

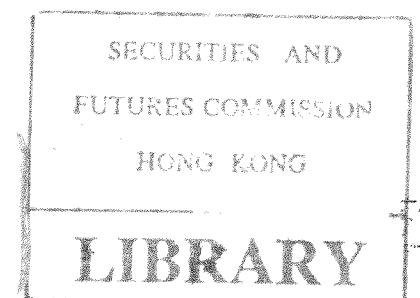
**SECURITIES AND FUTURES
COMMISSION**

**OFFERS OF SECURITIES
AND OTHER INVESTMENTS**

REPORT OF A WORKING GROUP

December 1991

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SECURITIES & FUTURES COMMISSION
OFFERS OF SECURITIES AND OTHER INVESTMENTS

The Commission presents as a consultation paper a report on "Offers of Securities and Other Investments" prepared by a working group set up by the Commission. The membership of the working group was as follows:-

Geoffrey Lewis	Chairman
David Shaw	Johnson Stokes & Master
Raymond Lee	Wardley Ltd
Edward L.G. Tyler	Hong Kong University (and now a Judge of the District Court)
Victor Chu	Victor Chu & Co., and a member of the Stock Exchange Council
Leslie Wright	Member of the Bar
Gerard McMahon)
David Little) Securities and Futures Commission
Norman Whiteley)
Stephen Leung)

The report deals with the law regulating the promotion and distribution of securities, such as shares and debentures, and of other investments where experience in Hong Kong and elsewhere shows that investors need special protection.

Reform of the law in this area was recommended by the Securities Review Committee in their Report of 1988. The Commission agrees with the Securities Review Committee that there is a need to clarify and tidy up the confused situation in this branch of the law. The purpose of the consultation document is to initiate discussion of what changes, if any, are necessary to produce the system best suited to Hong Kong.

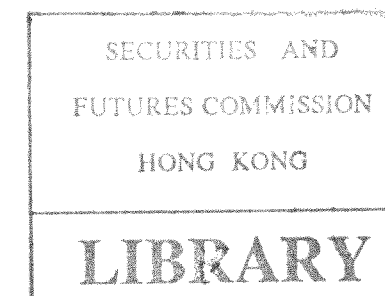
The general approach of the working group has been conservative: where market practices are well established and unobjectionable it does not propose interfering with them.

However, because of the variable nature of offers, the report necessarily covers matters in some detail. It is divided into the following parts:-

1. Introduction.
2. Summary of the existing law.
3. Proposals for reform.

There is also an appendix containing, for comparison, brief descriptions of the law on the subject in the United Kingdom, the United States, Australia, Canada and Singapore.

The Commission has authorised the issue of the report as a consultation document. It does not however follow that the Commission agrees with each and every recommendation contained in the report, and it may wish to make its own comments during the process of consultation.



The comments of all interested bodies and parties are welcomed. It is also hoped that the consultation process will enable the Commission to gain a fuller and more comprehensive knowledge of market practices and new investment media. Market practitioners are therefore requested to assist the Commission by providing information about new types of investment products which are being traded, or which are being considered as possible investment vehicles, and also to inform the Commission of whether there are any particular difficulties in categorising any of such products or vehicles within the present legislative framework.

You should please send your comments on the paper to The Secretary to the Working Group on Offers of Securities and Other Investments, Securities & Futures Commission, 38th Floor, Exchange Square 2, Hong Kong.

The form of the legislation which will be recommended after the consultation period will take account of the comments received, and will reflect the Commission's final views in the light of those comments.

Your comments should reach the Commission not later than 31 March 1992.

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I. INTRODUCTION

- 1.1 The purpose of this paper is to promote discussion on the reform of the Hong Kong law on offers of securities and other investments. That it is in need of reform can hardly be doubted - see for example the Securities Review Committee Report, Chapter XI. But the experience of other financial jurisdictions shows that it is a particularly difficult subject to get right. It is easier to say what is wrong with a particular legal system than it is to prescribe a cure.
- 1.2 The paper is divided into the following parts:
- (i) introduction
 - (ii) a description of the existing Hong Kong legislation
 - (iii) some proposals for reform.
- 1.3 We have included for purposes of comparison a brief description of the state of the law in the United Kingdom, the United States, Australia, Canada and Singapore. This can be found in the Appendix.
- 1.4 First, a word about the scope of the paper.
- It is intended to assist in the resolution of the following questions:
- (i) Which types of offer should be within, and which should be outside, the system for regulating offers of securities and other investments?
 - (ii) Of those which are inside, what should be the extent of the disclosure requirement for different types of offer?
 - (iii) Of those which are inside, what supervision by the regulatory authorities, and by which authority, should be required for different types of offer?
 - (iv) What liability should be incurred, and by whom, for false or misleading offers, or for failure to comply with disclosure requirements?
- 1.5 As was pointed out in a recent report on this topic by the Australian Securities Information Review Committee, a market for securities does not deal in goods. The article which is traded is a claim evidenced by a piece of paper, whose value is not intrinsic, but lies in the financial attributes of the enterprise against which the claim subsists. If the market is to reflect these values fairly, its traders must have full, up to date and reliable information about the underlying enterprises. It is for these reasons that adequacy of published information is crucial, and particularly so when offers of securities are made for the first time to the public.
- 1.6 What is adequate information in an offering of securities will vary according to the type of investment and the type of investor. The system therefore must have flexibility. So far as possible, it must also be clear. The problem of reconciling the need for both flexibility and clarity gives rise to much of the difficulty encountered in this branch of the law.

- 1.7 Because adequacy of information is crucial, the system must impose liability on those responsible for errors and omissions. The common law does not impose criminal liability, and imposes civil liability only in limited circumstances. It is therefore necessary to introduce statutory liability. For similar reasons, the system should also impose severe sanctions for fraudulent or reckless statements which are made in connection with offers of securities.
- 1.8 The traditional approach is that the best means of providing investor protection in connection with offers is to disclose all relevant information in the offering document. But investors may also be protected in other ways - as by imposing conditions on offers which must be fulfilled before investments are offered. These conditions may relate to the structure of the offeror, for instance a minimum capital requirement. Or they may take the form of restrictions on the offeror's activities, for instance on how the funds which are raised may be applied. The regulatory authority may take the view that condition of these types should be imposed if protection under the Listing Rules or under company law is inadequate. This is more likely to be so in certain types of collective investment schemes than in conventional share issues - see for example unit trusts (below, paragraph 2.41), and immigration schemes (below, paragraph 2.46).
- 1.9 The title of the paper needs some explanation. By "offers", we intend to include offers for both subscription and purchase, that is issues of new securities and sales of existing ones, as well as invitations or inducements which are not "offers" in the strict contractual sense.
- 1.10 By "securities and other investments", we intend to include not only "securities" and "investment arrangements" as those terms are now defined in Hong Kong securities legislation, but all forms of investment media which, if made the subject of an offer, raise the question of investor protection. This means that virtually everything would be covered, except physical property such as works of art or land over which the investor has exclusive control. Thus, advertisements for individual ownership of houses or flats would not be covered, but time-sharing arrangements would be, as would foreign exchange contracts and contracts for differences calculated by reference to movements in securities indices or currencies. However, as we explain later in the report (paragraphs 3.6 to 3.10) this does not imply that all such forms of investment vehicles should be brought into regulation.
- 1.11 Our review is concerned with the distribution of securities and other investments by way of issue or sale, and is not directly concerned with offers to buy existing securities from the holders. Such offers may be subject to the Takeovers Code, but they cannot be omitted from mention altogether. It is in our view necessary to have in place some statutory control over offers to buy, both by regulating the content of offer documents and to protect offerees against fraud. This is the present position under the Protection of Investors Ordinance, which makes it a criminal offence to issue a fraudulent or reckless offer to buy, and which makes offers subject to approval by the Commission unless specifically exempted by the Ordinance. It is our view that this position should be preserved.

II. EXISTING LAW

- 2.1 The Securities Review Committee described the existing law as unduly complex and outdated, and recommended that it should be brought up to date and consolidated in a single Ordinance with the assistance of private sector securities lawyers. Chapter XI of its Report contains a summarised review of the present regime, but it will be more convenient if this paper contains its own summary rather than referring to that given in the Report.
- 2.2 Before dealing with that, however, it should be observed that the Hong Kong system, like the U.K. one before the passage of the Financial Services Act in 1986, and like some other common law systems, is based on the concept of "offer to the public". Only "public" offers are regulated. Other offers are outside the system. The document by which an offer to the public of shares or debentures is made is a "prospectus" which must be filed at the Companies Registry and must contain certain specified information. The term "offer to the public" is therefore crucial, but it is not comprehensively defined. Some guidance is given in the Companies Ordinance (Cap.32), section 48A, but doubt and uncertainty persist in the application of the term to actual cases. It is a primary objective of this review to remove this doubt to the extent practicable, so that the line between what is regulated and what is free is as clear as possible.
- 2.3 In the summary of the existing law which follows, we propose to deal with the Companies Ordinance (so far as it regulates new issues of shares and debentures), the Listing Rules of The Stock Exchange and the statutory Listing Rules, the Protection of Investors Ordinance (Cap.335), and those parts of the Securities Ordinance (Cap.333) and the Commodities Trading Ordinance (Cap.250) which affect offers of securities and futures contracts.
- 2.4 Unit trusts and mutual funds may be authorised by the Commission under the Securities Ordinance, and the requirements for authorisation of those investment vehicles are set out in the Code on Unit Trusts and Mutual Funds, which has just undergone comprehensive revision. Certain other types of collective schemes are regulated separately under the Protection of Investors Ordinance, and two additional Codes have been promulgated, one for Immigration-Linked Investment Schemes and the other for Investment-Linked Assurance and Pooled Retirement Schemes. Since the methods of marketing these investments, and the relative regulatory arrangements, differ from those applicable to issues and sales of shares and debentures, they are dealt with separately below.
- Companies Ordinance**
- 2.5 The Companies Ordinance regulates offers to the public to subscribe for or purchase shares or debentures. Sections 37 to 41A deal with prospectuses, and sections 42 to 45 with allotments of new shares. These sections cover offers by companies incorporated in Hong Kong, and there are provisions which correspond (although not exactly) relating to companies incorporated abroad whether or not they have established a place of business in Hong Kong. These provisions are complicated and somewhat difficult to follow. We recommend that the process of reform should aim at simplifying and clarifying the requirements.
- 2.6 "Prospectus" is defined as a document which offers shares or debentures of a company to the public for subscription or purchase for cash or other consideration; or which is calculated to invite offers by the public to subscribe for or purchase such shares or debentures.

- 2.7 Because of the definition of "prospectus", the requirements of the Companies Ordinance therefore apply only to offers to the public, and they also apply only to offers of shares or debentures. The latter word is defined as including debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not.
- 2.8 The thrust of the prospectus provisions of the Companies Ordinance is to require registration, and therefore public disclosure, of the contents of offers to the public. The Third Schedule to the Ordinance lists the matters which must be included in a prospectus. These have not been much altered since the 19th century and are badly in need of modernisation. But it is important to note in passing that, unlike the parent English provisions (now in part repealed and intended to be repealed altogether) the Third Schedule contains in paragraph 3 a requirement that the prospectus must include "sufficient particulars and information to enable a reasonable person to form ... a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of issue of the prospectus." This provision, and section 38D(5), which entitles the Registrar of Companies to refuse to register a prospectus which contains any information which is likely to mislead its readers, probably oblige the Registrar to make judgments about the quality of information in prospectuses. This burdens the Registrar with duties which he would understandably like to shed.
- 2.9 Offers which are not made to "the public" or are of investments which are neither shares or debentures are not within the purview of the Companies Ordinance and are not registered with the Registrar. For overseas companies only, offers of shares or debentures to those whose ordinary business it is to buy or sell securities are not treated as "offers to the public" (section 343(2)). This is the "professional investors" exemption but, anomalously, it does not apply to Hong Kong incorporated companies.
- 2.10 The Registrar of Companies may grant a certificate of exemption from compliance with the disclosures required by the Third Schedule if, having regard to the size and other circumstances of the issue and the number and class of offeree, compliance would be either irrelevant or unduly burdensome (section 38A). Under this section, we understand that the Registrar customarily issues a certificate in the case of mutual funds which are authorised by the Commission under section 15 of the Securities Ordinance.
- 2.11 Additionally, compliance with the disclosure requirements in the Third Schedule is not required in the following cases:
- (a) issues of shares or debentures to existing shareholders or debenture holders (rights issues), whether or not the issue documents are renounceable (section 38(5)(a));
 - (b) issues of shares or debentures which are uniform with shares or debentures which are already listed (section 38(5)(b)).
- 2.12 Application forms for shares or debentures may not generally be issued without a prospectus which complies with the Ordinance, but this does not apply to:
- (a) underwriting agreements (section 38(3)(a)); or
 - (b) issues of shares or debentures not offered to the public (section 38(3)(b)). This simply states the converse of the limitations of the prospectus provisions to issues to the public: it does not help in interpreting the phrase.

- 2.13 Section 38D deals with the registration of prospectuses. The Registrar is not to register a prospectus for a company which is not then formed. He may also refuse to register a prospectus which does not comply with the Ordinance or which contains any information likely to mislead.
- 2.14 Both civil and criminal liability for untrue statements are imposed on directors and others who authorise the issue of the prospectus, but not on the issuing company itself. A statement is untrue if it is misleading in the form and context in which it is included. As regards civil liability, compensation is payable to all persons who subscribe for shares or debentures on the faith of the prospectus and who sustain loss by reason of the untrue statement. It follows that those who buy from the original subscribers, and later purchasers, are not entitled to compensation even if they can prove that they relied on the untrue statement.
- 2.15 The section imposing civil liability for misstatements (section 40) covers subscriptions for new shares, but apparently does not cover purchases of existing shares.
- 2.16 Sections 42-45 deal with the mechanics of allotment, and the contractual arrangements between the issuing company and subscribers. They provide for such matters as the minimum amount which must be raised in order that allotments may be made (section 42); and the avoiding of allotments of shares or debentures proposed to be listed, if an application for listing is not made, or if made, is refused, within prescribed periods (section 44B). Most of the corresponding U.K. provisions have been or will be repealed. So far as they concern listed securities, some at least of these provisions would be better dealt with in Listing Rules.
- 2.17 It has already been pointed out that the disclosure and registration requirements of the Companies Ordinance apply only to offers to the public. Such offers may relate either to listed or unlisted securities. Although no distinction is made between listed and unlisted issues, except in minor respects, the former are subject to the further requirements of the Stock Exchange's own (non-statutory) Listing Rules and the statutory Listing Rules. These two sets of rules will be referred to next.

Listing Rules of the Stock Exchange

- 2.18 A new third edition of these rules was issued in December 1989. This represented a comprehensive review and rewriting of the old set of rules. The rules were again revised and amended in May 1991. They cover separately the rules governing the admission to listing of equity securities, "investment vehicles" (unit trusts, mutual funds and investment companies) and debt securities.
- 2.19 Every new issue must be supported by a listing document, that is a prospectus or other offering document. There are detailed requirements for the content of the listing documents, which to a degree overlap, but also greatly extend, the requirements of the Companies Ordinance.
- 2.20 Each company whose securities are listed is required to enter into a Listing Agreement with the Stock Exchange, the form of which is set out in an appendix to the Listing Rules, and which comprises the continuing obligations of the company, in order to maintain listing for its securities. This agreement has contractual force as between the company and the Stock Exchange, but neither the Listing Rules nor the Listing Agreement has statutory force. In effect this means that the only sanction for breach by a company of its obligations is for the Stock Exchange to bring the listing of its securities to an end.

2.21 The Listing Rules, and any amendment, must be approved in writing by the Commission in order to have effect (section 35 of the Stock Exchanges Unification Ordinance (Cap.361)).

2.22 We do not think that any useful purpose would be served by burdening this paper with an attempt to summarise the content of the Listing Rules.

Statutory Listing Rules

2.23 Section 14 of the Securities Ordinance empowers the Commission, after consultation with the Exchange, to make rules prescribing the requirements to be met before securities may be listed on the Stock Exchange. These rules are subsidiary legislation, and must also be approved by the Governor. Penalties for breach may be imposed, for which the maximum sentence is an insubstantial fine of \$10,000; no penalty has in fact been prescribed by the rules.

2.24 Rules under this section were first introduced by the old Securities Commission in February 1986 under the title Securities (Stock Exchange Listing) Rules, and were revised, although not radically, in 1989.

