

**Consultation Conclusions on a Review of
the Codes on Takeovers and Mergers and Share Repurchases**

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Introduction

On 10 April 2001 the SFC issued a Consultation Paper inviting public comment on a number of proposed changes to the Hong Kong Codes on Takeovers and Mergers and Share Repurchases (**Codes**). The consultation period was originally scheduled to end on 31 May 2001. In response to public requests it was extended to 15 June 2001.

One of the objectives of the review was to ensure that the Codes are kept up to date with developments in the market and where relevant, with international practice. This is part of the SFC's policy to maintain Hong Kong's position as a leading financial centre and as a bridge between the Mainland and the international market.

The SFC received 76 responses in total from a wide range of respondents. **Appendix A** contains a profile of the respondents. As expected in a consultation of this nature, the comments varied considerably in range and depth, with some respondents focusing on specific issues and others on a wide range of principles and issues. The Takeovers Panel and the SFC welcome these comments and are grateful to those who have participated in providing submissions. Many of the comments have been accepted as described in this paper.

The Panel and the SFC have accepted most of the changes proposed in the Consultation Paper. This paper sets out detailed notes on the following major issues: (i) trigger, creeper and transitional provisions; (ii) Rules 2.2, 2.10 and 2.11 - schemes of arrangement and compulsory acquisition; (iii) Rule 11 – Asset valuations; (iv) Schedule VII - Conflicts of Interest Guidance Note; and (v) Code on Share Repurchases. It also sets out a summary of principal issues dealt with by the Panel and the SFC following the consultation period together with details of the material changes that have been made in light of public comment.

On 19 October 2001 the SFC announced an immediate reduction of the trigger threshold from 35% to 30% and the annual creeper from 5% to 2% in any 12 month period as originally proposed. At the same time transitional provisions were put in place for holders of 30% or more but less than 35% immediately prior to the implementation of the new Rules, in the case of the trigger for 10 years and in the case of the creeper as originally proposed. These changes are described in further detail at pages 2 to 5 of this paper. These amendments became effective on 19 October 2001. A copy of the announcement of these amendments is available on the SFC's website at www.hksfc.org.hk.

The text of the Codes as at May 2001 marked up with all the amendments arising from the consultation is set out in **Appendix B**. All these amendments, other than those which took effect on 19 October 2001, will become effective on 1 February 2002. Where this arrangement may produce major difficulties, the Executive should be consulted and will endeavour to reach a solution which is fair to all parties.

This paper should be read in conjunction with the Consultation Paper which is available on the SFC's website at www.hksfc.org.hk.

Rule 26.1 – Trigger, creeper and transitional provisions

Trigger

Proposal

The Consultation Paper proposed that the trigger be reduced to 30%. As mentioned in the Consultation Paper, during the 1999 consultation, respondents generally felt that 30% represented a more realistic level at which control passes and that Hong Kong should come into line with the UK and the Mainland. The Panel agreed that, given the desire for Hong Kong to project its position as a leading financial centre and as a bridge between the Mainland and the international market, there was good justification for a reduction of trigger to 30%.

Public comment

The majority of respondents supported or did not object to the reduction to 30%. Some respondents thought that the trigger percentage might need to be lower than 30% but that 30% should be first introduced and reviewed at a later date. A minority of the respondents objected to the reduction. Most of these thought the trigger should remain unchanged on the grounds that there was no evidence of abuse and they could not see any compelling reasons for the change.

Creeper

Proposal

The Consultation Paper proposed that the annual creeper be reduced to 2% in any 12 month period. The proposal recognised the need to take into account the purpose of the creeper in the context of the characteristics of the relevant market and the need to bring Hong Kong into line with other markets with similar characteristics such as Singapore.

Public comment

The majority of respondents supported or did not object to a reduction of the creeper to 2%. Most of these thought it should be zero as in London whilst accepting that 2% is a step in the right direction. Several respondents thought the creeper percentage should remain unchanged although a number of these thought that the creeper should be reduced over time, in some cases to zero. Some respondents did not object to a 2% creeper if the effect of share repurchases was exempted. The principal reasons put forward for the creeper remaining unchanged were:

- *As the paper stated there is no evidence of abuse, i.e. creep to statutory control;*
- *They could not see any compelling reasons for the change;*
- *Flexibility should be allowed in market making;*
- *Creeper reductions would inhibit share repurchases;*
- *Transitional provisions are too complex; and*
- *There is nothing wrong with consolidating control.*

Transitional provisions

Proposal

The analysis of the need for transitional provisions is set out in the Consultation Paper. The Consultation Paper set out two options for the length of time that the transitional provisions for the new trigger should be in place, namely indefinitely or for 10 years.

Public comment

Respondents had mixed views on this subject. Although respondents generally supported the introduction of transitional provisions, there was a divergence of opinion on the period for which such provisions should apply ranging from an unlimited period to 2 years. A small number of respondents thought there should be no transitional provisions and that holdings between 30% and 34.9% should be subject only to the creeper. The majority of respondents who expressed a view, thought that holdings between 30% and 34.9% should be capped (with reductions allowed but no increases) with no creeper allowed. All but one of these thought that if a cap was not introduced, at least the new 2% creeper should apply to such holders.

Several respondents were under the impression that, if the transitional period was limited, the holder would be required to sell down to below 30% at the end of the period. That is not the intention and the transitional provisions have been amended to clarify this.

Conclusion

Trigger and creeper - The Panel and the SFC welcomed respondents' support for the reduction of the trigger to 30%. They also noted the view, particularly among investors, that the creeper should be at zero or should ultimately be reduced to zero. They considered that a reduction of the creeper to 2% was appropriate to bring Hong Kong into line with international practice.

Transitional provisions - The Panel and the SFC remain firmly of the view that transitional provisions are essential in order to ensure as far as possible that all shareholders are neither advantaged nor disadvantaged as a result of the changes to the trigger. The transitional provisions are set out in Rules 26.6 and 26.7.

In relation to the trigger these apply to those shareholders who alone or with concert parties own between 30% and 34.9% of a company at the time these new Rules were implemented on 19 October 2001.

