

**CONSULTATION CONCLUSIONS
ON
PROPOSED AMENDMENTS TO THE
COMPANIES ORDINANCE
TO FACILITATE OFFERS OF SHARES AND DEBENTURES**

**Financial Services and the Treasury Bureau
Securities and Futures Commission
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Consultation Conclusions

Introduction

1. On 10 March 2003, the Financial Services and the Treasury Bureau (“FSTB”) and the Securities and Futures Commission (“SFC”) jointly issued a consultation paper to seek the views of the public on legislative proposals to rationalise the prospectus regime in the Companies Ordinance (“CO”) to facilitate offers of shares and debentures. Annexes to the consultation paper contained extracts from the draft Companies (Amendment) Bill 2003 (“Bill”). The full text of the proposed legislative amendments to the prospectus regime (definitive versions of which are now contained in Schedule 1 and Part 1 of Schedule 5 of the Bill) was sent to relevant stakeholders on 19 March 2003 for comments.
2. The consultation period ended on 31 March 2003 but late submissions were accepted and considered. The Bill was gazetted on 13 June 2003 and introduced to the Legislative Council (LegCo) on 25 June 2003. A Bills Committee was formed in July 2003 for detailed scrutiny of the Bill.
3. This document analyses the major comments received on the consultation paper and explains the rationale for the drafting proposals contained in the Bill. This paper should be read in conjunction with the consultation paper and the Bill.

Background

4. The regulatory framework in the CO for offers of shares in or debentures of companies incorporated in Hong Kong and overseas has been in place for decades and despite amendments made over the years, the current offering regime does not adequately accommodate offering structures and other market practices prevalent in other developed financial markets.

5. In June 2002, the Financial Secretary announced a three-phase approach to overhaul the existing prospectus regime. The first phase involved the issue of three SFC guidelines in February 2003 concerning -
- (a) the treatment of “offer awareness advertisements” and “summary disclosure materials”;
 - (b) the registration of “programme” and “issue” prospectuses as separate prospectuses in connection with “programme” or repeat offers of shares or debentures; and
 - (c) the use of faxed experts’ consent letters and bulk print proof prospectuses in the context of registration.

The first phase also involved the issue by the SFC of two class exemptions in March 2003 to facilitate the issue of prospectuses relating to offers of debentures. These exempt prospectuses from certain content requirements depending on whether or not the debentures will be listed. The class exemptions became effective on 23 May 2003.

Measures under the first phase were made in response to specific requests from market participants and did not involve amendments to the primary legislation.

6. The second phase concerns providing expressly in the law for the reform measures introduced in the SFC guidelines mentioned in paragraph 5 above and making other specific improvements to the prospectus regime. These are the subject of the Bill now before the Legislative Council. Finally, a proposed third phase will involve a comprehensive review of the regulatory framework for the offering of shares and debentures in Hong Kong, with a view to modernising the law and practices in this area.

Consultation Process

7. A total of 16 written submissions were received in response to the proposals in the consultation paper. These included one submission made on behalf of five financial institutions, and submissions from professional bodies, other market practitioners and organisations representing investor interests. Comments varied in range and depth, with some focusing on broad principles and others on points of detail. The following paragraphs highlight the more significant and specific comments received in relation to each of the main elements of the proposed reforms and our response to the comments.

Summary of Principal Consultation Conclusions

Safe harbours

8. A respondent queried the rationale for carving “safe harbours” from the definition of *prospectus* rather than providing, perhaps more simply, that offers to the relevant persons do not constitute *offers to the public*. The proposal as set out in the consultation paper is consistent with the “document-based” focus of the prospectus regime in the CO, which has been the prevailing regulatory philosophy for some considerable time, and we believe that care should be taken when considering a departure from this approach. Since this second phase of the reform process is intended to accommodate only very limited reform initiatives (see paragraph 6 above), a shift to a “transaction-based” regime was beyond the scope of the present exercise and will be considered in the third phase.
9. Several respondents commented on the monetary threshold of HK\$1,000,000 in respect of both the “small-scale offer” and the “minimum consideration/denomination” exemptions. The respondents were of the view that the cap for small-scale offers should be raised to between HK\$5,000,000 to HK\$10,000,000 in order for the exemption to be of practical use. Against the background of these comments, we have considered that a ceiling of