2.25 The statutory Listing Rules provide that applications for listing made to the Stock Exchange must comply with the Exchange's own rules, and must also contain certain specified details, together with the information "necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position of the company at the time of the application, and its profits and losses". Thus, in an indirect way, the applicant for listing is bound by law to comply with the Stock Exchange's own Listing Rules. However, the statutory Rules do not state what is the consequence of failure to comply, other than that the Commission may object to the listing (though that is about to change). It is doubtful whether there is any other legal sanction. Because of the words quoted above, the Commission is required to make a judgement in the case of all listing applications as to the sufficiency and the quality of the information proposed to be given to the investor. In practice, however, this is more honoured in the breach than the observance. The requirements mentioned in this paragraph do not apply to capitalisation issues, scrip dividend schemes, rights issues, or issues of substituted securities.

2.26 Under the present Rules (which are, however, in the process of being changed), a copy of each application for listing has to be served on the Commission, and the Commission may object to the grant of listing within 7 working days on any of the following grounds:

- (a) the application does not comply with the Stock Exchange's own Listing Rules or it does not, as stated earlier, contain the information referred to in paragraph 2.25;
- (b) the application contains something which is false or likely to mislead;
- (c) the applicant does not employ an approved share registrar;
- (d) in the case of an application to relist securities for which the listing has been cancelled, the Commission considers that the application ought not to have been made; or
- (e) the Commission is of the opinion that the listing is not in the public interest.

2.27 The Rules also currently provide for the Commission and the Stock Exchange to agree that certain provisions should be included in the Listing Agreement between the Exchange and each company whose securities are listed; and those provisions are not to be waived or varied either by the Company or by the Exchange without the prior consent of the Commission. In cases where any such provision is breached, the Commission may direct the Exchange to suspend dealings in the securities concerned.

2.28 The Commission may also direct the Exchange to suspend dealings in any securities if the company concerned has given the Exchange materially false, incomplete or misleading information. The Commission has a further general power to direct the Exchange to suspend dealings in any securities which may be specified if it appears to the Commission to be necessary in the interests of maintaining an orderly market.

2.29 The statutory Listing Rules thus give the Commission some control over the Listing procedures administered by the Stock Exchange; but except in the limited sense indicated in paragraph 2.25 they do not have the effect of giving statutory force to the Exchange's own Listing Rules. Moreover, the statutory Listing Rules do not, as stated earlier, contain any penal sanctions for breach, not even the fine of \$10,000 referred to in section 14 of the Securities Ordinance. The existence of two sets of Listing Rules, covering overlapping ground, one of which is contained in subsidiary legislation without sanction for breach, does not conduce to clarity of purpose or efficient administration. This situation will be improved with the repeal of the Rules referred to in paragraphs 2.26 and 2.27.

Protection of Investors Ordinance

2.30 This Ordinance was enacted in 1974 as part of the package of legislation found necessary as a result of the boom and bust of the preceding year but had been under consideration for a number of years prior to that. It was designed to regulate share-pushing, as well as the selling of other investment media. It was based on the U.K. Prevention of Fraud (Investments) Act which was first enacted in 1939 and revised in 1958, but was repealed by the Financial Services Act.

2.31 The Ordinance was intended (with limited exceptions) to control all invitations to members of the public to buy or sell securities and other forms of investment by making them subject to approval by the regulatory authority; and to make it a criminal offence for any such invitation to be made fraudulently or recklessly. Like the Prevention of Fraud (Investments) Act it is, in Professor Gower's words "based on the philosophy that the investor is entitled to protection against possible fraud".

2.32 Severe penalties are imposed on any person who induces another by fraudulent or reckless misrepresentation to enter into any agreement (i) for the acquisition, disposal, subscription or underwriting of securities, or (ii) for securing a profit from the yield or fluctuation in value of securities or other property.

2.33 The Ordinance also makes it an offence with similar penalties for any person to induce another by any fraudulent or reckless misrepresentation to take part in any "investment arrangements in relation to property other than securities". The quoted phrase is a defined term and was aimed at investment schemes in all forms of property other than securities.

2.34 "Securities" are defined in the same way in this Ordinance as in the Securities Ordinance, and (without reproducing the exact wording of the definition) comprise shares, debentures, loan stock, bonds or notes; rights, options, or interests in any of them; and participations or warrants to subscribe for or purchase any of them. It also includes "any instruments commonly known as securities" but does not include:

- (i) shares or debentures in private companies,
- (ii) partnership interests,
- (iii) certificates of deposit,
- (iv) bills of exchange and promissory notes, and
- (v) non-transferable debentures.

2.35 Although the intention of the Ordinance was to outlaw fraudulent or reckless invitations to acquire or dispose of all forms of investment, neither the definition of "securities" nor that of "investment arrangements" is effective to ensure that this purpose is fully carried out. One question which will emerge from this review is how to ensure that the scope of the necessary anti-fraud provisions is both sufficiently comprehensive and clear.

2.36 With a number of exceptions (some awkwardly worded) which are referred to below, section 4 of the Ordinance makes it an offence for a person to issue, or have in his possession for the purposes of issue, any advertisement or invitation to do any of the things which, if done fraudulently or recklessly, would be an offence under section 3 (see paragraphs 2.32 and 2.33 above) - that is, to induce another person to enter into an agreement to acquire or dispose of securities, or to take part in any other investment arrangement.

2.37 "Invitation" includes an offer, and an invitation made by telephone or personal visit. An advertisement or invitation which contains information likely to lead to members of the public entering into an agreement to buy, sell or subscribe for securities or to participate in an investment scheme is treated as an invitation to them to enter into such an agreement (section 2(2)(d)).

2.38 The general prohibition in section 4 against issuing advertisements or invitations applies only if they are made "to the public". "The public" is not defined anywhere in this Ordinance, and the meaning of the phrase therefore raises the same question as was discussed in relation to Companies Ordinance prospectuses.

2.39 An important exception to the general prohibition is that any advertisement or invitation which is authorised by the Commission is exempt (section 4(2)(g)). Unless covered by another exemption, or authorised by or under any other Ordinance, or constituting a private matter, every offering within the Ordinance is accordingly subject to control by the Commission. It is to be noted that this includes offers to buy (including takeover offers) as well as offers to issue or sell.

2.40 Of the long list of other exemptions the principal ones are as follows:-

- (a) the issue of a prospectus complying with the Companies Ordinance (section 4(2)(a), (b) and (c));

- (b) underwriting agreements (section 4(2)(d));
- (c) a prospectus or application form in relation to a mutual fund or unit trust authorised by the Commission under the Securities Ordinance (section 4(2)(e) and (f));
- (d) offers of certificates of deposit and certain other capital market instruments by authorised banks, certain international development banks, overseas banks, and the Government and certain other public bodies (section 4(2)(fa), (fb) and (fc));
- (e) offers of securities (but not investment arrangements in relation to property other than securities nor shares in unauthorised mutual fund corporations) made by or on behalf of a dealer or adviser who is either registered or exempt (section 4(3)(a)(i));
- (f) offers made by a company to holders of its securities or its creditors or employees (section 4(3)(a)(ii) and (iii));
- (g) offers of Hong Kong Government securities (section 4(3)(a)(iv));
- (h) offers by credit unions (that is, savings and loans clubs) (section 4(3)(a)(v));
- (i) offers by trustees to their beneficiaries (section 4(3)(a)(vi));
- (j) offers of securities (but not investment arrangements in relation to property other than securities) intended to be disposed of only to persons outside Hong Kong, or to persons in Hong Kong whose business involves dealing in or holding securities (section 4(3)(a)(vii));
- (k) advertisements issued by those engaged in the business of buying and selling property other than securities e.g. real estate agents (section 4(3)(b));
- (l) newspapers or other periodicals of general and regular circulation (section 4(5)(a)); and
- (m) offers to dealers or advisers who are either registered or exempt (section 4(5)(b)).

Code on Unit Trusts and Mutual Funds

2.41 Unit Trusts and mutual funds may be authorised by the Commission under section 15 of the Securities Ordinance. Once authorised, their prospectuses and application forms do not require separate approval, but their advertisements still do. A "mutual fund corporation" is defined as one which engages primarily in investing or trading in securities and which is offering redeemable shares for sale; and "unit trust" is defined as an arrangement for the participation by beneficiaries under a trust in profits or income arising from the holding or disposal of securities or any other property. The conditions for authorisation are contained in the Code.

2.42 The Code was first introduced in 1978 to fill a regulatory vacuum. It was not modelled on any overseas rules but resulted from discussions with local fund managers and had regard to British practice in the setting up and marketing of unit trusts. It dealt originally only with unit trusts, mutual funds being added in 1981. The Code, like the Takeover Code, is voluntary and contains no civil or criminal sanctions. Observance is secured by providing for conditions

which must be met if a mutual fund or unit trust is to be authorised for marketing to the public. These conditions continue in effect and any failure to comply with them may result in the withdrawal of authorisation. The mainly off-shore character of the industry has meant that regulation in Hong Kong relies heavily on the probity and professionalism of its participants. The experience here has been good, and in completing a major review of the Code recently, the Commission did not see any need to give the Code statutory force.

- 2.43 Authorisation as visualised by the Code is authorisation of an entire scheme rather than approval of one or more documents. In bare essentials, the Code provides for the appointment, separately, of a custodian or trustee to have custody of the property owned by the mutual fund or unit trust; and of a management company (normally registered as a dealer or adviser under the Securities Ordinance) to manage the scheme. The contents of the offering document are prescribed, and provision is made for the pricing, issue and redemption of units or shares. There are also requirements for investment limitations or prohibitions. Advertisements and invitations to the public to invest in a scheme must be separately submitted for the approval of the Commission.

Other Collective Investment Schemes

- 2.44 Only mutual funds and unit trusts, defined as mentioned in paragraph 2.41 above, can be authorised as schemes under the Securities Ordinance. Certain other types of collective investment scheme are regulated under the Protection of Investors Ordinance. If they relate to property other than securities, they are "investment arrangements", defined to mean ones by which participants share in profits or income from the holding, management or disposal of the property.
- 2.45 Advertisements or invitations to participate in these "investment arrangements" require approval by the Commission under section 4(2)(g) of the Protection of Investors Ordinance. Thus, it is the offering and supporting documents, rather than the whole scheme itself, for which approval must be sought.
- 2.46 Two further Codes covering separate categories of collective scheme have been promulgated. The first is for Immigration-Linked Investment Schemes, that is investment schemes relating to property or business ventures overseas in which one of the principal benefits for participants is the right to emigrate from Hong Kong to an overseas territory. Such schemes do not always fall within the definition of "investment arrangements" and sometimes may be offers of "securities." In that case the offering document may be a prospectus requiring registration under the Companies Ordinance. Once registered it is thereby exempted from the Protection of Investors Ordinance, and thus from the Code drawn up by the Commission. In fact, immigration-linked schemes are so varied that they straddle the differing regulatory requirements of the Protection of Investors Ordinance and the Companies Ordinance, and illustrate well the patchwork and haphazard nature of the present law.
- 2.47 The Code for Immigration-linked Investment Schemes provides for the submission to the Commission of a set of documents which must comply with detailed requirements; and for the independent appointment of promoters and managers, escrow agent, trustee or custodian, and Hong Kong representative, each with separately specified duties. The function of the escrow agent, for example, is to hold the subscription money until the minimum target amount has been received and until investors have been approved as immigrants into the overseas territory, whereupon it may then be released for investment.

- 2.48 The second type of investment scheme for which a Code has been issued is for Investment-linked Assurance and Pooled Retirement Funds. Investment-linked assurance is a form of investment, frequently in unit trusts, which is combined with life cover for the holder. Such schemes are usually established under an assurance contract in which the investor is the policy-holder. As such, they fall within the definition of investment arrangements, rather than securities, but only where investment, rather than insurance, is the dominant purpose. Decisions by the regulators that particular policies are in fact investment arrangements have sometimes been disputed by the promoters but generally there is now agreement that, if insurance represents only a minor part of the premium which the investor pays, the policy will be classified as an investment arrangement, subject to control under the Protection of Investors Ordinance.

- 2.49 Investment-linked life assurance is potentially within the jurisdiction of two regulatory authorities, the Insurance Authority and the Commission, reflecting the dual nature of the investment. The problem of overlapping jurisdiction is partly overcome by the Insurance Authority's primary role being that of regulating insurance companies, while the Commission's role is that of authorising the documentation of certain insurance products. It is for the latter function that the Code was promulgated. No regulatory authority is presently responsible for the conduct of insurance salesmen.

Securities Ordinance

- 2.50 This Ordinance controls share-pushing in three separate ways:
- (a) first, by the combined effect of section 3 and section 72, a registered dealer who wishes to offer to acquire or dispose of securities (defined as mentioned in paragraph 2.34 above) must do so in writing, including certain specified information, unless:-
 - (i) the offer is to an existing shareholder, an established customer (that is, a customer for whom the dealer has carried out at least three transactions in the last three years), a person whose business involves dealing in or holding securities, or a solicitor or accountant; or
 - (ii) the offer is made by one stockbroker to another on the Stock Exchange; or
 - (iii) the offer is made through a prospectus which complies with the Companies Ordinance; or
 - (iv) the offer is in relation to a mutual fund or a unit trust which has been approved by the Commission;
 - (b) unsolicited or "cold" calling by registered dealers is restricted by section 73; and
 - (c) the hawking of securities by visiting or by telephone by any person (whether a dealer or not) is restricted by section 74.

- 2.51 Two points should be noted. First, with the exception of such things as hawking and short selling, most of the restrictions in trading in securities in the Securities Ordinance affect dealers only. They do not extend to registered or exempt advisers or any other person. Secondly, the restrictions relate only to securities, and not to other forms of investment such as collective schemes formed as investment arrangements.

Commodities Trading Ordinance

- 2.52 This Ordinance contains restrictions on the hawking of futures contracts (section 60A) corresponding to those in the Securities Ordinance; and prohibitions against false trading and fraudulent conduct in connection with the purchase or sale of futures contracts (sections 62, 63). It is an offence to make false statements for the purpose of inducing any such sale or purchase (section 64).

III. PROPOSALS FOR REFORM

INTRODUCTION

- 3.1 In this part of the paper, we make proposals on the following topics:

Scope of regulation (paragraphs 3.6-3.36) - which forms of investment and which offers should be within the regulatory system?

Exemptions (paragraphs 3.37-3.68) - what should be exempted from the regulatory system?

Disclosure (paragraphs 3.69-3.82) - what information should be required to be included in regulated offers and how should it be specified?

Vetting (paragraphs 3.83-3.89) - which offers should be vetted before issue, and by which regulatory authority?

Collective investment schemes (paragraphs 3.90-3.92) - how should these be treated?

Advertisements (paragraphs 3.93-3.95) - how should advertisements be regulated?

Liability (paragraphs 3.96-3.113) - who should be liable and to whom for wrong or omitted information? Should liability be criminal as well as civil?

Conduct of Business (paragraphs 3.114-3.116) - what statutory protection should be given against fraud and other improper practices in connection with offers? What controls should there be on hawking, for example?

Repeals (paragraphs 3.117-3.120) - what Ordinances or subsidiary legislation might be replaced as part of the reform process?

- 3.2 The aim of the reform is to combine clarity with flexibility, offering protection to those investors who need it, while not over-extending the reach of regulation so that it covers those other investors who can fend for themselves. It is not an aim of the reform to place regulators in a position in which they are themselves making a qualitative assessment of the offer: the decision to invest or not must remain with investors.

- 3.3 The difficulty of designing such a regulatory scheme is that it must cater for the varied circumstances and conditions under which securities are distributed: what the Securities Review Committee described as a "five dimensional matrix" - different types of security, different types of issue, different types of issuer, different types of investor and different types of issuing house.

- 3.4 The scheme should also take account of the fact that there have not been serious legal difficulties in the way of fund raising in Hong Kong. Practitioners find the present regime illogical and untidy, but it would be an exaggeration to say that it has actually inhibited the raising of capital by issues and sales of securities. We think that these considerations lead to a cautious view on reform.

- 3.5 The suggestions which we are making are preliminary: in some cases they do no more than indicate the outline which reform might take, leaving the detail to be completed after consultation and at the drafting stage. In other cases, however, some degree of detail is necessary in order to explain or describe our proposals.

SCOPE OF REGULATION

Which forms of investment should be regulated?