For these shareholders, for as long as they continue to own between 30% and 34.9% and until 10 years after 19 October 2001, the old trigger of 35% will apply. If the holding falls below 30%, the new trigger of 30% will then apply.

For these shareholders, for as long as they continue to own between 30% and 34.9% and until 10 years after 19 October 2001, the new 2% creeper will not apply. For example, a shareholder owning 31% today will be able to buy and sell shares within

the range of 30% and 34.9% without having to make a mandatory offer. If the holding reaches 35%, he will have to make a mandatory offer.

In relation to the creeper, for 12 months from 19 October 2001, being the date the changes became effective, anyone who holds between 35% and 50% of a company and is about to acquire shares must look at two tests. First, will the shares he is about to acquire, when added to any shares he has acquired since 19 October 2001, exceed 2%? Secondly, will the shares he is about to acquire, when added to shares he has acquired in the 12 months prior to the date of acquisition, exceed 5%? If the answer is yes in either case, then he would exceed the creeper if he acquires the shares and he would have to make a mandatory offer. After 18 October 2002 the only test will be whether the total of shares acquired in the previous 12 months is more than 2%.

Effective for 10 years - The SFC noted the lack of consensus among respondents as to the period for which the transitional provisions should be in place, namely, indefinitely or for 10 years. The SFC carefully considered the options and concluded that a fixed period of 10 years was more appropriate as this would reduce the possible long term confusion which an indefinite two tier system might cause. The SFC is satisfied that this approach adequately safeguards the interests of minority shareholders.

Announcement on 19 October 2001

The Panel and the SFC decided that the changes should be implemented with immediate effect so that shareholders who were holding less than 30% immediately before the changes could not gain an advantage by having an opportunity to acquire further shares to take their holding above 30% before the implementation date. This was consistent with the objective of ensuring as far as possible that all shareholders were neither advantaged nor disadvantaged as a result of the changes. These amendments were announced and became effective on 19 October 2001. A copy of the announcement of these amendments is available on the SFC's website at www.hksfc.org.hk.

Register of shareholdings of 30% or more but less than 35%

In order to avoid market confusion a register is being compiled of shareholders who, immediately prior to implementation of the new Rules, alone or acting in concert either (a) owned between 30% and 34.9% of a company or (b) owned convertible securities, warrants, options or subscription rights that could upon exercise take them or their concert parties into the 30% to 34.9% range. All such shareholders have been asked to register their holdings with the Executive as soon as possible. If any shareholder or group of shareholders is in any doubt as to whether they fall within this band, the Executive should be consulted at the earliest opportunity.

Where appropriate, an application should be made to the Executive for a formal written ruling under section 8 of the Introduction to the revised Takeovers Code. In these circumstances, the Executive will not charge a fee for a ruling. All relevant shareholders are also asked to notify the Executive if their holdings fall below 30% so that their holdings can be removed from the register. The register is posted on the SFC's website at www.hksfc.org.hk.

Further amendments

Rule 26.6 has been further amended to clarify the position of holders of convertible securities, warrants, options or subscription rights (immediately prior to 19 October 2001) that could upon exercise take them and their concert parties into the 30% to 34.9% range. These amendments appear in bold in the marked up text in **Appendix B**. Effectively, such holders will only be entitled to enter the 30% to 34.9% range once, upon conversion or exercise of part of their convertible securities, warrants, options or subscription rights. From then on, they will be subject to the transitional provisions for as long as they remain within the 30% to 34.9% range. If they drop out of that range, they will cease to be able to take advantage of the transitional provisions contained in Rule 26.6 upon exercise of any remaining convertible securities, warrants, options or subscription rights. Where a holding has been diluted to below 30% the Executive should be consulted.

Rules 2.2, 2.10 and 2.11 - Schemes of arrangement and compulsory acquisition

Philosophy

The philosophy and logic behind these changes is discussed at pages 9 to 11 of the Consultation Paper.

Rule 2.2 - Approval of delisting by independent shareholders

Proposal

The Consultation Paper proposed that resolutions to delist a company should be subject to the same voting requirements as those proposed under Rule 2.10.

Public comment

Some respondents supported the amendment as proposed. A larger number of respondents suggested that 100% approval of shareholders should be required for delisting whilst accepting that if such suggestion was rejected the proposal should be adopted.

One respondent suggested that a delisting resolution during an offer should only be effective when the offeror becomes entitled to exercise rights of compulsory acquisition and this suggestion has been accepted.

Rule 2.10 - Takeover and privatisation by scheme of arrangement or capital reorganisation

Proposal

The Consultation Paper proposed expanding Rule 2.10 to cover all takeovers effected by way of scheme of arrangement or capital reorganisation, in addition to privatisations. It also proposed amending the two tier voting test to require 75% of disinterested shareholders present and voting to vote in favour and no more than 10% of disinterested shareholders to vote against.

Public comment

The majority of respondents supported the proposed amendments. A small number opposed the amendments suggesting that the Rule should be abolished or remain unchanged. One respondent suggested that the Rule should not be extended to non-privatisations or, if it was, that the voting hurdles should be no more than those required under statute.

Rule 2.11 - Exercise of rights of compulsory acquisition

Proposal

The Consultation Paper proposed a new Rule 2.11 providing that an offeror must acquire 90% of the disinterested shares before it is able to compulsorily acquire the remaining shares.

Public comment

The majority of respondents supported the addition of a new Rule 2.11. One respondent asked whether a company incorporated in Bermuda may be privatised by a shareholder holding 95% of its shares without compliance with Rule 2.11.

Conclusion

The Panel and the SFC note the strong support for the principles behind these amendments. They do not think that it is practical to require 100% approval by all shareholders for a delisting. The SFC has adopted the amendments as proposed in the Consultation Paper. In addition, a new paragraph (c) has been added to Rule 2.2 to provide that a delisting resolution must be subject to the offeror being entitled to exercise its rights of compulsory acquisition. The SFC confirms that a 95% shareholder of a company incorporated in Bermuda will be required to comply fully with Rule 2.11 before exercising its statutory rights of acquisition under Bermuda law. If an offeror acquires 95% of the entire issued share capital of an offeree company but these shares do not also represent a total 90% of the shares held by disinterested shareholders, the Executive will be concerned that the requirements of Rule 2.2 are fully complied with so that the listing status of the offeree company is maintained. This is consistent with one of the main objectives of the Codes in providing a level playing field for public companies in Hong Kong which are incorporated in different jurisdictions.