HK\$5,000,000 for “small-scale offers” is reasonable taking into account the costs associated with making an offer and the limited scope for abuse of this exception (given that it cannot be used in combination with any other safe harbours and offers made under this exemption within a rolling 12-month period will be aggregated for the purposes of determining whether the offer document in respect of a particular offer falls within the definition of *prospectus*). As regards the “minimum consideration/denomination” exemption, a few respondents suggested that “a threshold of HK\$250,000 is appropriate, on the basis that the most common minimum subscription amount for retail bonds is HK\$50,000”. We consider that as the exemptions are new to the market, a prudent regulatory approach should be adopted. The proposed minimum threshold of HK\$500,000 is justifiable on the basis that investors who are prepared to pay this sum are likely to be sufficiently knowledgeable about the risks associated with an offer to ask relevant questions when faced with non-“prospectus standard” offer documents. The same assumption could not so safely be made, if the threshold is lowered to HK\$250,000 or below.

10. The consultation paper proposed that documents in respect of an offer of shares or debentures made outside Hong Kong to persons outside Hong Kong would be excluded from the definition of prospectus. Some respondents suggested that offer documents in respect of offers targeted at persons outside Hong Kong, whether made in or outside Hong Kong, should be excluded from the prospectus regime. We agree with the principle that offers targeted at persons outside Hong Kong should not generally be the subject of Hong Kong securities offering regulation and have accepted this suggestion in the drafting of the Bill. This clarification will also align the position in the CO with that in section 103(3)(j) of the Securities and Futures Ordinance (“SFO”) which provides that documents issued in respect of securities which are intended to be disposed of only to persons outside Hong Kong, without distinguishing between offers made in or outside Hong Kong, are excluded from the prohibition in section 103(1).

11. The consultation paper proposed that documents in respect of offers made in connection with a takeover or merger which is in compliance with the Codes on Takeovers and Mergers and Share Repurchases should be excluded from the definition of prospectus. Some respondents felt that the exemption should also apply to an offer document for a share repurchase by way of a general offer made in compliance with the Code on Share Repurchases. We agree that the rationale of avoiding unnecessary double regulation (Code documents and prospectuses both being pre-vetted by the SFC and/or the Stock Exchange) would justify the same approach. These comments have been incorporated into the Bill introduced to LegCo on 25 June 2003.
12. Some respondents suggested that the exemption referred to in paragraph 11 above should also apply to offer documents in respect of a takeover or merger regulated by legislation or codes of other jurisdictions provided they are “approved” or “recognised” jurisdictions. We are not in a position at this stage to extend the exemption in this way as the SFC does not maintain a list of recognised takeovers authorities. However, the SFC will review this issue in the third phase.
13. Two respondents suggested that an exemption should be given to offers to policyholders in a mutual insurance company in connection with a demutualisation, provided it is regulated in the home jurisdiction of the insurer and all information to be circulated to policyholders is approved by a recognised regulatory body in that home jurisdiction. We do not consider it appropriate to extend the exemption in this way. Although demutualisation does not involve a change of ownership, it does cause owners to recognise they have a financial stake in the success of the company in a way that differs from before and disclosure of information in a regulated and uniform way is highly desirable.
14. Some respondents suggested that for the purposes of an offer to *qualifying persons* in Part 1 of the new Seventeenth Schedule, *qualifying persons* should be extended to cover officers who may not be directors or employees. *Officer* is defined in section 2(1) of the CO as including a director, manager or

secretary. We agree that it would be consistent with the rationale for this exemption to extend the definition so as to give flexibility to issuers who may want to reward officers who may not be employees or directors.

15. A few respondents noted that the definition of *consultant* is restricted to persons acting in a similar capacity to employees and limits the ability of companies which may wish to offer shares to consultants in a wider sense, such as members of an advisory board or people providing professional services. It is our intention that the definition of *consultant* be restrictive and that the exemption should not apply in the case of offers made to persons retained as consultants on ad hoc projects. Offerees should be persons who by reason of a pre-existing “employment” relationship with the company are likely to know enough about the company’s business and financial position not to require the fuller disclosure provided by a prospectus.
16. Several respondents suggested that the legislation should clarify whether the expression *qualifying person in relation to a company* means (i) the company whose shares are the subject of the offer or (ii) the offeror company. Since the intention is for qualifying persons to derive their status from being employees, directors, consultants, officers, etc. of companies falling within the group relationship contemplated by the CO definition, the drafting of the Bill has been clarified to provide that an offer by a company to qualifying persons is extended to employees, directors, consultants, officers, etc. of the holding company or any subsidiary in the same group.
17. It was also suggested that the scope of *same group of companies* should extend to joint ventures and affiliates, so as to enhance flexibility for issuers wishing to reward employees of joint ventures and affiliates. We do not agree that the scope of the provision should be extended in this way since the proposed exemption is intended to benefit offeror companies which reward persons who could safely be assumed to have a reasonable level of knowledge about the offeror and its group of companies. This would not necessarily be the case for persons employed by joint ventures and affiliates.