- 3.6 Later in this paper we shall be proposing that the relevant provisions of the Companies Ordinance, the Protection of Investors Ordinance and the Securities Ordinance be replaced by a single set of statutory provisions (see paragraph 3.118). If that is done and a single regime is, so far as practicable, uniformly applied to different kinds of investments, it will be necessary to give detailed attention to defining the investments the offering of which is to be governed by the proposed legislation. At present the Companies Ordinance governs the issue of prospectuses that offer **shares or debentures**, as defined in the Ordinance. The Protection of Investors Ordinance is concerned with **securities**, as defined in the Securities Ordinance, **with property other than securities** and with **investment arrangements** in respect of property other than "securities", as defined (at some length) in the Protection of Investors Ordinance itself. **Unit trusts** and **mutual fund corporations** are defined in the Securities Ordinance, which empowers the Commission (in section 15) to authorise them, and they are also referred to in the Protection of Investors Ordinance.
- 3.7 A significant amount of time and effort is spent in interpreting and endeavouring to apply these definitions because of the different statutory requirements that apply to different forms of investment. For example, although section 4(1) of the Protection of Investors Ordinance prohibits the advertisement of certain investments, section 4(3)(a)(i) exempts registered dealers and investment advisers from that prohibition in relation to securities, but not in relation to investment arrangements. Investment arrangements can only be advertised if authorised under section 4(2)(g); and unit trusts and mutual fund corporations only if they have also been authorised under the Securities Ordinance.
- 3.8 The present provisions therefore result in distinctions being drawn that may have little to do with the protection of investors. We also understand that there have been difficulties in practice in deciding within which present definitions new investment products fall, whether of "securities", "property other than securities", "investment arrangements", or "unit trusts" and "mutual fund corporations". It is therefore apparent that there is a need to clarify and rationalise the definitions. Moreover, any reduction in the need for practitioners and regulators to pick their way through the present statutory distinctions would itself be a significant improvement in the system. The opportunity will arise to make these changes if, as we propose, the relevant provisions of the present Ordinances are replaced, and a single regime is introduced for the purpose of regulating the way in which capital is raised from investors. The detailed consideration that will have to be given to definitions before our recommendations can be translated into draft legislation will need to draw both on Hong Kong experience and on comparative definitions in other jurisdictions, and must ensure that ordinary trading transactions are not drawn into the regulatory net. We hope that market practitioners will assist in the preparation of draft legislation by giving information during the consultative process about the various types of investment media which are current or which may be developed, and about the difficulties encountered in classifying these types under the existing legislation.
- 3.9 Although we do not propose in a paper of this nature to attempt to put forward any definitions, we consider that in any new legislation it may be appropriate to seek a single, comprehensive term to embrace all the relevant forms of investment, including securities, collective investments and other investment arrangements, although there may also need to be individual definitions for particular types of securities or investments because of provisions

specific to them. We note that the Financial Services Act contains the most recent attempt to formulate an all-embracing definition of investments covering virtually everything, except physical property such as goods or land over which the investor has exclusive control. Schedule 1 to that Act lists the classes of investment which are covered (shares, debentures, futures etc.) with notes appended to each class.

- 3.10 If an all-embracing definition of all relevant forms of investment were adopted, it would not follow that all those forms would or should become subject to regulation. A more convenient course would be to bring classes of investment into regulation by subsidiary legislation as and when it was thought necessary. Under such a scheme, shares and debentures (for example) would be subject to regulation immediately, but other forms of investment, such as foreign exchange contracts, could be regulated later and only if it were considered desirable. It must also be borne in mind that different regulatory treatment may be appropriate for different investments, particularly in the case of collective investment schemes - as to which see further, paragraph 3.90 below.

Offers to the Public

- 3.11 Every jurisdiction which we have considered, except Australia in its new law, attempts to define the scope of regulation by distinguishing between "offers to the public" and offers which are of a private character. The latter class is removed from the regulatory system because the cost of regulating offers which are private affairs is not balanced by commensurate benefits. But we do not suggest that "private" offers should become completely unregulated. The rules attaching criminal penalties to fraudulent or reckless statements or promises should apply to "public" and "private" offers alike, as they do now by virtue of section 3 of the Protection of Investors Ordinance.
- 3.12 In some systems the term "public" is not used, but the distinction is nevertheless made - by excluding from the general regulatory provisions types of offer which are made only to a restricted circle or special class of offerees. But, however worded, the distinction is a crucial one, and private placements are growing in importance in all developed financial markets. The making of a fair and workable statutory distinction between public and private offers is the single most important task of reform.
- 3.13 We consider that, as regards the scope of regulation, the contexts of the Companies Ordinance and the Protection of Investors Ordinance can be treated together. The question of where the line should be drawn raises exactly the same policy issues, whether one is considering if an offer should require a Companies Ordinance prospectus, or, under the Protection of Investors Ordinance, if an advertisement should require the consent of the Commission. In both cases, the question is: do the offerees need regulatory protection, or can they fend for themselves? We further **recommend** that when a legislative solution to this difficult problem is arrived at, it should be embodied in a single set of statutory provisions replacing both the prospectus sections of the Companies Ordinance and section 4 of the Protection of Investors Ordinance (and section 72 of the Securities Ordinance - see paragraph 3.118).

Which offers should be regulated?

- 3.14 There seem to be three possible solutions - essentially the same three canvassed by the Department of Trade and Industry in the UK - see Appendix, paragraph A1.8. They are set out below:

- (i) to maintain the term "offer to the public" without attempting a statutory definition but possibly giving some general guidance as to its meaning;
- (ii) to legislate clearly for the dividing line between offers that are regulated and those that are not, leaving no place for administrative discretion and minimal need for judicial interpretation;
- (iii) to treat offers as generally subject to regulation and to divide unregulated offers into two classes: those that are exempted by statute, and those that are capable of being exempted on a discretionary basis by the Commission.

- 3.15 Alternative (i) is basically the existing Hong Kong system. Alternative (ii) aims to be a complete code in itself, and could be expressed either as an exhaustive definition of the term "offer to the public", or as a precise list of exceptions to a general obligation to comply with statutorily-expressed offering requirements. Alternative (iii) would list a number of exceptions to the obligation to comply with offering requirements, with further classes of case within which the regulatory authority could exercise discretion. This is dealt with in more detail below. More generally, alternative (i) leans towards flexibility, (ii) prefers certainty, and (iii) seeks a via media. We set out below our views on each of the three alternatives.

Alternative (i) (retaining "offer to the public"):

- 3.16 The attempt to give statutory guidance as to the meaning of "the public" in section 48A of the Companies Ordinance, the existing Hong Kong example of alternative (i), must be accounted a failure. The authorities in the UK have for long regarded the corresponding provisions in the Companies Acts as unenforceable. The Securities Review Committee was informed that in Hong Kong the scope of the private placement exemption (the converse of an offer to the public) was so uncertain that it could not be relied upon (paragraph 11.35 of the SRC Report). Similar difficulties have been experienced in other common law countries. The new Australian Corporations Law has abandoned the use of the term "offer to the public" (Appendix, paragraph A3.2). A series of cases in New Zealand on the meaning of the phrase has not clarified the matter; and the Guidebook to New Zealand Companies and Securities Law comments:

"The cases on this point are legion and indicate that after many years of judicial pondering on the point no clearcut answer can be given in relation to the grey areas. Some help can be derived from them but the overriding principle is that the question whether or not an offer is made to the public is fundamentally one of fact and each case must be decided individually."

- 3.17 The main difficulty about the term "offer to the public" is that the Courts cannot be expected to define it in such a way that practitioners will know where they stand. In a recent Australian case, the High Court said:

"The question whether a particular group of persons constitutes a section of the public cannot be answered in the abstract. For some purposes and in some circumstances, each citizen is a member of the public and any group of persons can constitute a section of the public. For other purposes and in other circumstances, the same person or the same group can be seen as identified by some special characteristic which isolates him or them in a private capacity and places him or them in a

position of contrast with a member or section of the public." (*Corporate Affairs Commission v Australian Central Credit Union* (1985) 157 CLR 201 at p. 208).

In other words, each case will depend on its own circumstances.

- 3.18 Could the phrase be better elucidated by guidelines issued by the Commission under section 4(2) of the Securities and Futures Commission Ordinance? We understand that an attempt to do so has recently been made by the Commission, but that legal difficulties have arisen. The fact that guidelines would lack legal force is important. The Courts might take a different view of the meaning of the term. If that happened, practices adopted in reliance on the Commission's guideline would be undermined. This is a difficulty which is unavoidable where a regulatory authority seeks to interpret a statute. In Ontario, the Securities Commission's Policy Statements, although not possessing legal sanction in themselves, are backed by formidable discretionary powers, such as the power to order the stoppage of trading in a particular stock. These powers must influence the market to observe the Policy Statements. We doubt the efficacy of guidelines, even if they could be framed in a satisfactory way, without comparable powers.
- 3.19 We consider that if the term "offer to the public" were to be retained essential clarity would be lacking and the doubt which has dogged this branch of the law would not be removed.
- 3.20 Quite apart from these considerations, there is another point of at least equal importance. In our view, the test of whether an offer should be regulated or not ought to be whether the offerees need protection. This is the criterion which has been adopted by the Supreme Court of the United States: *Securities and Exchange Commission v Ralston Purina Co.* (1953) 346 U.S. 119 at p. 125. But the English and Australian Courts, faced with legislation which directs them to treat "offer to the public" as including any section of the public, and being in any case less purposive in their approach, have taken a different direction. The Hong Kong Courts, with similar legislation (Companies Ordinance, section 48A) and similar traditions, can be expected to follow the Anglo-Australian approach.
- 3.21 The most recent authoritative statement is the *Australian Central Credit Union Case* referred to in paragraph 3.17. A credit union offered unit trust units to all its 23,000 members (whose membership was restricted by employment and/or residence) representing an interest in a building which the union was constructing as its own headquarters. The High Court of Australia held that the offer was not "an offer to a section of the public". The Court decided that, in order that an offer should not be treated as being made to the public or a section of the public, there had to be some subsisting special relationship between the offeror and the offerees, and a common characteristic linking the offerees with the offer. Brennan J. put the test in these words:
- "The criterion which distinguishes an offer to a group of offerees who are not a section of the public from an offer to a section of the public is this: whether the offerees are members of a group who, by reason of their antecedent relationship with the offeror, have an interest in the subject-matter of the offer substantially greater than or substantially different from the interest which others who do not have that relationship would have in the subject matter of the offer."
- 3.22 In our view this test will be difficult to apply in practice. It is not at all the same test as the protection of offerees as investors, and its application is most unlikely to yield the same result. We adhere to our view that in reforming the law, the guiding principle should be to give protection only to those who need it. Accordingly, we reject this alternative.

Alternative (ii) (a complete code):

- 3.23 We do not believe that it is a realistic possibility to devise a precise list of exceptions to a general obligation to observe offering requirements that is both comprehensive and durable. No jurisdiction that we have considered has achieved it. As markets develop and change, the list of exceptions would have to be changed, on each occasion by the time-consuming and sometimes frustrating legislative process. Some residual discretion would in practice become inevitable, and the area over which discretion has to be exercised might well increase with time. Accordingly, we also reject this alternative.

Alternative (iii) (offers generally subject to regulation, with exemptions):

- 3.24 We **recommend** a solution along these lines. The Ordinance would prohibit offers or invitations unless they were effected by an offering document containing specified information, the issue of which had been authorised by an appropriate regulatory body, and a copy of which had been made available to the public through some forms of central registry (the establishment of which would require separate consideration). There would then follow a list of exemptions from this general prohibition, with a residual discretion for the Commission to exempt other cases on an individual or class basis.
- 3.25 In considering the ambit of the Commission's discretion, two considerations should be borne in mind: first, the need for the maximum degree of certainty which can be practically achieved, and secondly, the importance of avoiding too great an administrative burden on the regulator. Both point to the need to ensure that the statutory exceptions are as comprehensive as practicable so that the area of discretion is narrow.

A further alternative

- 3.26 One other variant has been suggested to us. This is to retain the term "offer to the public", but to make clear in the legislation that certain classes of offer would be treated as not being made to the public, while leaving the term to be interpreted in other instances. For example, the legislation could provide that offers to not more than a specified number of offerees, or offers with a specified minimum cash subscription or purchase price, would not be regarded as offers to the public.
- 3.27 The advantages of this proposal are, first, that it would help to clarify the term "offer to the public"; secondly, that the phrase is familiar to practitioners and regulators alike and should not lightly be dispensed with; and thirdly, that it would avoid the risk, attendant on our own preferred solution (paragraph 3.24), that the area of administrative discretion might be enlarged. If, as we have recommended, all offers are to be regulated except those exempted specifically or by discretion, it is argued that the Commission might become more involved in two ways. It might have to authorise more offer documents, and it would have to adjudicate on more applications for exemption under its residual discretion. If that were to happen, it would militate against the objective of narrowing the Commission's discretion which we advocate in paragraph 3.25.
- 3.28 We agree that if the two new exemptions mentioned in paragraph 3.26 were carved out of "offer to the public", it would go some way toward helping practitioners to interpret the term. Whether or not the present arrangements work satisfactorily and whether or not our suggestions would increase the Commission's burden cannot be determined without an understanding of the existing procedures.

3.29 At present the Commission assists practitioners by indicating informally, and without legal commitment, how invitations may be issued without their being treated as made "to the public" for the purposes of the Protection of Investors Ordinance. We also understand that, until two or three years ago, the Registrar of Companies had been giving similarly informal views about whether an offer of shares or debentures would require registration of a prospectus (that is, would constitute an offer to the public) for the purposes of the Companies Ordinance. The Commission has taken, as a rule of thumb, 50 as the maximum number of persons who may be approached without the invitation or offer being treated as made to the public. But the Commission also indicates that the circumstances in which invitations or offers are made are relevant, and has informally stipulated at least the following:

- (a) not more than 50 copies of the offering document or invitation should be issued;
- (b) each copy should be serially numbered;
- (c) each copy should be individually addressed to a named person;
- (d) each copy should make clear that only the named addressee is entitled to take up the offer or invitation, and that he is not entitled to transfer his acceptance to any other person.

Sometimes, additional matters are stipulated, but the primary concern has been that the number receiving the invitation or offer should not exceed 50, and that the circle of investors should not be widened.

3.30 As we mentioned in paragraph 3.18, the Commission recently attempted to codify this practice in a guideline, but we understand that it received legal advice which made this impracticable. We could understand that this might be so, because the tests being informally applied by the Commission are different from those which it seems likely that a Court would apply (see paragraphs 3.20 and 3.21).

3.31 This seems to us to reveal an unsatisfactory situation: both the regulators and the market seem prepared to abide by practical guidelines, but the arrangements may not always be in accordance with the law. Our wish, if it is practicable, is to reform the law so that it is not at variance with what both the market and those regulating it think appropriate, provided that investors are adequately protected.

3.32 For the reasons given in paragraphs 3.20 and 3.21, we came to the view that the term "offer to the public" should be dispensed with. In our opinion, it is not directed to the essential issue of investor protection and would continue to be a potential source of uncertainty.

3.33 We concede that the adoption of our preferred solution (paragraph 3.24) might increase the Commission's burden, although we would hope not to a significant extent. That part of the Commission's time on this subject which is taken up by the giving of informal guidance as mentioned in paragraph 3.29, although admittedly small, would be saved. Our proposals would codify this practice and avoid the necessity for any further guidance. The other exemptions which we propose later in this paper (notably the exemption for offers with a minimum individual cash subscription or purchase price of HK\$2.5m) are designed to cover other cases lying near the borderline. Although in the nature of things, we cannot guarantee that some may not emerge, we do not visualise any other class of borderline case with which the Commission might have to concern itself. Although the alternative suggested in paragraph 3.26 is not favoured by the working group, we understand that the Commission will

wish to consider the advantages and disadvantages in the light of views expressed in the consultation period that follows the publication of this report.