Rule 11 - Asset valuations

Rule 11

The proposed amendments to Rule 11 attracted useful comments, particularly those relating to discounted cash flow (**DCF**) valuations and the requirement for valuations based on business or financial methods to be reported on by financial advisers. The Panel and the SFC have accepted a number of these comments which clarify the requirements and underline the importance of and responsibility for valuations as described below. Further amendments have been made to Rules 11.1, 11.2 and 11.5.

Rule 11.1(a) – DCF valuations as profit forecasts

Proposal

The Consultation Paper proposed that Rule 11.1(a) should be expanded to clarify that valuations prepared on a DCF basis would be regarded as profit forecasts to which Rule 10 of the Takeovers Code applies.

Public comment

Several respondents pointed out that HKSA Auditing Guideline 3.341 “Accountants’ report on profit forecasts” does not allow accountants to report on forecasts for periods of longer than 12 months from the end of the current accounting period.

Other respondents argued that DCF valuations of an asset or business should not be regarded as profit forecasts. The arguments put forward included: (a) it is not possible to extrapolate the forecasted profits of a company from DCF valuations as they only relate to a particular asset or business of a company; (b) a DCF valuation comprises not only the profit element, but also capital expenditure and receipts, as well as disposal proceeds; and (c) profitability in any particular year cannot readily be extracted from the valuation.

Others pointed out that it is inconsistent to accept property valuations based on capitalisation of forecast rental yield, which is essentially the same as a DCF valuation.

Conclusion

For some time, the Executive has regarded valuations involving profit, earnings or cash flow projections as profit forecasts under Rule 10.6. For the purpose of the Takeovers Code, Rule 10.6 provides that even when no particular figure is mentioned or even if the word “profit” is not used, certain forms of words may constitute a profit forecast, particularly when a form of words puts a floor under, or a ceiling on, the likely profits of a particular period or contains the data necessary to calculate an appropriate figure for future profits.

As one of the key components of DCF valuations is forecast earnings streams, the Executive has also regarded such valuations as profit forecasts within Rule 10.6 which are subject to Rules 10 and 11 of the Takeovers Code. This is consistent with the approach of the London Panel. The changes to Rule 11.1(a) codify the current practice of the Executive. The Panel and the SFC believe that Rule 11.1(a) should be

clarified to distinguish between valuations of land and buildings and valuations of other assets. Where it is proposed to give a valuation of assets, other than land and buildings, based on DCF valuations or projections of profits, earnings or cash flows, the Executive must be consulted. Since it may be possible to derive a forecast of profits from such valuations, they will normally be regarded as if they were profit forecasts to which Rule 10 would apply. The Executive will normally only relax the requirements of Rule 11.1(a) in exceptional circumstances or where the predictability of cash flows is reasonably assured.

Rule 11.1(b) – The valuer and Rule 11.2 – Basis of valuation

Proposal

The Consultation Paper proposed adding a new Rule 11.1(b) clarifying that land and building valuations should be carried out by professional valuers with other assets being valued by business or financial valuation methods or models being carried out or reported on by financial advisers.

Public comment

Most respondents believed that all business valuations should continue to be carried out by professional valuers rather than financial advisers, subject to further requirements.

Several respondents suggested that valuers should be required to take responsibility for the valuation report and be obliged to state that they have made best efforts to verify and validate the assumptions used. In addition it was suggested that all material assumptions should be disclosed.

Others suggested that a self-regulatory body should be set up to educate and regulate valuers or that the SFC should maintain a panel of approved expert valuers.

Conclusion

The Panel and the SFC remain of the view that valuations of all assets, other than of land and buildings, should normally be carried out by the financial adviser to the relevant party. The original proposed reference to business or financial valuations methods or models has been dropped from Rule 11.1(b). Another principal concern is to ensure that assumptions contained in a valuation can be supported and that responsibility is taken for both the assumptions and the valuation. Further changes have been made to Rules 11.2 and 11.1(b) to emphasise this. The Panel and the SFC do not consider the suggestions to set up a self-regulatory body or a panel of approved expert valuers to be practical.

Schedule VII - Conflicts of Interest Guidance Note

Proposal

The Consultation Paper proposed the addition of a new paragraph (b) to Schedule VII to impose restrictions on financial advisers that are part of a multi-service firm involving an auditor's practice as set out below.

“A financial adviser that is part of a multi-service firm involving an auditor's practice should be particularly alert to possible conflicts of interest.

In the case of all offers, a financial adviser must not act for –

- (i) an offeror where the financial adviser, or any of its affiliated entities, is the auditor of the offeree company; and
- (ii) the offeree company where the financial adviser, or any of its affiliated entities, is the auditor of an offeror company;
- (iii) the offeree company as an independent financial adviser under Rule 2 if the financial adviser, or any of its affiliated entities, is the auditor of the offeree company, as it will be conflicted under Rule 2.7.”

Public comment – proposed paragraphs (i) and (ii)

Some respondents considered the proposed additions to Schedule VII to be fair and reasonable in order to ensure that the independence of auditors will not be affected by the financial advisory services offered by affiliated firms.

However, several respondents questioned why multi-service firms that include an auditor's practice had been singled out when there were similar potential conflicts in the banking sector involving, for example, lending institutions.

Some respondents specifically objected to the application of paragraphs (i) and (ii) where the offer was not hostile and not contested, since they believed that there appeared to be no conflict in these situations. In respect of paragraph (i), some respondents suggested that in order to address any conflict concerns the appointment of the affiliated financial adviser could be subject to the consent of the offeror and the offeree company board. They further suggested that in such cases, if the offer subsequently became hostile or contested, the affiliated adviser should step down unless the offeree and all offerors agree otherwise.

Public comment – proposed paragraph (iii)

All respondents who expressed an opinion agreed with or did not object to this proposal.