18. Several respondents suggested that the proposed exemption for an offer of shares *free of charge* to holders of shares in a company should be extended to cover scrip dividends. We agree that the exemption should include a scrip dividend offered as an alternative to a cash dividend, provided that the offer comprises shares of the company concerned and are of the same class as those in issue. The comment has been incorporated into the Bill introduced to LegCo on 25 June 2003. We do not think it appropriate to extend the exemption to cover shares of a second company offered as a distribution in kind or as an alternative to a cash dividend as it raises issues of adequacy of disclosure on the underlying company and fairness of the proposal to the shareholders concerned.
19. Several respondents considered that documentation in respect of offers in connection with a collective investment scheme that is a corporate entity should be entirely exempted from the regulatory ambit of the prospectus regime in the CO. Currently, although a class exemption published in December 2002 exempts a prospectus issued by a corporate collective investment scheme which is authorised by the SFC from all the contents requirements in the CO, such a prospectus still needs to be registered with the Registrar of Companies. We accept that no regulatory purpose is served by having a regulatory regime for corporate collective investment schemes under both the SFO and the CO. We agree that since collective investment schemes authorised by the SFC are subject to regulatory oversight under the relevant Code and offering documentation already benefits from the above class exemption, there is limited regulatory benefit in a small number of CO prospectus regime requirements continuing to apply to offering documents issued by authorised collective investment schemes. Investor protection should not be compromised as liability for misrepresentations in such offering documents will continue to attach under sections 107, 108 and 277 of the SFO.

Resale restrictions in sections 38AA/342AB

20. One respondent felt that the proposed repeal of the existing “professionals” exemption for overseas companies in section 343(2) of the CO may create

uncertainty regarding the legal treatment of offers that currently expressly rely on this exemption. Another respondent queried whether the existence of a *qualifying persons* exemption in the new Seventeenth Schedule would raise a presumption that cases falling outside the proposed exemption should not be regarded as falling within the *domestic concern* exemption in section 48A of the CO (which is generally construed as constituting an exemption for, among others, offers to employees). We accept that the use of the existing professionals exemption in section 343(2) and the domestic concern exemption in section 48A should not be prejudiced by the introduction of the new exemptions in the Seventeenth Schedule. An issuer could accordingly structure a transaction to bring it within such an exemption where the relevant offer does not fall within the categories of offers set out in the Seventeenth Schedule.

21. Several respondents felt that the existing section 41 would already serve as an adequate anti-avoidance provision without the need for the proposed new sections 38AA/342AB. The subject of resale restrictions on shares/debentures acquired under exempt offers was further considered by the Bills Committee at its meetings in October 2003. In view of Members' concerns raised at the Bills Committee meetings, the FSTB and the SFC have re-examined in detail the necessity for a resale restriction in respect of each of the 12 types of safe harbours under Part I of the Seventeenth Schedule of the Bill, taking into account investor protection provided for under the CO (together with the proposals under the Bill) and practices in overseas jurisdictions. After careful re-examination and in light of Members' comments, the FSTB and the SFC believe that the intended policy objectives of the proposed sections 38AA and 342AB would have been achieved by existing provisions in the CO and the SFO, or other proposed safeguards in the Bill, and hence may be dropped. A paper on "Resale restrictions on shares/debentures acquired under offers specified in the Seventeenth Schedule" was issued on 6 November 2003 to the Bills Committee to facilitate Members' discussion and consideration.

SFC's exemption power

22. One respondent felt that the SFC should be empowered to grant exemptions from any of the prospectus provisions in Parts II and XII of the CO on “Share Capital and Debentures” and “Restrictions of Sale of Shares and Offers of Shares for Sale” respectively. We disagree with this suggestion as it would have the effect of undermining the certainty concerning the prospectus regime. We also consider that suggestions for an exemption power relating to certain other provisions (such as the requirement for dating of the prospectus (sections 37/342(1)), the requirement for experts' consent to the issue of a prospectus (sections 38C/342B) and the provision for prospectus liability (sections 40 and 40A/342E and 342F)) are fundamental to investor protection and cannot envisage any circumstances in which exemptions from compliance with such provisions would be granted. It was also suggested that to provide greater flexibility the wording of the proposed new ground of exemption should be amended by inserting “materially” as follows: “that the exemption will not materially prejudice the interest of the investing public”. However, since the wording currently proposed should be easier to apply in practice and is consistent with that adopted in section 134(9) of the SFO, we consider that the proposed addition is not necessary.