3.34 In our view the essential question is: what is the maximum number of offerees that can be accommodated without real risk of endangering investor protection? Until now, the regulatory authorities have adopted 50, and this does not appear to have caused difficulties or to have put investors at risk. The choice of number is a matter of judgement, and it may well be that opinions will differ. It is also a pragmatic matter. An offer to one person may raise a question of investor protection, yet the Australian High Court thought 23,000 not too high. In fact, both English and Australian Courts have considered numbers irrelevant, and in a 1929 House of Lords decision, Viscount Sumner said:

"The public' ... is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole." (*Nash v Lynde* [1929] AC 158 at p. 169)

But if some certainty is to be achieved, we think that the choice of a maximum number is very desirable even if it may appear to some extent arbitrary. In considering what number is appropriate we draw attention to the corresponding number in the Australian Corporations Law (20) and the "seed capital" exemption in Ontario (50 invitees and 25 purchasers). In the light of the experience of the Commission in Hong Kong, we **recommend** a maximum number of 50. We also **recommend** that the precautions which the Commission has been taking to ensure that the circle is not enlarged, and which are mentioned in paragraph 3.29 should be made the subject of subsidiary legislation so as to give both clarity and legal force.

3.35 If, contrary to our expectations, it is found that the number of offerees should be reduced below 50, or that certain classes of investment should be excluded (so bringing those classes into the regulatory net), the changes should in our view be made by subsidiary legislation. We **recommend** that power be taken in the primary legislation to make these changes.

Summary of recommendations (which offers should be regulated?)

3.36 We **recommend** that:

- (i) the regulation of offers by reference to the test of whether they are "offers to the public" should be abandoned (paragraphs 3.16 - 3.22 and 3.26 - 3.35);
- (ii) instead the legislation should generally prohibit offers or invitations unless they are effected by an offering document containing specified information, the issue of which has been authorised by a regulatory body, and a copy of which is available on public file; but there would be a list of exemptions with a residual discretion for the Commission to exempt other cases on an individual or class basis (paragraph 3.24);
- (iii) the existing informal private placement exemption should be replaced by exemptions for (a) invitations to 50 or less persons, and (b) invitations for which the individual subscription or purchase price is at least HK\$2.5 million (paragraphs 3.33 and 3.34).

EXEMPTIONS

We set out in this section some comments on certain classes of case where particular difficulty or complexity arises. We shall then set out our proposals for exemptions from regulation, and finally compare those proposals with the present arrangements.

Brokers and Merchant Banks

- 3.37 At present, registered or exempt dealers and advisers may issue advertisements or invitations for securities without the approval of the Commission by virtue of section 4(3)(a)(i) of the Protection of Investors Ordinance, but are not exempt from the provisions of the Companies Ordinance if what they issue amounts to a prospectus. This includes documents "calculated to invite offers from the public". Dealers are also subject to section 72 of the Securities Ordinance, which imposes certain obligations on them when they offer securities (see paragraph 2.50 above). The question arises as to whether special treatment should be accorded to these classes of person if, as we recommend, the existing legislation is unified.
- 3.38 It is a normal part of brokers' business (at least in the case of the larger houses), to sell to and buy from clients, both for their own account and as agents for others. Brokers, and merchant bankers (most of whom are exempt dealers), also place securities privately with clients and others. These placings do not usually give rise to problems under the Companies Ordinance because in most cases there is no written document which could constitute a prospectus, and the arrangements are oral. Nor are they likely to contravene the requirements of section 72 of the Securities Ordinance because the exemption in section 72(5) will normally apply. And although the Protection of Investors Ordinance covers oral invitations (see the definition of "invitation" in section 2), registered and exempt dealers are exempt by reason of section 4(3)(a)(i) or, in some circumstances 4(3)(a)(viii). Even if there is an offering document, the view is taken that, in these placings, the number of offerees and other circumstances are such that the arrangements do not constitute an "offer to the public". One of the constraints which invariably applies is the prohibition on hawking of securities in section 74 of the Securities Ordinance.
- 3.39 We consider that, so far as possible, the existing practices of brokers and merchant bankers should continue as they are. We therefore propose that they should be free, without further regulatory control, to offer any of the following types of investment which, in our understanding, accords largely with existing practices:
- (i) existing securities which are listed or to be listed on the Hong Kong Stock Exchange or any other exchange which may be designated for the purpose by the Commission;
 - (ii) any investment (whether now falling within the definition of "securities" or the definition of "investment arrangements") which has been authorised by the Commission;
 - (iii) any class of investment which is made specifically exempt by statute;
 - (iv) unlisted shares or debentures (but not including unit trusts, mutual funds or any other shares or debentures which require authorisation from the Commission, but are unauthorised) to up to fifty offerees.

We comment below on each of these classes of investment.

- 3.40 **Existing listed securities.** We consider that it is an essential part of the business of brokers and merchant bankers to sell new listed securities in the secondary market, and to participate in the arrangements for distributing securities for which applications for listing have been made. Listings should not be confined to those on the Hong Kong Stock Exchange, but in our view should extend to other exchanges designated for the purpose by the Commission.
- 3.41 **Authorised Investments.** We consider that any investment which has been authorised by the Commission should be freely saleable by brokers and merchant bankers, subject to any distribution restrictions which might be imposed by the Commission as a condition of authorisation. Such authorised investments would include unit trusts, mutual funds and other forms of investment the subject of Codes promulgated by the Commission. This would preserve the existing situation whereby, under the Securities Ordinance, a person who deals in "securities" must either be registered or exempted.
- 3.42 **Exempted investments.** These include Hong Kong Government securities and various classes of capital market instruments referred to in the Protection of Investment Ordinance, section 4(2) (fa) to (fc). Again, we consider that registered and exempt dealers should be free to offer these unless the terms of their specific exemptions provide otherwise.
- 3.43 **Unlisted Shares and Debentures.** We understand that a small number of brokers and merchant bankers sometimes offer share or loan capital in enterprises at the initial or an early stage in the development of the project. In such cases the securities are neither listed nor (at that stage) to be listed, and we understand that the offerees are not more numerous than fifty. We consider that this practice should be permitted to continue without regulatory control, but should be limited to shares and debentures, and be so framed so that it would not extend to unauthorised unit trusts, unauthorised mutual funds, immigration schemes and other collective investment schemes. We do not consider it is necessary to impose restrictions on these offers to prevent the circle of investors from being widened, such as are mentioned above in paragraph 3.29. Our understanding is that share and loan capital of this type is usually placed firm in known hands; and in any event control can be exercised, if necessary, through the licensing and exempting system. We therefore recommend that no restrictions should be imposed on the manner in which such offers are made other than a maximum number of 50 offerees.
- 3.44 It is also part of the normal business of brokers to recommend investments by means of brokers' letters and in other ways. These letters have a wide circulation and the recipients are not limited to clients or professional investors. From informal enquiries we have made, we understand that investments which are recommended by registered or exempt dealers fall into the first three classes of investment mentioned in paragraph 3.39 (securities which are listed or to be listed, authorised investments and exempted investments). We therefore recommend that these classes of person should be free, without further regulatory control, to so advertise those three classes of investment. We do not think it either necessary or desirable for the classes of investment to be extended to include unlisted shares and debentures - the fourth class mentioned in paragraph 3.39. We deal with the subject of advertisements more fully below, in paragraphs 3.93 to 3.95.

Summary of recommendations (brokers and merchant bankers)

3.45 We recommend that registered and exempt dealers (brokers and merchant bankers) should be free without further regulatory control:

- (i) to offer
 - (a) securities which are listed or to be listed on the Hong Kong Stock Exchange or any other exchange designated for the purpose by the Commission;
 - (b) investments which have been authorised by the Commission;
 - (c) investments which are specifically exempted by statute;
 - (d) unlisted shares and debentures to not more than 50 offerees without other restrictions on the manner and terms of offer; (paragraph 3.39)
- (ii) to recommend or advertise by way of private letter or circulation (but not in the public media) investments falling within (a) (b) or (c) above. (paragraph 3.44)

Extraterritorial considerations

3.46 Two different cases must be distinguished. First, distributions of securities outside Hong Kong; and secondly, distributions of securities of overseas entities within Hong Kong.

3.47 As a matter of English and Hong Kong law, there is a general presumption that statutes are applicable only within the jurisdiction of the legislature; and as regards criminal sanctions, the Privy Council has stated that "All crime is local. The jurisdiction over the crime belongs to the country where the crime is committed" (see *Halsbury's Laws* 4th Ed, Vol. 44 para 908; and *Macleod v. Att. Gen. of NSW* [1891] AC 455, 458). Hong Kong legislation regulating the distribution of securities is therefore presumed to be limited to distributions within Hong Kong; and the criminal sanctions imposed for breach are applicable only if the offending act is committed within Hong Kong. The prospectus provisions of the Companies Ordinance are to be read in this way; and the Protection of Investors Ordinance similarly. In the latter case, the presumption is supported (and possibly extended) by the express words of section 4(3)(a)(vii) which exempts advertisements or invitations "with respect to securities intended to be disposed of to persons outside Hong Kong."

3.48 It may be difficult to determine in any particular case whether an offer of securities or an inducement to invest is made inside or outside Hong Kong, and whether, in consequence, an offence has been committed. Each case will depend on its own circumstances. But there is a line of decisions in England on the (now repealed) Prevention of Fraud (Investments) Act, 1958 which may still give guidance in what is a difficult area. (see *R v. Markus* [1974] 3 All ER 705; *Sec. of State v. Markus* [1975] 2 WLR 708). In drafting legislation at a later stage, the possibility of using a formulation similar to that in section 207(3) of the Financial Services Act should be considered. The effect of this, in determining whether an offer is within the regulatory act, is to look at the place or places where offerees are rather than the place where the offer is issued.

3.49 We do not consider it practicable to frame statutory provisions which would effectively codify the presumption to which we refer in paragraph 3.47. We take the view that the question of whether a crime related to the offering of securities has been committed in Hong Kong is better left to the courts to determine on the facts of each case. This is particularly so in cases of fraudulent conspiracy where, as in the *Markus* case, some of the acts constituting the conspiracy may take place outside the jurisdiction. We therefore recommend that the statutory provisions outlawing fraud and recklessness (which are now to be found mainly in section 3 of the Protection of Investors Ordinance) should not contain any express territorial limitation.

3.50 We have considered whether, for similar reasons, the exemption for advertisements and invitations "with respect to securities intended to be disposed of to persons outside Hong Kong" now in section 4(3)(a)(vii) of the Protection of Investors Ordinance, should be removed. The effect of the exemption is to free such advertisements and invitations from the requirement that they should be approved by the Commission. It is true that the fact that all the persons to whom securities are intended to be disposed of are outside Hong Kong may not be determinative of the question of whether an invitation to invest has been made in Hong Kong; and that, as a consequence, the exemption may be too wide. However, we are not aware of any consequent abuse. It is true also that "persons outside Hong Kong" is an imprecise phrase, difficult to construe. But on balance, we take the view that, provided the jurisdiction of the Hong Kong courts is unimpaired in cases of fraud and recklessness, as we recommend in the previous paragraph, the retention of the exemption in section 4(3)(a)(vii) is not objectionable. We therefore recommend that offers to distribute securities only to persons outside Hong Kong should not require approval from the Commission.

3.51 In any event, the developing co-operation between regulatory authorities in different jurisdictions should assist in ensuring that control is exercised in proper cases where distributions of securities are effected across national borders. One of the helpful ways in which international co-operation is developing is in the mutual recognition of offer documents between regulatory authorities in different jurisdictions, for example between the United States and some Canadian provinces and within the European Community.

3.52 The second question is more straightforward. In our view, distributions of securities of overseas entities which take place in Hong Kong should be regulated. In most cases, these will be effected through a registered or exempt person. We have already given our views about the extent of the exemptions from regulatory control which we consider is appropriate for these classes of person.

3.53 We appreciate that difficulties of enforcement may still arise where offerors of foreign securities are temporary visitors to Hong Kong who perhaps take a hotel room for a half-day "seminar" and then leave the territory. In our view, these cases should be within the scope of regulation, and the rules should be comprehensive and clear, so far as possible. If limitations on the capacity to enforce the law have the consequence that some may escape the net, that would not distinguish Hong Kong from any other financial jurisdiction.

Summary of recommendations (extraterritorial considerations)

3.54 We recommend that:

- (i) the statutory provisions outlawing fraud and recklessness in connection with

offers should not contain any express territorial limitation (paragraph 3.49);

- (ii) the existing exemption from regulatory control of offers made "with respect to securities intended to be disposed of to persons outside Hong Kong" should be preserved (paragraph 3.50);
- (iii) distributions within Hong Kong of securities of overseas entities should in general be regulated, but should have the benefit of the exemptions which we are proposing in common with other offers (paragraphs 3.52 and 3.53).

Secondary offers

3.55 We stated at the outset that we intended to include both issues and sales of investments within this review. Although both the Companies Ordinance and the Protection of Investors Ordinance are framed so as to include both, the Companies Ordinance deals in detail with sales, or "secondary" offers, only in one class of case. This is the "offer for sale" where shares or debentures are allotted "with a view" to their being offered for sale. In such cases, section 41 treats the document offering them for sale as if it were a prospectus issued by the company whose securities are being offered. There is a presumption that an allotment is made "with a view" to a public sale if either such a sale is made within 6 months of allotment, or the whole consideration has not been received by the issuing company at the time of the offer (sections 41(2)(a) and (b)). We **recommend** that a provision to this effect should be retained.

3.56 Some other jurisdictions, including the United States and Canada, have separate rules applicable to secondary offers. On the other hand, the Hong Kong Companies Ordinance does not treat secondary distributions separately except in the case mentioned in the preceding paragraph.

3.57 However, we do not consider that further detailed regulations designed specially for secondary offerings are necessary. Our understanding is that most secondary offerings of securities are made through registered or exempt persons. If these distributions are made as part of a public issue in the circumstances mentioned in paragraph 3.55, as where an issuing house subscribes for an entire issue and then immediately offers the securities for sale to the public, we consider that a full prospectus should be required. In other cases of sales of listed securities by registered or exempt persons, we **recommend** that there should be specific exemptions from regulatory requirements in accordance with paragraph 3.45. Our understanding is, however, that while the majority of "investment arrangements" are by their nature capable only of being offered in what constitutes the primary market, some may be of a type that can be offered in circumstances which constitute secondary trading. Further, there are no controls at all over persons who may offer "investment arrangements" once those investments have been authorised under the Protection of Investors Ordinance. In other words persons offering them do not have to be either registered or exempt persons, whether making offers in the primary or secondary market. This is in contrast to the position under the Securities Ordinance, which requires those who deal in securities to be registered or exempt persons. The Commission may therefore have to consider what (if any) further controls are desirable over the offering of authorised "investment arrangements".

3.58 In all other cases, we **recommend** that sales of existing securities should be subject to regulation in the same way as issues of new securities, and that they should be eligible for the same exemptions - to which we refer below in detail in the following paragraphs.

Summary of recommendations (secondary offers)

3.59 We **recommend** that:

- (i) the "offer for sale" provision in section 41, Companies Ordinance should be preserved (paragraph 3.55);
- (ii) further detailed regulations specifically for secondary offerings are unnecessary (paragraphs 3.57 and 3.58);
- (iii) the Commission should review the present lack of controls over those who may offer authorised "investment arrangements" and consider whether some form of regulation for these persons is desirable (paragraph 3.57).

Proposed Exemptions

3.60 We now set out our proposals for exemptions, in each case with explanatory notes. In paragraphs 3.65 to 3.68 we give a comparison between our proposed exemptions and the existing exemptions under the present law.

3.61 Offerors

- (i) The Hong Kong Government

Note : The exemption should extend only to Government securities, and not to the sale of securities in some other entity which the Government might wish to sell off, such as a Government-owned utility. In such cases, it is our view that investors should be provided with full information about the other entity.

The exemption should include any branch or department of the Government, but not statutory bodies such as the Trade Development Council, which should in our view, be treated similarly to commercial companies. We do not consider that foreign governments or international bodies should be exempt.

However, it is desirable for individual public or international bodies to be capable of being designated as exempt. We **recommend** that the designation of these bodies should be by agreement between the Commission and the Administration (Financial Secretary).

At present, banks and certain "multilateral agencies" (including the World Bank) and certain "exempted bodies" (including the Trade Development Council) have limited exemptions under the Protection of Investors Ordinance to offer certificates of deposit or other debt instruments without Commission authorisation (paragraphs (fa) to (fc) of section 4(2)), subject to meeting certain criteria in the issue and filing particulars with the Commission thereafter (section 7A). It is envisaged that these exemptions would be preserved in subsidiary legislation, in order to avoid unnecessarily complicating the primary Ordinance. We refer to this type of case below in paragraph

3.63(iv). We understand that the Commission is presently reviewing this system of exemptions with the Administration and the Commissioner of Banking.