Proposal

The Consultation Paper also proposed the addition of the following :

“In the case of a securities exchange offer -

- (i) a financial adviser must not act for an offeror if the financial adviser, or any of its affiliated entities, is the auditor of the same offeror company; and
- (ii) if a financial adviser is advising an offeror, and a company audited by the financial adviser, or any of its affiliated entities, makes a competing offer, the financial adviser may continue to act but the auditor of the competing offeror must not issue any profit forecast report during the offer period.

In other cases if a financial adviser is acting for an offeror or the offeree company and the financial adviser or any of its affiliated entities is asked to issue an accountants’ report in connection with the offer, the Executive should be consulted.

In this paragraph (b) references to an offeror or the offeree company include the parent, material subsidiaries and material associated companies of such offeror or offeree company.”

Public comment – proposed paragraph (i)

Those respondents who disagreed with this proposal mostly did so for the same reasons given under (i) and (ii) above. One respondent thought that any conflict concerns could be resolved by the appointment of an independent financial adviser to advise the independent shareholders of the offeror.

Public comment – proposed paragraph (ii)

The only respondent to respond on this point thought that an auditor in such circumstances should be able to report on a profit forecast provided it did not breach the Accountants’ Code on professional ethics issued by the HKSA.

Public comment – final two paragraphs

There were no specific comments on these paragraphs.

Conclusions

The Panel and the SFC acknowledge that conflicts may also arise within multi-service financial organisations that do not have auditing practices. Accordingly paragraph (b) has been amended to acknowledge this possibility, with specific reference to both auditor’s practices and lending institutions. Paragraph (b) has been further amended so that instead of identifying some specific instances where a conflict arises, it provides that in all cases of possible conflict the Executive must be consulted. The Panel and the SFC believe that it is more appropriate for the Executive to assess possible conflicts on a case by case basis.

Although the paragraph no longer singles out auditing practices, the Executive notes that auditors carry out a vital and unique public role when engaged by a public company. The Executive is concerned that this public role, which hinges on the independence of the auditor's function, may be compromised where a financial advisor affiliated with the offeree or offeror company's auditor is appointed to act in connection with a transaction. Recent high profile examples of problems (mainly overseas) which have been attributed in part to conflicts involving consultancies and auditors which are part of the same multi-service organisations have led to a greater public awareness that auditors must observe very high standards of independence. The Executive should be consulted at the earliest opportunity whenever a potential conflict of interest involving an auditor arises.

Code on Share Repurchases

Proposal

The Consultation Paper proposed the complete reorganisation of the Share Repurchase Code relating to share repurchases by general offer by referring to the Takeovers Code and the incorporation of additional specific requirements for such offers as well as for other share repurchases.

Public comment

All respondents welcomed the proposal to rationalise the Share Repurchase Code. Several respondents pointed out that a number of Rules of the Takeovers Code are not applicable or may not be. However, concern was expressed that wholesale application of all the 'relevant' Rules of the Takeovers Code with minor carve-outs might not be the best way to achieve consistency between the two Codes and was likely to lead to greater uncertainty and confusion. Some respondents also pointed out that it was not clear whether the company carrying out the repurchase is the offeror or offeree, or both.

Proposal

The Consultation Paper proposed a new section 4.4 of the Introduction to the Codes stating, amongst other things, that “share repurchases by way of general offer will be considered to be partial offers or, where relevant, full offers ...”.

Public comment

One respondent pointed out that section 4.4 should not refer to partial offers. The reasons for this were that as most of Rule 28 of the Takeovers Code (namely, 28.1, 28.2, 28.4, 28.5 and 28.6) refers to the offeror's shareholding percentages in the offeree company, it is mostly irrelevant to share repurchases as a company is not entitled to hold its own shares. As such, it was argued that only Rules 28.3 (prohibition of on market share repurchases during the offer period), 28.8 (pro rata entitlement provisions) and 28.9 (comparable offer provisions) could logically apply to a share repurchase.

Conclusion

New Rule 5.1 of the Share Repurchase Code has been completely revised to show the Rules of the Takeovers Code that will normally apply to every share repurchase general offer and those that would also normally apply to a privatisation or delisting.

The Panel and the SFC accept the points raised concerning the reference to partial offers in section 4.4 of the Introduction to Codes. To ensure that the relevant parts of Rule 28 of the Takeovers Code still apply to share repurchases, Rules 28.3 and 28.8 have been included as new Rules 5.3 and 5.4 of the Share Repurchase Code. The relevant part of Rule 28.9 is already in new Rule 3.4 of the Share Repurchase Code as originally proposed.

Summary of principal issues and further changes

The Panel and the SFC have accepted most of the changes proposed in the Consultation Paper for the reasons set out in that paper. The text of the Codes as at May 2001 marked up with all the changes that became effective on 19 October 2001 together with those changes which will become effective on 1 February 2002 is set out in **Appendix B**. A summary of the principal issues dealt with by the Panel and the SFC following the consultation period together with details of the material changes that have been made in light of public comment is set out below.

INTRODUCTION (new section numbers)

The Introduction has been substantially redrafted and reorganised as originally proposed.

1. Section 4.2 – Companies and transactions to which the Codes apply

Section 4.2 has been amended as originally proposed.

Explanation - Some respondents suggested that the criteria should include, or should simply comprise, whether a company has had access to the market in Hong Kong via an IPO or fund raising. The Panel and the SFC consider that this is effectively covered by reference to the test of the extent of share trading and the number of shareholders in Hong Kong.

2. Section 8 – Applications for rulings

The original wording in old section 15.3 (new section 8.3) has been reinstated.

Explanation - The wording has been reinstated in response to comments by several respondents that it was unreasonable to expect financial advisers to “ensure the truth, accuracy and completeness” when filing a submission for a ruling.

3. Section 9 – Review of Executive rulings

Section 9.1 (old section 11.1) has been amended as originally proposed. It has also been amended further to clarify that the Executive must also supply a statement of its case to the relevant party.

Explanation – The further amendment was added in response to a request by a respondent for clarification.

4. Section 11 – The Takeovers and Mergers Panel

Section 11.3 (old section 6.3) has been amended as originally proposed. It has also been further amended to state specifically that Executive Directors or staff of the SFC may not be members of the Panel.