Awareness advertisements

23. The consultation paper proposed that an advertisement falling within the proposed section 38B(2)(e) should state that directors of the company take responsibility for its contents. Some respondents argued that it should be unnecessary to require explicit directors' responsibility statements in awareness advertisements given their very limited contents. Also, each requirement to set out mandatory particulars may in practice restrict the ability of issuers to adopt certain forms of wording to cover the matter in question. We accept that as it is proposed that publications falling within section 38B(2) will attract civil and criminal liability under sections 40 and 40A of the CO as if they were prospectuses (and that directors of issuers will in any event be liable for misstatements in such publications), it is unnecessary to include

explicit directors' responsibility statements in awareness advertisements. In addition, we agree that issuers should have the flexibility to use wording in a form to the like effect of that provided in the draft legislative provisions. These comments have been incorporated into the Bill introduced to LegCo on 25 June 2003.

Dual prospectus structure

24. The consultation paper proposed, in relation to the "dual prospectus" structure, that the programme prospectus should remain valid for not more than 12 months from its date of issue or until publication of the next annual report and accounts of the issuer, whichever is the earlier. Several respondents believe that the new legislation should allow issuers to update their programme prospectus within a certain period after the annual report has been issued. Our view is that it should largely be up to issuers to determine when they update their programme prospectuses, but that offers should not be made on the basis of outdated information whether such information is financial in nature or otherwise. We believe that both of the proposed events signalling the expiry of the period of validity of the programme prospectus are entirely appropriate and necessary.
25. Two respondents queried the extent to which the constituent prospectuses must be kept up to date during the term of a programme. It is not intended to mandate when issuers must update their programme prospectuses, as this will depend on the particular circumstances of the issuer. The legislative proposal simply prevents new offers of shares or debentures being made on the basis of out of date information.
26. One respondent stated that the legislation should provide that each of the programme prospectus and issue prospectus should be treated separately as a prospectus in its own right. We agree with this comment which has been incorporated into the Bill introduced to LegCo on 25 June 2003.

Prospectus liability provisions

27. Some respondents referred to the proposed wording deeming persons acquiring shares or debentures in an offer for subscription or offer for sale through an agent as *persons who subscribe for any shares or debentures on the faith of the prospectus* for the purposes of section 40 of the CO. They observed that this creates an anomaly, in that a person who subscribes for or purchases shares through an agent need not prove that he did so *on the faith of the prospectus* and would be in a better position than other investors (who have to prove their reliance on the prospectus in the context of a claim for compensation under section 40). We agree that the words *on the faith of the prospectus* should be deleted and this comment has been incorporated into the Bill introduced to LegCo on 25 June 2003 to the effect that investors who subscribe for or purchase shares or debentures through an agent will not be in a better position than investors subscribing for or purchasing the shares or debentures directly.
28. We consider that the same investor protection should be accorded to investors who acquire shares or debentures pursuant to arrangements made between the issuer or vendor of the shares or debentures and intermediaries appointed by the issuer for the purposes of the offer. In addition, several respondents felt that although the proposed amendment to section 342E extends section 40 to a prospectus for an offer for sale by overseas companies, section 40 of itself would not make the civil remedy available to persons who purchase shares or debentures directly in an offer for sale. The above comments have been incorporated into the Bill introduced to LegCo on 25 June 2003 to the effect that the following categories of persons will be deemed to be *persons who subscribe for any shares or debentures* for the purposes of section 40 -
- (a) persons who subscribe for or purchase shares or debentures pursuant to an offer in a prospectus;
 - (b) persons who by means of an agent acquire shares or debentures pursuant to an offer in a prospectus; and

(c) persons who acquire shares or debentures pursuant to arrangements made between:

- the issuer or vendor of the shares or debentures; and
- intermediaries appointed for the purposes of the offer.

The Bill introduced to LegCo on 25 June 2003 has also incorporated amendments to provide the SFC with the power to add to the categories of persons subject to the deeming provision (provided this follows public consultation and by order in the Gazette subject to negative vetting by the Legislative Council) in order to accommodate any new categories of offerees which may arise from innovations in offering structures.