(ii) Registered or exempt dealers and advisers

Note : As discussed in paragraphs 3.37 - 3.45, we **recommend** that these classes of person should be free to offer investments of the following classes:

- (a) securities which are listed or to be listed on the Hong Kong Stock Exchange or any other exchange designated for the purpose by the Commission;
- (b) investments authorised by the Commission;
- (c) investments specifically exempted by statute;
- (d) unlisted shares or debentures to not more than 50 offerees without restriction as to the manner or terms of offer.

We also **recommend** that registered and exempt dealers should be free to recommend or advertise by private letter or circulation (not newspaper media) investments within classes (a)(b) and (c) above, but not (without the consent of the Commission) class (d).

The present situation in regard to takeover offers that they must be made by a registered or exempt person, or be subject to approval by the Commission, should be preserved.

(iii) Offers by credit unions to their members

Note : This exemption currently conferred by section 4(3)(a)(v) of the Protection of Investors Ordinance should be continued. These bodies are regulated by their own Registrar and should in our view fall outside the ambit of securities legislation.

(iv) Newspapers and periodicals

Note : In our view, section 4(5)(a) of the Protection of Investors Ordinance is drawn too widely. It appears to exempt written material which would otherwise need the consent of the Commission, simply because it is reproduced in a newspaper or other generally circulating periodical.

We **recommend** that in its place there should be a more narrowly framed exemption for financial journalists, and all others concerned in the production or distribution of the newspaper or periodical concerned, for the information and opinions given by the journalist.

Section 5 of the Protection of Investors Ordinance prohibits anyone other than a registered investment adviser from holding himself out as prepared, for reward, to give investment advice or manage a portfolio. The section contains an exemption similar to that in section 4(5)(a) for newspapers and periodicals. We **recommend** that this exemption should be preserved.

3.62 Offerees

General Note : This group of exemptions is intended to be cumulative. Consequently, a single offer made simultaneously to more than one class of exempt offeree would enjoy exemption from regulation under each exemption, increasing the total number of persons to whom the offer could be made without falling into the regulatory net.

(i) Underwriters

Note : There is no comprehensive definition of "underwriting" in the Companies Ordinance or any other comparative legislation which we have considered. The word has however been judicially defined as meaning "agreeing to take so many shares as are specified in the underwriting contract, if the public do not subscribe for them" (*Re Licensed Victuallers Assn.* (1889) 42 Ch.D.1).

The Australian Corporations Law defines underwriting as including sub-underwriting, and we agree that the exemption should extend to sub-underwriting.

It sometimes happens in Hong Kong that one or more principal shareholders make separate arrangements to take up a proportion of an issue if the original offerees do not. We consider that such arrangements should be entitled to the benefit of the exemption.

(ii) "Professionals"

Note : We **recommend** that this exemption should extend not only to securities, as it now does - but also to "investment arrangements", as it now does not, since "professionals" are by definition investors who can fend for themselves.

The exemption for offers made only to "professionals" in the Protection of Investors Ordinance is in the form : "persons whose business involves the acquisition, disposal or holding of securities, whether as principal or agent" (section 4(3)(a)(vii)); whereas in the Companies Ordinance, section 343(2) (overseas companies only) different wording is used: "any person whose ordinary business it is to buy or sell shares or debentures, whether as principal or agent."

Except under the new Australian Corporations law, comparable exemptions are available in all the other jurisdictions we have considered. In Singapore, for example, wording identical to that in the Companies Ordinance is used, but issues to certain other specified classes of professional investors are also exempt: licensed banks, registered insurance companies, licensed investment advisers, pension funds, unit trusts and certain investment companies.

We do not think it necessary to list exempt categories of investor as in Singapore, and prefer a more general form of wording. We prefer the wording in the Protection of Investors Ordinance to that in the Companies Ordinance since it includes not only

buying and selling, but also holding investments. We suggest the following :

“any person whose business includes the acquisition, disposal, or holding, whether as principal or agent, of securities or investment arrangements.”

We do not consider that there need be a separate exemption, as there now is under section 4(5)(b) of the Protection of Investors Ordinance, for offers made only to registered or exempt persons. Except in the case of registered or exempt advisers, for whom an additional exemption could easily be included if it is needed, the wording suggested above should be sufficient to cover offers made exclusively to registered or exempt persons.

There is a risk that this exemption might be abused by the formation of \$2 companies with objects clauses designed for investment activities, and behind which individuals might seek to shelter. We are however unaware of any history of such abuse. If there were evidence of abuse, it would be possible to deal with the problem by providing for example (by subsidiary legislation) that the exemption was available only to investors controlling not less than a stated minimum amount for investment. The Australian legislation contains such a provision in Corporations Regulation 7.12.05.

- (iii) Offers made to not more than 50 persons in any period of 12 months.

Note : As discussed in paragraphs 3.29 - 3.35, and separately from the recommendation in paragraph 3.39, we **recommend** that offers to 50 or less persons should be exempt. We are not absolutely satisfied either that 50 is necessarily the right number (although we have been influenced by the Commission's practice of treating offers to 50 persons or less as private matters) or that the same number is uniformly appropriate for all types of investment. For those reasons, we **recommend** that power should be taken by subsidiary legislation to lower the limit below 50, or to exclude certain classes of investment if that should prove necessary or desirable for the protection of investors.

Provision should be made by subsidiary legislation to ensure that the circle is not widened beyond 50, by persons other than the original invitees being in a position to accept the offer (see paragraph 3.29).

The exemption should not be available to an offeror in respect of the same securities more frequently than once a year.

- (iv) Offers of securities of the offeror to or for the benefit of the offeror's directors or employees.

Note : We understand that employee share schemes are normally limited to directors and senior executives, and do not extend to more junior staff with insufficient knowledge and experience to be able to form an assessment of the shares being offered. That being so, we propose that there should be a general exemption for these schemes. If it becomes more common to include junior employees, the Commission could issue a guideline or make regulations in the form of subsidiary legislation stipulating minimum content requirements for employee share schemes.

The existing exemption in section 4(3)(a)(ii) of the Protection of Investors Ordinance extends to employees and securities of a “related corporation” - that is, another member of the same group of parent and subsidiaries. We **recommend** that this exemption should be similarly framed.

We do **not recommend** that the exemption should extend to creditors or agents as well as employees as does section 4(3)(a)(ii). Except for the case of offers made to holders of loan capital, an offer to creditors is a remote contingency, and one made to “agents” even more so. Offers to loan capital holders are in our view best treated as rights issues, and we see no reason which would lead to a conclusion that offers to other creditors or agents should be unregulated. We do not consider it safe to assume that all “creditors” and “agents” are in a position to fend for themselves.

- (v) Offers to persons outside Hong Kong

Note : As discussed in paragraphs 3.46 - 3.51, we **recommend** that the exemption now in section 4(3)(a)(vii) of the Protection of Investors Ordinance should be preserved.

3.63 Types of offer

- (i) Offers in relation to collective investment schemes which have been authorised by the Commission.

Note : The present law deals only with the subject matter of the Code on Unit Trusts and Mutual Funds, and then but briefly, as well as with collective investment schemes comprising “investment arrangements in relation to property other than securities”, and “securities”. The issue of prospectuses of unit trusts and mutual fund corporations which have been authorised by the Commission under section 15 of the Securities Ordinance (and of application forms for units or shares in the trusts or funds) does not require further approval from the Commission under the Protection of Investors Ordinance; there is an exemption under section 4(2)(e) and (f).

If the managers of these funds wish to advertise them then further approval is required from the Commission (section 4(2)(g).) Further, although there is a general exemption under the Protection of Investors Ordinance available to registered and exempt dealers and investment advisers for the issue by them or on their behalf of “securities” (section 4(3)(a)(i)), and unit trusts and mutual funds are by definition “securities”, that exemption does not include *unauthorised* unit trusts or mutual funds (section 4(2)(8)). The intention is to ensure that only authorised unit trusts and mutual funds are offered to the public.

A mutual fund corporation (but not a unit trust) is a company, and therefore within the provisions of the Companies Ordinance, but the Registrar upon authorisation by the Commission of a mutual fund corporation prospectus customarily issues a certificate of exemption from compliance with the Third Schedule to the Companies Ordinance. This is because of the scrutiny which the prospectus has already

undergone in the process of authorisation by the Commission.

Offers of other forms of collective investment schemes would generally come within the definition of "investment arrangements in relation to property other than securities" under the Protection of Investors Ordinance, and would require authorisation from the Commission before being offered to the public (section 4(2)(g)). We say "generally" because it is not beyond the bounds of possibility that other forms of collective investment schemes could be devised by promoters which fell within the definition of "securities." But in that case certain provisions of the Securities Ordinance would apply to them and they might also still require authorisation by the Commission under the Protection of Investors Ordinance.

In principle, it ought to be permissible to offer units or other forms of collective investment under a scheme previously approved by the Commission under one of its Codes without further regulatory involvement. That is the purpose of this proposed exemption.

The Codes which are relevant for purposes of this exemption are the Code on Unit Trusts and Mutual Funds, the Code on Immigration Schemes and the Code on Investment-linked Assurance and Pooled Retirement Schemes. Other Codes dealing with different forms of collective scheme may be promulgated from time to time.

(ii) Offers with a minimum specified cash subscription or purchase price per offeree.

Note : We consider that there would be merit in introducing in Hong Kong, as has already been done in some other jurisdictions, a separate exemption for large individual cash subscriptions. Our preliminary view, which can be tested during the process of consultation, is that an exemption of this type can be extended to "investment arrangements" as well as to securities. But in any case, power should be taken by subsidiary legislation to exclude certain classes of investment from such an exemption if that is necessary in the interests of the protection of investors.

The Singapore exemption for "sophisticated investors" (Appendix, paragraph A5.5(vii)) provides for the alternatives of (a) individual cash price of S\$200,000, or (b) net assets of S\$1m or annual income of S\$200,000 per individual offeree. We do not favour the latter alternative which would require difficult and possibly fruitless enquiry into the personal circumstances of each offeree.

The minimum cash subscription exemption in the Australian Corporations Law is A\$500,000.

We consider that the minimum cash subscription price to qualify for this exemption in Hong Kong should be set relatively high to take account of the correspondingly high levels of personal wealth in Hong Kong. We suggest HK\$2.5m.

The framing of this exemption may have to include safeguards against the "pooling" by the promoters of subscriptions from several investors so as to qualify for exemption.

(iii) Bonus issues and stock dividend schemes

Note : These types of issue involve no raising of funds and should in our view be outside the scope of regulation. It is for consideration whether a bonus issue of short-dated warrants should be treated as an issue calling for the raising of funds and therefore should be subject to regulation.

(iv) Additional cases

Note : We recommend that the primary legislation should provide for the possibility of subsidiary legislation promulgated by the Commission to exempt certain additional limited classes of offeror and/or investment. An example of this type of case is the preservation of the existing exemptions for issues of certificates of deposit and certain other capital market instruments by banks, specified public bodies and other entities now provided for in the Protection of Investors Ordinance, section 4(2)(fa), (fb) and (fc). We suggest that, in accordance with the notes to paragraph 3.61(i), any further such exemptions should be made available only with the concurrence of the Financial Secretary.

3.64 Discretionary Cases

Note : In our view, the Commission should have a discretionary power to exempt offers wholly or in part from regulatory control. The question is : what tests should be applied in such cases?

The Companies Ordinance, section 38A, gives the Registrar of Companies a power to relieve from the full requirements of disclosure in cases where compliance "would be either irrelevant or unduly burdensome".

No comparable test is laid down in the Protection of Investors Ordinance.

In Singapore, the Minister may declare by order that the regulatory provisions of the Companies Act relating to prospectuses should not apply to an offer if either "the cost of providing a prospectus outweighs the resulting protection to investors"; or "otherwise it would not be prejudicial to the public interest if a prospectus were dispensed with". (Singapore Companies Act, section 106B(2)). The first alternative is not dissimilar to the "unduly burdensome" test, although more explicit; but the second alternative, involving the public interest, is of wider import.

For the reasons given in paragraph 3.25 above, we consider that the Commission, being the relevant regulatory authority, should have a relatively narrow discretion. We recommend the adoption of the "unduly burdensome" test, adding "or unnecessary for the protection of investors" or wording to similar effect.

We propose that this test should be made explicit in primary legislation, and that the Commission should be given power to exempt either in individual cases (by order of the Commission) or on a class basis (by subsidiary legislation).

Comparison of Proposed Exemptions with Existing Law

3.65 Having set out our suggested exemptions from the basic regulatory requirements, it is helpful to compare them with those presently in force under the Companies Ordinance and the Protection of Investors Ordinance. We refer to them in the order in which they appear in the text of this paper - above.

3.66 Companies Ordinance

Section 343(2) (paragraph 2.9) : professional investors exemption, overseas companies only.

This is covered in a more precisely drawn proposed exemption - paragraph 3.62(ii), extending to all offerors, whether or not incorporated in Hong Kong.

Section 38(5)(a) (paragraph 2.11) : issues to existing shareholders and debenture holders.

Since this is essentially a matter of disclosure, we deal with it below under that head (paragraph 3.73).

Section 38(5)(b) (paragraph 2.11) : issues which are uniform with those already listed.

We consider that this is a matter which should more appropriately be dealt with in the Stock Exchange's listing rules.

Section 38(3)(a) (paragraph 2.12) : underwriting agreements.

This is covered in a proposed exemption - paragraph 3.62(i).

Section 38(3)(b) (paragraph 2.12) : offers which are not made to the public.

If, as we recommend, the term "the public" were to be discontinued, it would follow that there would then be no need to retain this exemption or section 48A whose purpose is to explain the phrase.

3.67 Protection of Investors Ordinance

The relevant exemptions are set out above in paragraph 2.40, sub-paragraphs (a) to (m).

(a) **Section 4(2)(a), (b) and (c)** : issues of prospectuses complying with the Companies Ordinance.

Since we recommend that the relevant parts of the Companies and Protection of Investors Ordinance should be replaced by a single set of statutory provisions there should be no need to retain this group of exemptions.

(b) **Section 4(2)(d)** : underwriting agreements.

We have already referred to these in the preceding paragraph in reference to the Companies Ordinance.

(c) **Section 4(2)(e) and (f)** : offers of authorised unit trusts and mutual funds.

This is covered by a proposed exemption - paragraph 3.63(i).

(d) **Section 4(2)(fa), (fb) and (fc)** : offers of certificates of deposit etc. by certain banks, public bodies and other entities.

As mentioned in paragraphs 3.61(i) and 3.63(iv), it is envisaged that these exemptions would be preserved by subsidiary legislation, but these are currently under discussion between the Commission, the Administration and Commissioner of Banking.

(e) **Section 4(3)(a)(i)** : offers of securities by registered or exempt persons.

This is covered in a more precisely drawn proposed exemption - paragraph 3.61(ii).

(f) **Section 4(3)(a)(ii)** : offers made by a company to holders of its securities, or its creditors, servants or agents.

For the reasons given in the notes to paragraph 3.62(iv), we **recommend** that this exemption should no longer extend to creditors or agents, but that an exemption should continue to be available for offers to employees (paragraph 3.62(iv)). As mentioned above, we deal with offers to shareholders and debenture holders under the heading "Disclosure".

(g) **Section 4(3)(a)(iii)** : offers made by the manager or trustee of an authorised unit trust to holders of its units, or its creditors, servants or agents.

For reasons similar to those referred to in the note to paragraph 3.62(iv), we **recommend** that this exemption should no longer extend to creditors, servants or agents, but that the exemption should continue to be available for offers to unit holders of an authorised unit trust, and that a parallel exemption should be available for offers by an authorised mutual fund to its shareholders (paragraph 3.63(i)).

(h) **Section 4(3)(a)(iv)** : issues by the Hong Kong Government.

This is covered by a proposed exemption, limited to Government securities - paragraph 3.61(i).

(i) **Section 4(3)(a)(v)** : offers by credit unions.

This is covered by a proposed exemption - paragraph 3.61(iii).

- (j) **Section 4(3)(a)(vi)** : offers by trustees to their beneficiaries.

Except for the case of unit trusts (see sub-paragraphs (c) and (g) of this paragraph) there does not seem to us to be any need to preserve this exemption. Offers to 50 or less offerees would be covered by the proposed exemption in paragraph 3.62(iii). Offers to a larger number of people should in our view be regulated.

- (k) **Section 4(3)(a)(vii)** : offers of securities to persons outside Hong Kong, or to professional investors.