Explanation – The further amendment has been made in response to a request by a respondent for clarification.

DEFINITIONS

5. Acting in concert

The definition of acting in concert has been amended as proposed. A new Note 9 has also been added to clarify the position of underwriters of a cash alternative.

Explanation – New Note 9 has been added in response to requests by several respondents for clarification of the position of underwriters. New Note 9 follows the existing practice in London.

6. Offer period

The offer period has been extended from the original proposal to run until the offer closes.

Explanation - On further analysis a number of areas have been identified where action may be taken after the offer has been declared unconditional in all respects that would have Code consequences if it had been taken during an offer period. In particular, where an offeror holding more than 50% of the shares of the offeree company intends to exercise its rights of compulsory acquisition in a privatisation offer, it may immediately declare the offer unconditional and thereafter take action such as buying shares for cash (Rule 23) or issuing a profit forecast (Rule 10) which would not be subject to Code discipline. The Panel and the SFC are concerned that in such circumstances, offeree shareholders may not be afforded fair treatment. The extension of the offer period aims to remedy this situation.

One of the consequences of extending the offer period is that dealing disclosure under Rule 22 of the Code will be required after the offer has become unconditional up until the date the offer closes. The Panel and the SFC believe that it would be unduly burdensome to require associates (other than persons acting in concert with any offerors) to disclose dealings during this period. Accordingly, a new Note 3 to Rule 22 has been added to clarify that such associates will not have to disclose dealings during this period (see paragraph 20 below).

CODE ON TAKEOVERS AND MERGERS

7. Rule 1.2 – Identity of offeror

Rule 1.2 has been amended to require disclosure of the identity of the ultimate controlling shareholders and parent companies of the offeror or, where there is a listed company in the chain, the identity of that company.

Explanation – No changes were made to the amendments originally proposed. The requirement for disclosure of the identity of the ultimate offeror is consistent with similar changes to Rule 3.5(b) and paragraph 2 of Schedule 1 (see paragraph 39 below). The reference to disclosure of a listed company in a chain has been to ensure consistency with the existing requirement in paragraph 2 of Schedule I.

8. Rule 2.1 – Board of offeree company

Rule 2.1 has been amended as originally proposed. It has also been amended to provide that the board of the offeree must announce the appointment of the independent financial adviser in the initial announcement or as soon thereafter as the appointment is made.

Explanation - Several respondents commented on this Rule. Some suggested the appointment of an independent financial adviser should be announced immediately so that shareholders are informed promptly. The Panel and the SFC agree with this and Rule 2.1 has been amended accordingly.

9. Rules 2.2, 2.10 and 2.11 - Schemes of arrangement and compulsory acquisition

Rules 2.10 and 2.11 have been amended as originally proposed.

Rule 2.2 has been amended as originally proposed. It has also been amended further so that resolutions to delist a company will only be effective when the offeror becomes entitled to exercise, and does exercise, rights of compulsory acquisition.

Explanation – The further change to Rule 2.2 was made in response to a respondent’s suggestion. See pages 6 to 7 of this paper for a fuller commentary on the changes to Rules 2.2, 2.10 and 2.11.

10. Rules 2.6 – Persons not suited to give independent advice

Rule 2.6 has been amended as originally proposed. In addition, references to “likely” have been changed to “reasonably likely” and “Significant” has been added to the heading of the Note to Rule 2.6.

Explanation – The further changes have been made in response to respondents’ comments. References to “likely” have been changed to “reasonably likely” as

their use was inconsistent in Rule 2.6. “Significant” has been added to clarify that the relevant standard is a “significant connection within 2 years”.

11. Rule 3 – Announcements of offers or possible offers

Most of the amendments proposed in the Consultation Paper have been adopted. A number of further amendments have been made as described below.

The words “*outside those who need to know in the companies concerned and their immediate advisers*” in Rule 3.2(c) and “*firm*” in Rule 3.2(a) have been reinstated.

Explanation - These words have been reinstated in response to comments by several respondents that their deletion might cause confusion.

New Note 3 to Rule 34 as proposed in the Consultation Paper has been moved to become new Note 4 to Rules 3.1, 3.2 and 3.3 and amended to allow an approach to a small number of sophisticated investors who have a controlling shareholding to obtain an irrevocable commitment without reference to the Executive. In all other circumstances the Executive must be consulted in advance.

Explanation - One respondent pointed out some inconsistency and lack of clarity between Rules 3.1, 34.4 and Note 3 to Rule 34.

Rule 3.5(b) has been amended further to require disclosure of the identity of the ultimate controlling shareholders and parent companies of the offeror or, where there is a listed company in the chain the identity of that company.

Explanation – The requirement for disclosure of the identity of the ultimate offeror is consistent with similar changes to Rule 1.2 and paragraph 2 of Schedule 1 (see paragraph 39 below). The reference to disclosure of the identity of a listed company in a chain has been added to ensure consistency with the existing requirement in paragraph 2 of Schedule I.

Note 3 to Rule 3.5 has been amended further to clarify that a financial adviser acting responsibly would not be required to produce cash itself.

Explanation – Several respondents questioned whether the changes to Rule 3.5 and Note 3 to that Rule as proposed in the Consultation Paper would impose a higher standard and additional responsibility on financial advisers in giving a confirmation of financial resources. The amendment as proposed in the Consultation Paper merely codified the current standard expected of financial advisers and did not impose additional responsibility. The further amendment to Note 3 clarifies that a financial adviser who has acted responsibly and taken all reasonable steps would not be required to produce cash itself.

Rule 3.7 has been amended as originally proposed to cover announcements of possible offers or talks announcements with monthly up-date announcements thereafter.

Explanation – Some respondents raised concerns that the requirement that a potential offeror be named at an early stage may create confusion especially if the offeror is a listed company. Concern was also expressed that “frequent” up-date announcements might also lead to market confusion. The principal purpose of Rule 3.7 is to ensure that information is available equally to all shareholders and to avoid the creation of a false market. The Panel and the SFC are satisfied that the provisions relating to the identity of offerors and monthly up-dates will help achieve this. It is not accepted that monthly up-date announcements in the context of takeovers are too frequent.