29. A number of respondents argued that there should not be statutory liability for omissions in a prospectus until an overall standard of disclosure, against which the omission can be tested, has been prescribed. They expressed the view that as the standard set out in paragraph 3 of the Third Schedule to the CO is not expressly tied to the civil and criminal prospectus liability provisions, any contravention of the Third Schedule content requirements would only result in a fine and not other civil or criminal sanctions. One respondent, however, welcomed the proposal to amend the definition of *untrue statement* to include a *material omission* for the purposes of the liability provisions but suggested that what constitutes a *material omission* be clarified through the publication of guidelines.
30. The proposed section 41A(2) is to clarify the application of civil and criminal liabilities under sections 40 and 40A to misrepresentation in the form of material omission. Disclosure requirements for prospectuses are clearly set out in Parts II or XII of, and the Third Schedule to, the CO and it is the responsibility of, among others, the issuer and its directors to ensure that the prospectus satisfies these requirements. In light of the proposed amendments to paragraph 3 of the Third Schedule to the CO (which would more specifically define the information to be disclosed in a prospectus by reference

to the nature of the shares or debentures offered, the nature of the issuer and of the persons likely to consider acquiring them), we consider that it is appropriate to impose prospectus liability for omissions from prospectuses. The changes proposed to paragraph 3 should make it possible for issuers to tailor their disclosures to a particular offer subject to SFC vetting. This will encourage issuers to provide full disclosure, which is in the best interests of investors. The SFC will consider in the third phase whether other changes to the prospectus regime are necessary to ensure the liability provisions operate as intended.

Meaning of “debenture”

31. Although the consultation paper did not invite comments on the definition of *debenture*, we received a number of representations on the subject. All pointed to the lack of clarity caused by the inclusive definition and the reference to *any other securities*. It was suggested that the CO should empower the SFC to exclude by notice in the Gazette specified types of security from the definition. We are aware that there is substantial case law on the meaning of *debenture* and consider that it is entirely appropriate for the legal advisers of issuers of financial instruments to advise their clients whether or not a particular financial product falls within the definition of *debenture* for the purposes of the CO. The SFC intends that the definition of *debenture* will be one of the topics for review in the third phase.

Other proposed amendments

32. The consultation paper proposed to replace the requirement for registration of material contracts together with the prospectus by a requirement that such material contracts be on display for not less than 14 days from the date of publication of the prospectus. Whilst no respondent raised any objection to this proposal, some felt that the display requirement should be extended to include a requirement to make available a copy of any such contract upon request and payment of a reasonable fee. In light of the comments of the Bills Committee expressed at its meeting on 17 October 2003, we wrote to all

relevant stakeholders on 24 October 2003 to invite their specific comments on this subject.

33. Some respondents pointed out that section 38(3) would prohibit the sending of application forms to persons who are the subject of offers falling within Part 1 of the Seventeenth Schedule as section 38(3) states that it is unlawful to issue a form of application without a CO compliant prospectus. Given the policy decision to disapply the prospectus regime to documents issued in respect of offers falling within the safe harbours, we agree that an additional proviso to section 38(3) should be inserted to deal with this issue and have incorporated this into the Bill introduced to LegCo on 25 June 2003.
34. One respondent suggested that documents in respect of offers falling within any of the safe harbours in Part 1 of the Seventeenth Schedule should also be exempt from the prohibition in section 103(1) of the SFO. Much as prospectuses complying with or exempt from the requirements of the CO are excluded from the prohibition in section 103(1) of the SFO, we consider that documents in respect of offers falling within any of the safe harbours should also be exempt from such prohibition. Such documents will be required to contain a warning statement that they have not been reviewed by any regulatory authority in Hong Kong and that investors are advised to exercise caution in relation to the offer in such documents. Investor protection will not be compromised as civil and criminal liability under sections 107, 108 and 277 of the SFO respectively will continue to attach to misrepresentations made in those documents.
35. One respondent suggested that the application of section 342B(1A)(b) should be expanded to cover debentures offered for sale (i.e. in addition to those offered for subscription) by overseas incorporated companies. After further consideration, we take the view that the discrepancy in treatment caused by the existing wording of the provision should be resolved in an alternative way. Accordingly, we have proposed in the Bill to repeal section 342B(1A), so that overseas incorporated companies will need to comply with the time limits in sections 44A and 44B which have always applied to Hong Kong companies.

However, to preserve flexibility in those cases which may genuinely require it, all subsections dealing with time limits in sections 44A and 44B (in addition to section 44A(2), which is already subject to the SFC's exemption power) have now been added to the list of requirements which may be exempted by the SFC under the proposed new section 342A(4).

36. Other comments received related mainly to technical issues arising from the Bill. We have accepted most of the comments or suggestions arising from the consultation exercise, and have incorporated these comments into the Bill introduced to LegCo on 25 June 2003.