We **recommend** that offers should continue to be exempt from regulation on the sole ground that the securities are intended to be disposed of only to persons outside Hong Kong. We discuss this recommendation in paragraphs 3.45 - 3.51 above, and it is covered by a proposed exemption - paragraph 3.62(v). We also **recommend** that the "professional investors" exemption should be preserved under a separate head - see paragraph 3.62(ii) - and extended to such classes of "investment arrangements" as may be specified in subsidiary legislation.

- (l) **Section 4(3)(b)** : offers made by persons in the ordinary course of their business of buying and selling property other than securities, but not including offers of participations in collective schemes.

We hope and intend that the definitions which will have to be prepared in connection with these reforms will make clear that such matters as the ordinary advertisement of real estate by surveyors and estate agents are outside the scope of regulation. If that is done, we do not consider it would be necessary to preserve this exemption.

- (m) **Section 4(5)(a)** : issues of newspapers or periodicals of general and regular circulation containing invitations to invest.

We are proposing a more narrowly drawn exemption - see paragraph 3.61(iv).

- (n) **Section 4(5)(b)** : offers to registered or exempt dealers and advisers.

For the reasons given in the note to paragraph 3.62(ii), we do not consider that a separate exemption is necessary. All that should be required is a well-drawn exemption for professional investors, as we are recommending in paragraph 3.62(ii).

3.68 In our recommendations, we have proposed two new substantive exemptions from regulation - for large cash subscriptions (paragraph 3.63(ii)) and for offers made to 50 persons or less (paragraph 3.62(iii)). Both are designed to free those cases where the benefits to the investing public of regulation are clearly outweighed by its cost and effort.

DISCLOSURE

Detailed Obligations

3.69 The new Australian Corporations Law provides that a prospectus must contain all such information as investors and their professional advisers would reasonably require in order to make an informed assessment of the securities being offered. Apart from very limited additional requirements about the disclosure of directors' interests, there are virtually no other detailed requirements as to content. Although the Law does provide for the possibility that detailed requirements may be specified in regulations, we understand that it is the view of the Australian authorities that it is the primary responsibility of the promoters and their advisers to ensure that all material information is included.

3.70 We have considered the possibility of eliminating all content requirements from this branch of the law except a general obligation such as we refer to in paragraph 3.75. On the whole, however, we do not think that Hong Kong is ready for such a radical departure from tradition, and we consider that guidance about what should be included is still a valuable part of the legislative framework. It will be interesting to see how matters develop in Australia and whether it will be found necessary there to make regulations specifying details for inclusion in at least some classes of prospectus. Accordingly, we **recommend** that new legislation should make provision for detailed matters to be included in offering documents, and that these matters should be prescribed by the Commission in subsidiary legislation.

3.71 In cases where the securities being offered are intended to be listed, the requirements should coincide with, and preferably not exceed, those contained in the Stock Exchange's Listing Rules. Alternatively, as the Listing Rules must be approved by the Commission, the requirements for offers of listed securities could be simply those provided for in the Listing Rules. The distinction between the two alternatives is that in the latter case, any particular requirement could be waived by the Exchange, whereas it would have statutory force if prescribed in subsidiary legislation. It would be consistent with the tenor of the recommendations of the Securities Review Committee in Chapter XI of their Report, particularly paragraph 11.59, if the content of offer documents relating to securities intended to be listed were a matter for the Stock Exchange. We **so recommend**.

3.72 As to unlisted offers, the content to be prescribed by subsidiary legislation, as we propose, could conveniently be divided into parts, some of which would be mandatory and others of which could be waived at the discretion of the Commission, depending on the circumstances of the offer.

Rights Issues

3.73 The Companies Ordinance, section 38(5), provides for an exemption from the content requirements of the Third Schedule in the case of rights issues, and issues which are uniform with securities already listed on the Stock Exchange. In our view, it is not appropriate for these issues to be exempt from regulation. The shareholders and debenture holders to whom rights are offered are entitled to protection as investors, but because they already hold securities in the issuing company, it will usually be the case that the information they need in order to assess the merits of the offer is less than it would be in the case of a flotation. This is the approach of the Stock Exchange's Listing Rules. We **recommend** therefore that, so

far as concerns issues of share and loan capital which are intended to be listed, reduced obligations as to content should be specified in the Listing Rules and, for unlisted issues, correspondingly reduced obligations should be prescribed in subsidiary legislation. For this purpose, we intend the term "rights issue" to include an issue of new securities pro rata to the holders of existing securities in right of their holdings, including issues to holders of warrants.

- 3.74 As we observed in paragraph 2.8, the contents prescribed for prospectuses in the Third Schedule to the Companies Ordinance is out of date, while the Stock Exchange's Listing Rules have recently been updated (see paragraph 2.18). The latter will therefore serve as a better model for a new set of detailed requirements.

Overriding Obligations

- 3.75 We **recommend** that the statutory provisions should contain an overriding requirement that offer documents relating to any regulated offer should not contain or omit any matter so as to mislead offerees; and should also contain a similarly overriding requirement (as in the Companies Ordinance, Third Schedule, paragraph 3, and the Statutory Listing Rules, paragraph 3) that the documents contain sufficient information to enable a reasonable person to make an assessment of the investment.

- 3.76 The obligations referred to in the preceding paragraph should, we propose, override the detailed requirements as to content (which are referred to above) in a sense similar to that by which in the U.K., under section 228 of the Companies Act 1985, the obligation to prepare true and fair accounts overrides the detailed requirements as to their content. In this respect, the language of the UK Companies Act is to be preferred to that of section 123 of the Companies Ordinance. The former positively requires additional or different information than is laid down in the detailed requirements if it is necessary for the accounts to give a true and fair view. There are also overriding disclosure obligations provided for by the Financial Services Act 1986, sections 146 and 163. These require, in addition to the detailed information prescribed, the disclosure of "all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there for the purpose of making an informed assessment" of the investment.

Continuing Obligations

- 3.77 As the Securities Review Committee said, the regulator should aim to ensure both that the issue of securities is accompanied by sufficient information to enable prospective investors to make an informed judgement, and that shareholders are subsequently fully informed of significant developments affecting their company (paragraph 11.2 of the SRC Report). We agree that the maintenance of up-to-date relevant information is as important as full disclosure at the time when securities are first offered, at least where the securities are likely to be traded.
- 3.78 The Securities Review Committee distinguished between listed and unlisted issues in this respect (see paragraph 11.47). While the Listing Rules of the Stock Exchange provide that listed companies must keep investors up-to-date with price sensitive information, there are no corresponding obligations for unlisted companies. "A prospectus to an unlisted issue", said the SRC, "is a one-off snapshot intended to form the basis of a contract between offeror and individual subscribers. There will be no on-going disclosure except that required periodically by company law." (paragraph 11.48)

- 3.79 The question of continuing information raises important issues for consideration: for example, whether the disclosure obligations in the Listing Rules should be accompanied by legal sanctions; or whether there should be more stringent obligations of disclosure for unlisted public companies; or whether prospectuses should be updated annually as in the United States. But in our view, this is a separate study outside the scope of this review.

Supplementary Information

- 3.80 We **recommend** that the legislation should contain an obligation on those responsible for an offering document, to prepare and lodge on the public register a supplementary document, giving details of any significant change affecting a matter contained in the original offering document which has occurred at any time before dealings begin (in the case of an offering of a listed security) or at any time while an agreement to subscribe or purchase may be entered into (in the case of an unlisted security). The provisions of sections 147 and 164 of the Financial Services Act are to similar effect and may serve as a model.

- 3.81 We **recommend** that the sanction for failure to prepare and lodge a supplementary document should be that provided for in the corresponding provisions of the Financial Services Act - civil liability towards anyone who acquires the securities under offer and sustains a loss as a result of the failure to publish the corrective information (Financial Services Act, sections 150(3) and 166(3)).

Summary of Recommendations (disclosure)

- 3.82 We **recommend** that:
- (i) the detailed content of offering documents should be prescribed, as regards listed issues, in the Listing Rules of the Stock Exchange; and as regards unlisted issues, in subsidiary legislation (paragraphs 3.71 and 3.72);
 - (ii) the Ordinance should provide for an overriding obligation that offer documents should not contain or omit anything so as to mislead; and should contain sufficient information to enable an informed assessment to be made of the investment being offered (paragraph 3.75);
 - (iii) the question of continuing disclosure should be the subject of a separate study (paragraph 3.79);
 - (iv) provision should be made in the Ordinance for supplementary information to be disclosed if changes occur after issue of the offering documents and before dealings begin (paragraph 3.80).

VETTING AND LODGEMENT OF OFFER DOCUMENTS

- 3.83 The Securities Review Committee recommended that sole responsibility for the vetting of prospectuses for listed issues should be undertaken by the Stock Exchange, when a sufficient degree of professionalism and independence on the part of its listing division had been demonstrated and audited (paragraphs 11.55 and 11.64 of the SRC Report). We understand that both the Commission and the Administration have decided to adopt this recommendation and to implement it as soon as legislation can be brought into force. The chosen method of proceeding is for the Commission to assume the power of authorising the issue of offer documents and to transfer that function, so far as concerns listed issues, to the Stock Exchange under section 47 of the Securities and Futures Commission Ordinance. It will be necessary first to amend section 47 so that the functions falling within its scope include the vetting of offer documents. However, the Commission will retain responsibility for certain securities even if they are listed. These include the shares of mutual funds and units in unit trusts. We entirely agree with these decisions.
- 3.84 We have considered whether the Commission should retain an ultimate right to scrutinize any particular offering document and to give or withhold approval, notwithstanding that it has transferred the vetting function to the Exchange. We do not consider that an effective check could be made unless the Commission were to review in detail all offering documents for securities for which applications for listing are made. Neither an occasional spot check nor a cursory scrutiny of documents would in our view be satisfactory. A full review would mean a complete duplication of function with serious consequences for manpower requirements in the Commission office. We therefore **recommend** that the Commission should transfer the vetting function to the Exchange, without retaining any residual power to carry out checks itself other than the power conferred by section 47 of the Securities and Futures Commission Ordinance to call for a re-transfer of the function to itself, and except in the case of investments where it retains responsibility as mentioned in paragraph 3.83. We understand that the Registrar General considers that approval to an offer should be capable of being withheld on public interest grounds, for example if the subject of the offer were politically sensitive. The Commission has set up arrangements with the Exchange to ensure that the Exchange will withhold approval to an offer where this is justified on public policy grounds.
- 3.85 We **recommend** that offers of unlisted securities and other investments should also be subject to regulatory authorisation before issue, unless exempted by specific statutory exclusion or by the exercise of the Commission's discretion, and that, as proposed in the Securities Review Committee Report, paragraph 11.60, vetting of these offers should be by the Commission. The Registrar General does not wish to continue to pre-vet prospectuses; and if, as is suggested, the Commission is to be charged with the responsibility of prescribing the content of unlisted offer documents, and of exercising discretionary power to exempt certain offers from these requirements, it would be logical for it to have the cognate responsibility of authorising regulated offers.
- 3.86 We **recommend** that the documents relating to all offers which are not exempt should be lodged with the Registrar of Companies and so be made available on public file. This would apply not only to offers of shares or debentures now required to be lodged under sections 38D and 342C of the Companies Ordinance, but also to other regulated offers now subject to approval by the Commission under section 15 of the Securities Ordinance (mutual funds and unit trusts) and section 4(2)(g) of the Protection of Investors Ordinance (other "investment arrangements").

The Authorisation Process

- 3.87 We **recommend** that the Ordinance should provide, simply, that no regulated offer should be issued without its having been authorised in advance by the appropriate authority - in the above proposals, either the Stock Exchange or the Commission. It would not be right for the Ordinance to require the regulator to satisfy itself that the offer document is not misleading, or that it contains adequate information for an informed assessment to be made. Wording of that sort places too heavy a burden on the regulators, and might open them to civil liability. A general discretion to authorise the issue of documents is preferable. It should also be satisfactory to offerors, because in our view the exercise of such a discretion would be reviewable by the Courts on principles applicable to judicial review cases. In order to put matters beyond doubt, we **recommend** that the legislation should make it clear that the vetting authority (Stock Exchange or Commission) is not obliged to satisfy itself that all material information is being disclosed in the offering document in accordance with the overriding obligation to which we refer in paragraphs 3.75 and 3.76; and that all regulated offering documents should state that the vetting authorities take no responsibility for their contents. We further **recommend** that the legislation should provide that the vetting authority is not to be treated as having authorised the issue of the offering documents for purposes of liability (see below, paragraph 3.102).

Ancillary Powers

- 3.88 Consideration should also be given to the powers of the Commission during the process of scrutiny and after an offer document has been authorised and lodged at the Companies Registry. At present the statutory Listing Rules give power to the Commission to order a suspension of dealings in cases where false, incomplete or misleading information has been given, or where it appears necessary in order to maintain an orderly market. Whatever should be the fate of the statutory Listing Rules, we **recommend** that powers of this nature should be retained by the Commission. We further **recommend** that the Commission should have power to restrain the issue or sale of securities under an offering document which is found to be false, incomplete or misleading or is in breach of the legislation. There are provisions in the new Australian Corporations Law having comparable effect. The exercise of the power to stop a public issue or sale is a serious matter which could cause damage to the reputation of the issuer. We therefore **recommend** that it should be exercisable only by an executive director of the Commission and that it should be subject to review by the full Commission. Because, however, it may be necessary to act with speed, we think power should be given to make an interim stop order having immediate effect, and that such an order should require authorisation by two directors of the Commission, at least one of whom should be an executive director. It is also necessary for the Commission to have power to investigate allegations made by investors that an offer document is misleading or otherwise deficient. This would require powers to call for papers and to question those thought to have relevant information.

Summary of Recommendations (vetting and lodgment)

- 3.89 We **recommend** that:
- (i) the function of authorising offer documents for listed issues should be transferred to the Stock Exchange (paragraph 3.83);

- (ii) the Commission should undertake the authorisation of unlisted issues (paragraph 3.85);
- (iii) all offering documents which are not exempt from regulation should be lodged with the Registrar of Companies and so be available on public file (paragraph 3.86);
- (iv) the legislation should make clear that the regulatory authorities are not responsible for the content of offering documents (paragraph 3.87);
- (v) the Commission should have powers to suspend dealings or stop an issue if the offering document is found to be false or misleading (paragraph 3.88).

TREATMENT OF COLLECTIVE INVESTMENT SCHEMES

- 3.90 As indicated earlier in this report, the marketing and authorisation processes for mutual funds, unit trusts and other collective schemes are at present very different from those applicable to issues of share and loan capital by commercial companies. Moreover, the collective investment schemes are to a large extent regulated by voluntary codes which do not have the force of law. These codes, particularly that governing mutual funds and unit trusts, have worked very satisfactorily, and the Commission and the Administration may wish to bring in further codes to regulate other forms of investment, for example, foreign exchange schemes.
- 3.91 There therefore seems no good reason to make radical changes to these procedures. Schemes for collective investment should, we **recommend**, continue to be subject to authorisation by the Commission, and, where appropriate, voluntary codes should specify the requirements for authorisation, including the content of offer documents. To the extent possible, the procedures for authorising and monitoring unit trusts and mutual funds (on the one hand) and other collective investment schemes (on the other) should be aligned. In all cases, it should be the entire scheme rather than one or more individual documents which should be authorised, so that the regulatory authority has a proper power of scrutiny. It would be convenient if an overall definition of "collective investment scheme" could be incorporated in the legislation (as there is in the Financial Services Act, section 75).
- 3.92 However, we **recommend** that, in principle, the question of whether such schemes ought to be regulated or be exempt should be decided according to the same criteria as are applicable to offers of shares and debentures. This would mean that the exemptions which we have proposed in paragraphs 3.61 - 3.64 would apply to offers of participations in collective schemes as they apply to offers of shares or debentures. However, the question of whether a particular exemption is as appropriate for, say, an immigration scheme as it is for a listed share, is a matter requiring consideration during the consultation phase. As example of an exemption which might not be appropriate for immigration schemes is that for individual cash subscriptions of HK\$2.5m and above (paragraph 3.63(ii)). Civil and criminal liability for misleading statements in offering documents issued in connection with collective investment schemes should attach to the same persons and in the same circumstances as for share and debenture issues.