12. Rule 8.2 – Offer document time limit

Rule 8.2 has been amended as originally proposed. A new Note 3 has also been added to require evidence of the date of despatch of the offer document to be given to the Executive.

Explanation – Rule 8.2 allows a 3 day difference between the date of the offer document and the despatch date. The Executive closely monitors these dates. New Note 3 has been added to facilitate this (see also paragraph 39 below).

13. Rule 10.10 – Merger benefit statements in securities exchange offers

New Rule 10.10 has been amended as originally proposed. It has been also been amended further to clarify that it applies only to merger benefit statements made in securities exchange offers.

Explanation – One respondent suggested that Rule 10.10 should only apply to securities exchange offers. This is consistent with the principle that a merger benefit statement is a profit forecast and a profit forecast of the offeror is not required to be reported on in a cash offer. The Panel and the SFC agree with this amendment. The same respondent also suggested that Rule 10.10 should follow the London Code and not apply in a recommended securities exchange offer unless a competing offer is made and the merger benefit statement becomes a material issue. The Panel and the SFC do not think that it is appropriate in Hong Kong to draw a distinction between recommended and contested bids in securities exchange offers. They believe that in both cases (particularly in privatisation offers recommended by the offeree board which are common in Hong Kong) the requirements of Rule 10.10 should be complied with in order to protect the interests of minority shareholders who are provided with merger benefit statements.

14. Rule 11 - Asset valuations

Rule 11 has been amended to incorporate some of the amendments as originally proposed together with others that have been made in light of respondents' comments. A summary of the changes is set out below.

Rule 11.1(a) has been amended to clarify that DCF valuations will be regarded as profit forecasts which are subject to Rules 10 and 11 of the Takeovers Code. Rule 11.1(a) has been further amended to distinguish between valuations of land and buildings and valuation of other assets. A new provision has also been added to clarify that the Executive will only relax the requirements of Rule 11.1 in exceptional circumstances or where the predictability of cash flows is reasonably assured.

Explanation – Please see pages 8 and 9 of this paper.

Rule 11.1(b) has been amended further to clarify that normal land and buildings valuations should continue to be carried out by professional valuers with all other valuations carried out, or reported on by financial advisers.

Explanation – Please see page 9 of this paper.

Rule 11.1(f) has been amended as proposed.

Explanation - Two submissions suggested that 15% was too low a figure as the test for significant property assets and that it should be increased to 30%. One suggested as an alternative that the test should be the higher of 15% of book value or 15% of the offer value. The Panel and the Executive continue to believe that 15% is the correct level.

Rule 11.2(a) has been amended further to provide that the material assumptions made in a valuation must be stated in the valuation.

Explanation – Please see page 9 of this paper.

Rule 11.5 has been amended further to clarify that a valuation must be made with due care and consideration by the valuer or financial adviser making the valuation.

Explanation – This change has been made to clarify the standard expected by the market.

15. Rule 12 – Issuance of documents

Rule 12.2 has been amended as originally proposed. It has also been amended further to enable listed companies to follow the publication requirements of the Listing Rules and to require copies of all documents to be sent in electronic form to the SFC and the Stock Exchange.

Note 1 to Rule 12 has been amended to delete references to clearance of documents on Saturdays.

Explanation – The changes have been made in response to a respondent’s suggestion that the Code should be adapted to allow for the move to web-based disclosure.

One respondent asked about the application of Note 1 to Rule 12 since the Listing Division does not work on Saturdays. Given that there is only a limited staff available on Saturdays in the SFC, reference to clearance of documents on Saturdays has been deleted.

16. Rule 13 – Appropriate offers for convertibles, warrants, etc.

New Rules 13.2 and 13.4 have been added as originally proposed. In addition, Note 1 to Rule 13 has been amended and a new Note 2 added to clarify the existing position.

Explanation – The amendments codify the decision of the Panel on the proposed privatisation of Asean Resources by Huey Tai in May 1996. The decision is available on the SFC’s website at www.hksfc.org.hk.

17. Rule 15 – Offer timetable

Rule 15 has been amended as originally proposed.

18. Rule 19 – Announcement of results of offer

Rule 19 has been amended as originally proposed. A new Note 7 to Rule 19 has been added to clarify that in partial offers and share repurchases the results announcement must disclose details of the way in which each shareholder’s pro rata entitlement was determined.

Explanation - In reviewing respondents’ comments on share repurchases and partial offers it became apparent that the Code did not specifically require the disclosure of the details of the way in which each shareholder’s pro rata entitlement was determined. The new Note has been added to rectify this.

19. Rule 21.5 – Dealings in offeree company securities by certain offeree company associates

New Note to Rule 21.5 has been added to clarify that the Executive will normally grant a waiver from the requirements of Rule 21.5 in a non-competitive recommended bid or an unconditional mandatory offer.

Explanation – This Note has been added to clarify the existing interpretation of the Rule by the Panel and the Executive, which is the same as the interpretation adopted by the London Panel.

20. Rule 22 – Disclosure of dealings during offer period

Note 3 to Rule 22 has been amended to clarify that associates (other than the concert parties of any offeror) do not have to disclose dealings after the offer has been declared unconditional in all respects.

Explanation – The Panel and the SFC consider that disclosure of dealings by associates (other than concert parties of any offeror) in such circumstances would be unduly burdensome. This amendment arises from the extension of the offer period as explained in paragraph 6 above.

21. Rule 24 – Purchases resulting in an obligation to offer a minimum level of consideration

Rule 24 has been amended as proposed with some additional changes as described below.

Some of the references to “*securities*” have been changed back to “*shares*”.

Explanation – These changes have been made to correct some inconsistencies in Rule 24 as proposed in the Consultation Paper.

The words “before the offer closes for acceptance” in Rule 24.1(b) have been replaced by “during the offer period”.

Explanation – This change reflects the changes described under “offer period” in paragraph 6 above.

22. Rule 25 – Special deals with favourable conditions

Rule 25 has been amended as originally proposed.

Explanation – Respondents who expressed a view welcomed the clarification of Rule 25.

