 meeting as the inside information regime was not codified in the SFO until 2013.

Therefore, although the ruling is useful in clarifying the concept of a MAC in the context of financial position, directors of listed companies

will need to be careful of the broader context of obligations now in place in respect of adverse information. In particular, information less ominous than a MAC may, depending on the circumstances, constitute inside information that must be disclosed as soon as reasonably practicable under section 307B(1) of the SFO. The late disclosure of inside information has been the focus of several recent MMT rulings and it is likely that the same fact pattern if repeated today would constitute a late disclosure of inside information.

Although the Exchange’s Guidance Letter on disclosures of MACs in IPO prospectuses does not form part of the Listing Rules, listing applicants are expected to follow the Exchange’s guidance when preparing IPO prospectuses. It should therefore be borne in mind that the scope of a MAC in a listing document context will, in practice, be broader (as per the guidance in the Guidance Letter) than the one applicable to non-IPO circulars.

Finally, in the context of private commercial agreements with a material adverse change clause, the language of the material adverse change clause is often drafted more broadly than the No-MAC Statement that was considered by the MMT. In particular, a commercial agreement material adverse change clause may include material changes to the business of a company (and not just its financial position) and/or include a future element by covering “prospects” as well as the existing state of affairs. Care should therefore be taken to consider the exact language of a material adverse change clause before translating across the analysis of the MMT ruling to a particular agreement.



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