ADVERTISEMENTS

- 3.93 As mentioned in the Appendix paragraph A1.10, the Financial Services Act deals with "investment advertisements" separately and, unless they constitute offers which are regulated elsewhere in the Act, prohibits their issue except by or with the approval of an "authorised person" (the equivalent of a registered dealer or adviser).
- 3.94 In Hong Kong, advertisements by companies in relation to prospectuses are controlled by the Companies Ordinance, while advertisements for securities or investment arrangements are controlled by the Protection of Investors Ordinance. The Companies Ordinance (section 38B) prohibits advertisements in the press or other media except full prospectuses or those made in the "prescribed form". Although no form is prescribed, the Registrar-General will only permit a "tombstone" advertisement giving credit to those who participated in the transaction or a form of abridged particulars. Under the Protection of Investors Ordinance, advertisements for securities (including unit trusts and mutual funds) and investment arrangements must be separately authorised. For collective investment schemes where Codes are in force, requirements for authorisation of advertisements are set out separately in the respective Codes. The overlap between the two Ordinances has created inconsistencies for companies such as mutual funds, whose advertisements are authorised under the Protection of Investors Ordinance.
- 3.95 There seems no good reason for disturbing present arrangements for advertisements, except to eliminate the overlap for mutual funds. Collective investment schemes are advertised throughout the life of the scheme, and some degree of control is desirable. Although the responsibility for approving advertisements could ultimately be devolved on self-regulatory organisations, if and when they come into existence, we **recommend** that the Commission retain this power for the time being. The Commission might develop a Code for advertisements for the guidance of the industry. We also **recommend** that the Commission should have the complementary power to restrain undesirable advertisements by injunction.

LIABILITY FOR MISSTATEMENT

Civil Liability

- 3.96 The existing law on civil liability for untrue statements in prospectuses is contained in section 40 of the Companies Ordinance.

Persons Liable

- 3.97 These are listed in section 40 as:
- (a) directors and those named as having agreed to become directors;
 - (b) promoters (that is, promoters who are parties to the preparation of the prospectus, but not including "any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company" - a significantly narrow exclusion); and
 - (c) "every person who has authorised the issue of the prospectus".

An expert who has given consent to the inclusion of a report made by him (for example, reporting accountants) is not thereby treated as having authorised the issue of the prospectus, except in respect of an untrue statement in his report.

- 3.98 Three substantial points arise. First, the issuing company is not itself liable, as it is, for example, under sections 152 and 168 of the Financial Services Act. We **recommend** that this gap should be closed. Secondly, it is far from clear who might be included in the phrase "promoter". The issuing house which sponsors an issue may be liable as a "promoter", and (although perhaps less likely), so might the solicitors to the issue if, for example, the issuing company was not incorporated for the purpose, but is an existing company. Thirdly, it is also unclear who is included in the widely drawn phrase, "every person who has authorised the issue ..." and how far this phrase widens the class of those liable beyond "promoters". So far as we are aware, there is no authority on the meaning to be given to these imprecise phrases.

- 3.99 In addition to the issuing company itself, and its directors, the Financial Services Act imposes liability on :

- (a) "each person who accepts, and is stated [in the offering document] as accepting, responsibility for, or for any part of" the offering document; and
- (b) any other person who has authorised the contents of, or any part of, the offering document. (Sections 152 and 168).

However, a person who gives advice in a professional capacity as to the contents of an offering document is not treated as being responsible for it (sections 152(8) and 168(7)). This seems to have the effect of absolving solicitors to an issue from liability under head (a) above, but it is not clear whether such persons might nevertheless remain liable under head (b) as persons who authorise the contents of the offering document.

3.100 The new Australian Corporations Law is more specific. As well as the issuing company and its directors, it lists as responsible for a prospectus: promoters, experts whose expert statements are included or referred to, persons named (with their consent) as stockbrokers, underwriters, auditors, bankers, solicitors, and other persons so named as having performed a function in a professional, advisory or other capacity. It is to be noted that except in the case of the issuing company and its directors, liability depends on the person concerned being named (with his consent) in the prospectus.

3.101 Although the interests of clarity might seem to favour a more comprehensive statutory list of persons who are responsible for offering documents, we do **not recommend** following the new Australian approach. Our reasons are, first, that the more general wording in the Companies Ordinance has not given rise to difficulty - as is attested by the lack of case law on the meaning of the relevant phraseology; and secondly, the new Australian law is part of a comprehensive and radical change of direction, in which the parties to the preparation of the offering document are expected to assume greater responsibility for its contents, and the regulatory authorities correspondingly less. We would not favour such a shift in Hong Kong at least until some experience of the working of the new Australian provisions is available to consider.

3.102 We do however consider that some clarification of the wording now in the Companies Ordinance is desirable. We therefore **recommend** that the following should be stated to be responsible for offering documents -

- (a) the offering company;
- (b) its directors and persons who have agreed to become directors;
- (c) persons who accept responsibility for the offering document or any part of it, and are stated in it to have accepted that responsibility; and
- (d) any other person who has authorised the issue of the offering document.

We **further recommend** that those who advise professionally on the content of an offering document should be liable for professional negligence and no more; and that those who authorise the issue of an offering document in an administrative way only (such as printers) should not be treated as responsible. If those qualifications are made, then we consider that the interpretation of the phrase "authorise the issue of the offering document" can be left to the courts and be dependent on the facts of each case.

Persons Who May Claim

3.103 By section 40 of the Companies Ordinance, compensation is payable "to all persons who subscribe for any shares or debentures on the faith of the prospectus ...". This appears to preclude claims by anyone except the original subscriber. In principle, it seems that someone who buys in the secondary market should be entitled to compensation if he suffers loss as a result of a misstatement in the prospectus. We **recommend** that the legislation make this clear. We **further recommend**, however, that there should be a cut-off date for such claims by reference to purchases up to say, 6 months after the later of the first issue and the date when the misstatement comes to light. This is because after a period the effect on the market of disclosures in a prospectus wears off and the market makes its own assessment of the investment. Any period which is chosen is necessarily arbitrary, but 6 months appears reasonable.

Basis of Liability

3.104 We question why someone who claims compensation for a misleading statement in an offer document should be put to proof that he actually read it and relied on it. If the statement is misleading and loss resulted to subscribers or purchasers, then in our view that should be enough to found a claim. Sections 150 and 166 of the Financial Services Act adopt this view and provide that -

"the person or persons responsible shall be liable to pay compensation to any person who has acquired any of the securities in question and suffers loss in respect of them as a result of any untrue or misleading statement in the [offer document] or the omission of any matter required to be included ..."

3.105 We **recommend** that this approach be adopted and that any claimant for compensation, whether original subscriber or subsequent purchaser, who claims within 6 months after first offer or (if later) the discovery of the misstatement, should not be required to prove reliance on the offer document, but should only have to establish a causal connection between the misleading statement and his loss.

3.106 With the exception we mention in the next paragraph, we also **recommend** that liability at common law or under any other Ordinance should be expressly preserved (see for comparison sections 150(4) and 166(4) of the Financial Services Act). In our view, the statutory liability to compensate those who suffer loss as a result of a misstatement in a prospectus and which has been part of the U.K. and Hong Kong Companies legislation over a long period, was always intended to be in addition to, and not in substitution for, the common law and statutory remedies for deceit, negligence and misrepresentation.

3.107 We **recommend** that section 3(1) of the Misrepresentation Ordinance (Cap.284) should be disapplied for purposes of civil claims arising out of misstatements in offering documents. This section enables damages to be awarded for innocent (as contrasted with fraudulent) misrepresentations, ground which is essentially the same as that covered now by section 40 of the Companies Ordinance. To preserve both statutory remedies side by side would in our view lead to confusion and overlap. Some commentators have taken a similar point on the U.K. legislation - see for example *Gore-Browne on Companies* 44th ed. section 11.6.

3.108 The Companies Ordinance provides for the possibility that applications for shares may be revoked if a public notice is given by someone responsible for the prospectus excluding or limiting his responsibility, on the ground, for instance, that he had discovered an untrue statement in the prospectus (sections 40(2) and 44A(6)). Corresponding provisions are in the 1985 Companies Act, but these either have been or are to be repealed, and there is nothing similar in the Financial Services Act. We **recommend** the repeal of these provisions in Hong Kong. We consider that the position of purchasers or subscribers is sufficiently protected if their common law remedies (which may include rescission, depending on the circumstances) are preserved, as we recommend in paragraph 3.106, and if the defences available to those responsible for the preparation of the offering document are more clearly and narrowly drawn, as we recommend in paragraphs 3.110 and 3.111.

Defences

3.109 Section 40 of the Companies Ordinance provides for defences where the person responsible can show -

- (a) that the prospectus was issued without his knowledge or consent, or
- (b) that he had reasonable ground for believing that the misstatement was true and did so believe up to the date of allotment of the securities, or
- (c) that he reasonably relied on a statement by an expert.

3.110 The Financial Services Act (sections 151 and 167) contains defences which are substantially similar, but using language which in our view is clearer and, because it imposes heavier obligations on those responsible if they are to escape liability, is to be preferred. The principal improvements are that -

- (a) there is a requirement that reasonable belief must be founded on "such enquiries (if any) as were reasonable" in the circumstances; and
- (b) the person responsible must establish, in order to be excused, that he had taken all reasonable steps to secure that corrective information was brought to the attention of those likely to acquire the securities in question.

We **recommend** that these defences be preserved with the improvements which are incorporated in the Financial Services Act.

3.111 Similarly, section 40 exempts an expert from liability if he shows that the prospectus was issued without his consent. He will also be free from liability if he establishes that he was competent to make the statement concerned and reasonably believed it to be true. Again, we **recommend** the retention of these defences with improvements which correspond with those we mentioned in the preceding paragraph. An "expert" is defined to include an engineer, valuer, accountant, "and any other person whose profession gives authority to a statement made by him."

Criminal Liability

3.112 Section 40A of the Companies Ordinance imposes criminal liability for untrue statements in a prospectus on "any person who authorised" its issue. The defences available are that the statement was immaterial, or that the defendant had reasonable grounds for believing that the statement was true. The question arises whether it is appropriate for it to be a criminal offence to make an untrue statement in a prospectus. There are criminal sanctions for misstatement in every jurisdiction we have considered, and we **recommend** that from the regulatory point of view criminal sanctions should be retained in Hong Kong.

Summary of Recommendations (liability for misstatement)

3.113 We **recommend** that:

- (i) the persons liable for misstatement in an offering document should be:
 - (a) the issuing company;
 - (b) directors;
 - (c) others who accept responsibility for the document;
 - (d) others who authorise its issue (paragraph 3.102);
- (ii) professional advisers should be liable only for professional negligence and those who act in only an administrative way should not be treated as authorising the issue of an offering document (paragraph 3.102);
- (iii) anyone who acquires the securities which are offered and can prove that he suffered loss as a result of a misstatement should be entitled to claim within 6 months after the later of the date of issue and the date when the misstatement is discovered (paragraphs 3.103 - 3.105);
- (iv) the common law and other statutory remedies (except under section 3(1), Misrepresentation Ordinance) should be expressly preserved (paragraphs 3.106 and 3.107);
- (v) the existing defences to civil liability in the Companies Ordinance should be retained with the improvements mentioned in the text (paragraphs 3.109 - 3.111);
- (vi) criminal liability for misstatement should be retained (paragraph 3.112).

CONDUCT OF BUSINESS

Fraud

- 3.114 It has been part of Hong Kong law since 1974 that it is a crime fraudulently or recklessly to induce or attempt to induce anyone to acquire or dispose of securities and other forms of investments (section 3, Protection of Investors Ordinance). The statute from which this derives, the Prevention of Fraud (Investments) Act, dated from 1939. A similar rule finds a place in some shape or form in every other jurisdiction which has been considered.
- 3.115 It should be part of Hong Kong securities law that the investing public are protected by the criminal law from possible fraud, and we **recommend** that the substance of what is now section 3 of the Protection of Investors Ordinance should remain on the statute book. We also **recommend** that it should be made clear that false or reckless statements about the future value of securities constitute an offence. In considering the possible reformulation of this provision, section 47 of the Financial Services Act may provide a helpful model.

Other Matters

- 3.116 We **recommend** that hawking and unsolicited calling should continue to be generally forbidden. The general proscribing of fraud will cover the worst cases, but it is still necessary to prohibit hawking and calling without invitation, whether or not fraudulent or reckless statements are made. We **recommend**, however, that registered or exempt intermediaries should be excluded from these bans and understand that the view of the Commission is that it would be better to regulate these persons through a code of business conduct rather than by legislation with criminal sanctions. We agree. Consideration must also be given to whether further exceptions are desirable for salesmen of investment-linked assurance and other collective investment schemes, to take account of traditional and unobjectionable methods of marketing.

CONSOLIDATION AND REPEALS

- 3.117 It is quite inappropriate to make detailed proposals for the reformulation of the Ordinances at this stage, but it will perhaps be helpful, as a guide to the suggestions in this paper, if we give an indication in broad terms of how we visualise the reformed statutory provisions.
- 3.118 We propose that the prospectus provisions of the Companies Ordinance (sections 38-41A and the Third Schedule and the corresponding provisions for overseas companies), the offering restrictions in the Protection of Investors Ordinance (section 4) and the restrictions on offers by dealers in the Securities Ordinance (section 72) be replaced by a single set of statutory provisions:
- (i) distinguishing between those offers which are regulated and those which are not;
 - (ii) prescribing the requirements as to form, content, authorisation and lodgement of those which are regulated, and distinguishing in these respects between different classes of regulated offer, and in particular between offers of share and loan capital of companies, and collective schemes;
 - (iii) laying down civil and criminal liability for misstatements in regulated offers.
- 3.119 We understand that a review of the conduct of business requirements in the Commodities Trading Ordinance and the Securities Ordinance is being carried out by the Commission. Subject to the results of that review, we suggest that the anti-fraud provisions of the Protection of Investors Ordinance (section 3), and the conduct of business restrictions in the Securities Ordinance relating to offers (sections 73, 74) and in the Commodities Trading Ordinance (section 60A) should be replaced by a single set of provisions covering the same ground.
- 3.120 As a consequence of these reforms, it should be possible to repeal the Protection of Investors Ordinance. It would also be desirable to repeal some at least of those sections of the Companies Ordinance which prescribe detailed requirements for the allotment of shares in connection with offers (sections 42 to 44B); and to replace them (for listed issues) by Listing Rules; and for unlisted issues (if any such provisions are necessary) by subsidiary legislation.

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APPENDIX

OTHER JURISDICTIONS

There follows a short description of the present state of the law on offerings of securities in the U.K., U.S.A., Australia, Canada and Singapore. The descriptions of these other systems, are given only in bare outline, partly because of the impossibility of giving comprehensive accounts, and partly because we take the view that the purpose of comparisons is to give pointers to possible solutions rather than to prepare an encyclopaedia.

United Kingdom

- A1.1 The Hong Kong Companies Ordinance (so far as it concerns prospectuses) and the Protection of Investors Ordinance are based on the U.K. legislation as it was before it was comprehensively reformed by the Financial Services Act of 1986. The changes made in the U.K. in 1986 had their origins in a consultative document, "Review of Investor Protection", submitted by Professor L.C.B. Gower in 1982. He had been commissioned the previous year by the Secretary of State for Trade to review the law on investor protection and the control of financial intermediaries and to advise on the need for new legislation.
- A1.2 Professor Gower concluded that the then existing law was complicated, uncertain and irrational, inflexible and difficult to enforce, and suffered from a diversity of regulations and regulators. He made recommendations for reform. As regards offerings of securities, the report proposed that a new Securities Act should include redrafted provisions covering all issues and distributions of securities and that the Takeover Panel should be "converted into a "Public Issues and Takeover Agency" charged with the task of prescribing the contents of, and scrutinising for accuracy and fairness, all prospectuses and not only those circulated on a takeover or merger".
- A1.3 As a result of the process of consultation and the impact of EEC Directives, Professor Gower modified his proposals in a Report published in two parts in 1984 (Cmnd. 9125) and 1985. This proposed that the Stock Exchange should pre-vet all prospectuses for listed issues, and either the Department of Trade or a body representing various self regulatory organisations should be responsible for unlisted public offerings.
- A1.4 The Financial Services Act, which resulted from the Gower reports, set out to provide a single statutory framework for all public offers. In conformity with EEC directives, it distinguishes between listed and unlisted offerings. As regards securities which are to be listed, the International Stock Exchange is designated as "competent authority" with power to make rules and to approve or disapprove of the offering documents. The "listing particulars" whose content is prescribed by The Stock Exchange are required to be filed at the Companies Registry. The persons responsible for the listing particulars are liable to pay compensation to anyone who has acquired the securities in question and suffered loss as a result of any untrue or misleading statement in the particulars.
- A1.5 Part V of the Act, sections 158-171, dealing with offers of unlisted securities, has not yet been brought into force. However, the EEC Council has issued a Directive (89/298/EEC) dealing with prospectuses, and all Member States are required to bring their legislation into conformity with it. Some amendment of Part V will be necessary before bringing it into force, and amendments are in process of being drafted by the Department of Trade and Industry (see paragraphs 1.8 and 1.9 below).
- A1.6 The Directive applies to "transferable securities which are offered to the public for the first time in a Member State", and which are not already listed on a stock exchange in the EEC. All such offers are to be subject to publication of a prospectus. If the securities are to be listed, then the contents of the prospectus and the procedure for scrutiny must accord with another EEC Directive (80/390/EEC). This places matters under the control of the stock exchange concerned as has already been done in the U.K. (see paragraph 1.4). In other cases, the prospectus must contain sufficient information to enable offerees to make an informed assessment of the investment, and must also contain certain specified details.