23. Rule 26.1 – Trigger and creeper

On 19 October 2001 the SFC announced an immediate reduction of the trigger threshold from 35% to 30% and the annual creeper from 5% to 2% in any 12 month period as originally proposed. At the same time transitional provisions were put in place for 10 years for holders of between 30% and 34.9% immediately prior to the implementation of the new Rules. Transitional provisions were also put in place for the creeper as originally proposed.

Explanation – Please see pages 2 to 5 of this paper.

24. Note 6 to Rule 26.1 – Acquisition of voting rights by members of a group acting in concert

Note 6 has been amended as originally proposed.

25. Note 10 to Rule 26.1 – Convertible securities, warrants and options

The reference to the possibility of a whitewash waiver being invalidated by a purchase of voting rights prior to exercise of a whitewashed convertible security, warrant or option has been deleted.

Explanation – This reference has been deleted as it contradicts the existing paragraph 7 (new paragraph 8) of Schedule VI which clearly allows purchases of voting rights prior to any exercise of a whitewashed convertible security, warrant or option subject to certain conditions (see paragraph 40 below).

26. Note 14 to Rule 26.1 – 2% creeper – placing and top-up transactions

A reference to Note 15 to Rule 26.1 has been added to clarify the lowest percentage holding of a placing shareholder who has completed a whitewashed transaction within the 12 month period immediately before the placing and top-up transaction.

Explanation – This change has been made in response to one respondent's comment that it was unclear what would happen if the lowest percentage holding of the placing shareholder in the 12 months immediately before the placing and top-up transaction had been below the trigger but was increased by a whitewash transaction during that period. The new wording clarifies that in such circumstances the principle of a 'clean slate' after a whitewash would apply (see paragraph 27 below).

27. Note 15 to Rule 26.1 – The 2% creeper – effect of whitewash

Note 15 has been amended to provide that following a whitewash waiver transaction (under Note 1 of the Notes on Dispensations from Rule 26) the lowest percentage shareholding for the purposes of the creeper will be the shareholding immediately following completion of the whitewash transaction; in other words a 'clean slate'. The requirement that a shareholder must obtain a separate creeper authorisation from shareholders before he can acquire further voting rights in the following 12 months has been removed.

Explanation – The 'clean slate' approach following a whitewash transaction has been adopted in view of the newly reduced creeper (2%) and in the interests of reducing complexity. The requirement for creeper authorisation following a whitewash has been removed. This is because in practice the creeper authorisation is routinely sought and often granted by shareholders at the same time as the whitewash waiver approval. Similar changes have been made to Note 1 of the Notes on Dispensations from Rule 26 and to paragraph 7 of Schedule VI. Additional paragraphs have been added to Schedule VI (see paragraph 40 below).

28. Rule 26.6 – Holdings of between 30% and 35%

New Rule 26.6, which contains the transitional provisions in relation to holdings between 30% and 34.9% as proposed in the Consultation Paper, came into effect on 19 October 2001. A number of further amendments have been made since that date to clarify the position regarding convertibles as discussed below. These amendments appear in bold in the marked up text at **Appendix B**.

Rule 26.6 has been amended further to clarify the position of holders of convertible securities, warrants, options or subscription rights that could upon exercise take them and their concert parties into the 30% to 34.9% range. Effectively, such holders will only be entitled to enter the 30% to 34.9% range once, upon conversion or exercise of part of such convertible securities, warrants, options or subscription rights. From then on, they will be subject to the transitional provisions for as long as they remain within the 30% to 34.9% range. If they drop out of that range, they will cease to be able to take advantage of the transitional provisions contained in Rule 26.6 upon exercise of any remaining convertible securities, warrants, options or subscription rights. Where a holding has been diluted to below 30% the Executive should be consulted.

Rule 26.6 has also been amended further to confirm that a person who holds between 30% and 34.9% at the end of the 10 year transitional period and has been subject to the transitional provisions will not be required to reduce such holding to below 30%.

Explanation – The second paragraph of Rule 26.6 has been added to codify the Panel and the Executive’s existing interpretation of Rule 26.6 (see page 5 of this paper).

Several respondents were under the impression that, if the transitional period was limited, the holder would be required to sell down to below 30% at the end of the period. That is not the intention and the last paragraph of Rule 26.6 has been added to clarify this.

29. Note 1 of Notes on dispensations from Rule 26 – Whitewash

Note 1 has been amended as proposed. It has also been amended further to reflect the changes to Note 15 to Rule 26.1 described in paragraph 27 above.

30. Note 2 of Notes on dispensations from Rule 26 – Enforcement of security for a loan, receivers, etc.

The reference to “*administrator*” has been deleted.

Explanation – The reference in the Note to an administrator of a company has been deleted as the concept of administration as an alternative to receivership or liquidation does not exist in Hong Kong.

31. Note 6 of Notes on dispensations from Rule 26 – Placing and top-up transactions

Note 6 has been amended as originally proposed.

Explanation – The Consultation Paper proposed that a waiver for a placing and top-up should only be available to enable a placing shareholder to subscribe for a number of shares equal to the number of shares placed rather than equal to the percentage shareholding of that shareholder before the transaction. Some respondents commented that this was unfair on the participating shareholder and would act as a disincentive to such shareholders to raise funds by placing and top-ups transactions. Others agreed with the change. The Panel and the SFC are satisfied that the amendment to Note 6 is consistent with the principle of treating all shareholders equally.

32. Rule 28.7 – Precise number of shares to be stated

Rule 28.7 will not be deleted as originally proposed.

Explanation – Upon further reflection, the Panel and the SFC are concerned that the deletion of Rule 28.7 might lead to confusion particularly with regard to whether or not an offeror would still be required to state the number of shares under offer in a partial offer. In order to avoid such confusion, Rule 28.7 has been reinstated. A full review of Rule 28 will be carried out at a later date as recent experience has shown that a number of the requirements of the existing Rule 28 may not be relevant to a partial offer that does not involve a change of control.

33. Rule 31.1 – Delay before subsequent offer

New Note 4 has been added to Rule 31.1 as originally proposed.

34. Rule 31.3 – 6 months delay before acquisition above offer price

Rule 31.3 has been amended as originally proposed. In addition, the words within 6 months “*of the closure*” have been replaced by “*after the end of the offer period*”.

Explanation – This change reflects the changes described under “offer period” in paragraph 6 above.

35. Rule 33 – Inducement fees, break fees and standstill agreements

New Rule 33 has been added as originally proposed.

Explanation – Respondents who expressed an opinion generally supported the addition of this Rule. Some respondents asked for an explanation of the rationale for Rule 33. The purpose of new Rule 33 is to ensure that offeree shareholders are fully informed of and not adversely affected by inducement fee arrangements or

standstill agreements. Similar provisions are already in place in London. New Rule 33 introduces various safeguards including the requirement that an inducement fee or break fee must be de minimis (normally no more than 1%) and that the offeree board confirms that the fee is in the best interests of shareholders. Disclosure of inducement or break fees and standstill agreements is also required.

36. Rule 34 – Shareholder solicitations

Proposed Rule 34.4 has not been adopted and Note 3 has been transferred to Rule 3 as described under paragraph 11 above.

Explanation - Rule 3.1 refers to approaching a “wider group” to seek an irrevocable commitment to accept an offer whereas the proposed new Rule 34.4 referred to “proposing to contact shareholders other than institutional investors” in the same context. Accordingly the proposed Rule 34.4 has been deleted.

37. Rule 36 – Obligations of other persons

New Rule 36 has been added as originally proposed.

Explanation – One respondent commented that principal members of the concert group should be excluded from the general offer obligation if they confirm that they exert no influence over the dealing decision of a non-principal member which triggers the offer obligation. The purpose of new Rule 36 is to clarify the meaning of the words in the current version of Rule 26.1 “the principal members of the concert group, as the case may be, shall extend offers ...” and to ensure that the same principle applies to other applicable Rules in the Codes. The question of whether or not the relevant obligation will attach to a particular principal member of the concert group will be determined by the Executive according to the circumstances of the case.

CODE ON SHARE REPURCHASES

38. Share Repurchases

The Code on Share Repurchases has been completely reorganised as originally proposed. Rule 5.1 of the Share Repurchase Code has been revised to set out the Rules of the Takeovers Code that will normally apply to share repurchases by general offer and those that would normally apply to a privatisation or delisting. The reference to partial offers has been removed from section 4.4 of the Introduction to the Codes and Rules 3.4, 5.3 and 5.4 added to the Share Repurchase Code.

Explanation - A number of amendments have been made to the original proposal in light of public comments. In particular, Rule 5.1 of the Share Repurchase Code sets out the specific Rules of the Takeovers Code that apply to share repurchases to avoid uncertainty and confusion. Following the deletion of the reference to partial offers in section 4.4 of the Introduction to the Codes, Rules 3.4, 5.3 and

5.4 have been added to ensure that the relevant parts of Rule 28 of the Takeovers Code still apply to share repurchases (see page 13 of this paper).

SCHEDULES

39. Schedule I – Offer document for takeover and merger transactions

Most of the amendments proposed in the Consultation Paper have been adopted.

The proposed new requirement in paragraph 1 of Schedule I for the document to state the date when the document is despatched has not been adopted.

Explanation – One respondent suggested that this requirement would be over burdensome as it might not always be possible to state precisely the date of despatch. It is also noted that the proposed new requirement is inconsistent with the wording of Rule 8.2 which provides that the offer document must not be dated more than 3 days prior to despatch. The proposed new requirement for the document to state the date of despatch has been deleted. A new Note 3 has been added to Rule 8.2 to assist the Executive in monitoring these dates (see paragraph 12 above).

Paragraph 2 of Schedule 1 has been amended further to require disclosure of the identity of the ultimate controlling shareholders of the offeror.

Explanation – This change reflects a respondent’s suggestion that if an offeror or principal member of the concert group is a company, disclosure should be made of such company’s ultimate controlling shareholder. This is consistent with the principles of Rules 1.2 and 3.5(b) which have also been amended to this effect.

The word “liabilities” has been added to paragraph 29 of Schedule 1.

Explanation – This word has been added in response to a respondent’s suggestion.

40. Schedule VI – Whitewash Guidance Note

Paragraph 4(g) has been amended further to remove any implication that valuations are always required for a whitewash.

Changes have been made as described in paragraph 27 on Note 15 to Rule 26.1 above.

The second paragraph of paragraph 7 has been moved to become paragraph 8 on convertibles and new wording has been added to require disclosure in a company’s accounts of any outstanding convertible that has been whitewashed.

A new paragraph 9 has been added to reflect principles similar to those in paragraph 7 to deal with a situation where the percentage shareholding of a shareholder who is holding whitewashed convertibles is increased as a result of share repurchases and how this will affect the conversion of the whitewashed convertibles.

Explanation – The changes to Schedule VI described above have been made to reflect the “clean slate” approach and to ensure consistency with other related Rules. The reasons for these changes are set out in paragraph 27 above.

A new paragraph 10 has also been added to set out the application of these principles to underwriting.

Explanation – A “clean slate” approach has been applied to underwriting a rights issue that has been whitewashed regardless of the actual percentage voting rights that the underwriter may acquire as a result of the underwriting.

41. Schedule VII - Conflicts of Interest Guidance Note

Paragraph (b) has been amended further to cover conflicts that may arise in any multi-service financial organisation with specific reference to organisations involving an auditor’s practice or a lending institution. Paragraph (b) has also been further amended to provide that in all cases of possible conflict the Executive must be consulted. As originally proposed, paragraph (b) confirms by way of example, that a financial adviser must not act as an independent financial adviser to an offeree company if that adviser is an auditor or affiliated to an auditor of the offeror. The other scenarios originally proposed to be set out in paragraph (b) have been deleted.

Explanation – Paragraph (b) has been amended to reflect a number of respondents’ comments that it should not be limited to multi-service firms involving practices of an auditor and a financial adviser. The Panel and the SFC believe that it is more appropriate for the Executive to assess possible conflicts on a case by case basis. Accordingly, save for the example set out in the originally proposed paragraph (b)(iii), the specific scenarios have been deleted. Please see pages 10 to 12 for a fuller explanation.