- A1.7 The Directive itself lists certain classes of offer and certain classes of security which are exempt. One type of exempted offer is "where transferable securities are offered to a restricted circle of persons", but neither this phrase nor "the public" is defined. Member States will therefore have a degree of latitude in deciding how they frame their new laws, and it is likely that there will be differences in approach as to what is meant by "offer to the public".
- A1.8 The Department of Trade and Industry put out a consultative paper preparatory to framing its own legislation. It canvassed three possibilities:
- (a) "offer to the public" would not be precisely defined but some general guidance would be given as to what is meant;
 - (b) the phrase would be tightly defined by a series of rules which leave no scope for discretion in applying them;
 - (c) what the Department described as a hybrid of (a) and (b).
- A1.9 The Department expressed a preference for the third solution. On this footing, the legislation would contain a list of specific exemptions (e.g. offers to existing shareholders or debenture holders), and might also contain "indications" that offers would not be treated as made to the public in two additional classes of cases:
- (a) where offerees are linked by some common attribute (e.g. members of a sports club); or
 - (b) where the offer is not calculated to result in its becoming available for acceptance by persons other than (i) those receiving it, or (ii) "professionals" (dealers, fund managers etc.)
- The results of the consultation process are not yet completely known, but it seems likely that a scheme not unlike our own proposals (paragraphs 3.14 to 3.36) will be put forward, in which "offer to the public" will not be defined statutorily. Instead, the scope of regulation would be determined by exemptions, which would include offers to a limited number of persons and offers with a minimum individual price. It is however too early to say how the new provisions forming Part V of the Financial Services Act will be finally framed.
- A1.10 The Financial Services Act also prohibits the issue of any "investment advertisement" unless it is issued or approved by an "authorised person" (that is, the equivalent of a registered dealer or adviser). Offers which are made by means of listing particulars (see paragraph 1.4 above) or under Part V of the Act (offers of unlisted securities - see paragraphs 1.5 - 1.9 above) are exempted. The Secretary of State may also make regulations exempting advertisements including those which have a private character, or which deal with investments only incidentally, or which are issued to persons who can understand the risks involved. Exemption orders have been made covering a large number of detailed circumstances.
- A1.11 The anti-fraud provisions of the Prevention of Fraud (Investments) Act have been replaced by section 47 of the Financial Services Act. This section is found in that part of the Act regulating the conduct of investment business, and makes it a criminal offence for anyone to make a statement, promise or forecast dishonestly or recklessly for the purpose of inducing the acquisition or disposal of an investment.

A1.12 The new U.K. regime has made radical changes many of which have been dictated by EEC directives:

- (a) It abandons the attempt to define the scope of regulation by distinguishing between offers to the public which ought to be controlled, and those of a private character, which need not. Instead, all offers of listed securities must comply with Stock Exchange rules and are pre-vetted by the Exchange. The offer document is lodged with the Registrar of Companies so as to be available for public inspection. But because of the EEC Directives, offers of securities which are not intended to be listed in London will be divided into those which are "public" and those which are not. The D.T.I. are still considering how best to make this distinction.
- (b) To a degree, the old distinction between issues of new securities (primary offers) and sales of existing securities (secondary offers) has gone.
- (c) Most of the rules formerly in the Companies Act dealing with the mechanics of allotting new shares have been repealed. In the case of listed offers, these are now a matter for the Stock Exchange.

A1.13 However, the new regime does not fully reflect Professor Gower's original recommendation to impose a uniform and logical system across the whole field of offers of securities. Offers to acquire shares (including takeover offers) are not within the statutory scheme except in relation to "investment advertisements" and the anti-fraud provisions, and the requirements of the EEC Directives have led to offers of listed securities being treated differently from other offers of a public character.

A1.14 More generally the Financial Services Act has been much criticised as an unsuccessful attempt to provide a single system of securities regulation. As even this brief summary of one aspect shows, it is over-complicated. It has also imposed extra costs on the market and subjected it to a multi-layered bureaucracy. On any view, its value as a pointer to help decide how Hong Kong law should be reformed is limited.

The United States of America

A2.1 The Securities Act of 1933 regulates the initial and subsequent distribution of securities, whereas the Securities Exchange Act of 1934 regulates financial intermediaries, dealers and exchanges and is generally concerned with the regulation of securities trading, the financial reporting of public companies, communications with shareholders and takeovers. The regulation of mutual funds, unit trusts and other investment advisers, is covered by the Investment Company Act and the Investment Advisors Act of 1940. These Acts are all federal statutes and their application is limited to transactions involving the mails and other channels of interstate commerce. However, they are far more important than state securities legislation and self-regulation by stock exchanges and securities associations. They do not deal directly with the internal rules for companies which are covered in companies legislation at the state level.

A2.2 For purposes of the federal Securities Acts, the term "securities" is defined to include not only shares, stocks, bonds and notes but also "investment contracts" which in turn have been defined by the Supreme Court as follows:

... contract[s], transaction[s] or schemes[s] whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. *SEC v. W.J. Howey Company*, 328 U.S. 293 (1946).

The regulatory net is therefore very wide.

A2.3 The underlying principle of federal regulation of securities is disclosure, i.e. the concept of obliging participants in the markets to make full and fair disclosure and allowing investors to make their own decisions. The Securities and Exchange Commission enforces the regulations and also expects and encourages private investors to police the system by bringing civil law suits based on so-called "securities fraud".

A2.4 The most general anti-fraud provision is Rule 10b-5 made under the Securities Exchange Act of 1934. This makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of any security, to employ any scheme or engage in any act which would operate as a fraud or deceit, or to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they are made, not misleading. In addition market manipulation by issuers, underwriters and certain other persons interested in distributions of securities is specifically addressed in Rule 10(b) made under the same Act.

A2.5 Section 5 of the 1933 Act requires that securities offered by the use of the mails or other channels of interstate commerce be registered with the SEC.

Certain classes of securities, however, are exempt, for example those issued or guaranteed by the United States or any state of the U.S., and commercial paper having maturities of nine months or less.

A2.6 Section 4 of the 1933 Act exempts from registration certain classes of transactions of which the most important are:

- (1) transactions by any person other than an issuer, underwriter or dealer; and
- (2) transactions by an issuer not involving any public offering.

The Courts and the SEC have interpreted this latter class of exempt transaction as indicating offerings to persons who are able to fend for themselves and can obtain access to the same kind of information that registration would provide.

A2.7 In 1982 a regulation made under section 4(2) of the 1933 Act and known as Regulation D was adopted which, while not affecting the generality of the exemption in the section, made clear that certain classes of offer would be treated as private. These rules, providing what are commonly known as "safe harbors", go into some detail in defining those "accredited investors" who are deemed to be able to fend for themselves and specifying the classes of offer which are exempt from registration as not involving any public offering.

The relevant factors include:

- (a) aggregate offering price;
- (b) number of investors;
- (c) type of investor (accredited or not);
- (d) manner of the offering;
- (e) limitations on resale; and
- (f) information required for investors.

For example, an offer in which the aggregate offer price does not exceed US\$500,000 is completely exempt from registration; whereas one in which the aggregate offer price does not exceed \$5 million may be exempt subject to certain limitations on the number and class of investors. Private offers that are confined to accredited investors are exempt, notwithstanding the number of investors and amount of the offering. Even exempt offerings, however, remain subject to the anti-fraud rules referred to above in paragraph 2.4.

A2.8 Securities that have been distributed in a registered offering may be resold freely unless they are held by the issuer or one of its affiliates. Securities so held, as well as securities placed privately, are subject to restrictions on resale. Due to these restrictions, it is common to find that shares of public companies, even if belonging to a class of securities listed on the New York Stock Exchange for example, may not be freely resold in the market.

A2.9 Another "safe harbor" rule, Rule 144A introduced in April 1990, defined exemptions from registration for transactions in which unregistered securities are issued or sold to "qualified institutional buyers", that is institutional investors who own, or invest on a discretionary basis in securities of a specified minimum value.

A2.10 After a company registers securities under the 1933 Act or has over U.S. \$1 million in total assets and at least 500 holders of a class of equity securities, it is obliged to file lengthy detailed reports with the SEC, including quarterly reports with financial statements. In addition, the solicitation of proxies from its shareholders and takeover bids for its shares become subject to regulation under the 1934 Act.

A2.11 The shareholders of U.S. public companies do not generally have a pre-emptive right to subscribe for new shares, and such companies normally raise equity capital by offering shares to the public through underwriters or making exempt private placements. Public companies also are relatively free to repurchase their own shares and to declare dividends out of capital surplus (as well as retained earnings), and they are not subject to specific prohibitions against giving financial assistance in connection with the purchase of their own shares.

A2.12 The U.S. federal legislation relating to the distribution of securities is more than fifty years old and has developed in a markedly different way from those systems, including that of Hong Kong, which are based on the U.K. model. For that reason, we consider that, except by way of analogy, the U.S. experience does not greatly assist us in making recommendations for reform.

Australia

- A3.1 Australia has recently replaced its companies and securities laws with new uniform national legislation, the Corporations Law, which commenced on 1 January, 1991. The Corporations Law contains radical reform of the law with respect to offers of securities for subscription or purchase.
- A3.2 The Corporations Law abandons the notion that a prospectus is required only when securities are offered to the public. Instead, s.1018 provides that a person shall not offer for subscription or purchase, or issue invitations to subscribe for or buy, securities of a corporation unless a prospectus has been lodged and, where appropriate, registered. This requirement applies to private as well as public offers and invitations, and applies to sales in the secondary market as well as new issues. There is no general "professional investor" exception.
- A3.3 However, the Corporations Law and the Corporations Regulations create a series of exceptions to the prospectus requirement, including the following :
- (a) offers or invitations for subscription of at least \$500,000 per subscriber, or where the amount payable by the purchaser is at least \$500,000 (s.66(3)(a) and Reg.7.12.06(b));
 - (b) offers or invitations to underwriters (s.66(3)(b));
 - (c) offers or invitations for no consideration (s.66(3)(c));
 - (d) personal offers or invitations to no more than 20 persons in any period of 12 months (s.66(3)(d));
 - (e) offers or invitations made under an executive employee share scheme (s.66(3)(e));
 - (f) offers or invitations of debentures to existing debenture holders and of convertible notes to existing convertible note holders (s.66(3)(g) and (h));
 - (g) offers or invitations to dealers as principals and to certain other institutional investors and superannuation funds (Reg.7.12.06(a));
 - (h) offers or invitations in respect of interests in certain superannuation funds (Reg.7.12.06(c), (d) and (e));
 - (i) offers or invitations to existing shareholders under dividend reinvestment plans, bonus issues and the like (Reg.7.12.06(g));
 - (j) an offer or invitation to a person who, for the purpose of investment in securities, controls (directly or through an associate or under a trust) an amount of not less than \$10,000,000 (Reg.7.12.06(j));
 - (k) offers or invitations in connection with certain takeover schemes or schemes of arrangement (Reg.7.12.02).

This list is not exhaustive.

- A3.4 Further exemptions apply to the particular case of offers for the purchase of securities in the secondary market :
- (a) There is a "grandfathering" clause which permits offers in secondary trading where securities in the same class as those offered were listed securities continuously from 1 January 1991 to the date of the offer (s.1018(2));
 - (b) Offers in secondary trading are permitted for issued securities that are in a class of listed securities if at some earlier time a prospectus was lodged and, where appropriate, registered, and certain prescribed Listing Rules have been complied with (none are yet prescribed) (s.1018(5)).
- These exceptions are not available where a company allots securities for the purpose of on-sale (s.1018(8) and s.1030).
- A3.5 Where the law requires a prospectus, the prospectus must either be registered by, or lodged with, the Australian Securities Commission. A prospectus must be registered, and not merely lodged, unless :
- (a) the shares or debentures are listed for quotation;
 - (b) the offers are made to existing members of the corporation (thus, lodgment will be sufficient for rights issues);
 - (c) the offers are made to certain specified institutional investors;
 - (d) in the case of a listed corporation, or an unlisted corporation which has adequate arrangements to keep employees informed about its operations - the offers are made to employees (s.1017A).
- A3.6 Where registration is necessary, the Commission has a duty to register within 14 days unless it appears that the prospectus does not comply with the law or contains false or misleading statements or omissions (s.1020A).
- The Commission has indicated that it will register all prospectuses as a matter of course with minimal checking. The Commission will rely on the increased civil liability provisions and its power to issue stop orders, rather than detailed "pre-vetting", for prospectus integrity.
- A3.7 Instead of prescribing prospectus contents in detail, the Corporations Law (s.1022) requires a prospectus to contain "all such information as investors and their professional advisers would reasonably require, and reasonably expect to find in the prospectus, for the purpose of making an informed assessment of :
- (a) the assets and liabilities, financial position, profits and losses, and prospects of the corporation; and
 - (b) the rights attaching to the securities".
- The word "prospects" may be particularly significant. The standard in the case of a "prescribed interest" prospectus (including a prospectus for a unit trust) is expressed to include a reference to assessing the merits of participating in the scheme and the extent of the risks involved (Reg.7.12.12).

- A3.8 For the purpose of deciding what information is required to be disclosed in a prospectus, regard is to be had to the nature of the securities in the corporation, the kinds of persons likely to consider subscribing, the fact that certain matters may reasonably be expected to be known to professional advisers whom the investors may reasonably be expected to consult, and any information known to investors by virtue of a law (s.1022(3)). Where the offerees are shareholders, regard may be had to whether the relevant information has previously been given to them.
- A3.9 There is a statutory obligation (s.1024) to lodge a supplementary prospectus where there is a significant change affecting any matter contained in the prospectus, or a significant new matter arises of which relevant information would have been required if it had arisen when the prospectus was prepared.
- A3.10 The Commission may issue a stop order where it appears that the prospectus contravenes the law in a substantial respect, or contains a statement, promise, estimate or forecast that is false, misleading or deceptive, or contains a material misrepresentation (s.1033).
- A3.11 Civil liability has been expanded, principally in two respects. Section 995 provides that a person shall not, in or in connection with (inter alia) any dealing in securities or any prospectus issued in relation to securities, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.
- A3.12 By s.996 a person must not authorise or cause the issue of a prospectus in relation to securities of a corporation, in which there is a material statement that is false or misleading, or from which there is a material omission. "Prospectus" is broadly defined to include any written instrument containing an offer or invitation of the securities for subscription or purchase (s.9). A document may be a prospectus within this definition whether or not it is used to offer securities widely or privately, and whether or not the offers of securities fall within one of the excluded categories listed above.
- A3.13 A person who suffers loss or damage by conduct of another person that was engaged in in contravention of various provisions including s.995 and s.996 may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention (s.1005).
- A3.14 Where the complaint relates to a material misstatement or omission, certain parties listed in s.1006(2) are deemed to be involved in any contravention which occurs. The list of those who are deemed to be involved in the contravention include the corporation, its directors and promoters, experts, persons named as underwriters, stockbrokers, auditors, bankers or solicitors of the corporation and others who authorise or cause the issue of the prospectus.
- A3.15 Defences are made available for each of these various categories of defendants. Thus, experts, auditors, bankers and solicitors, but not stockbrokers and underwriters, are liable only in respect of misstatements purporting to be made by them as experts, and omissions of material for which they are responsible in their expert capacity (s.1009). A person who is named in part only of a prospectus is not liable in respect of statements made in another part of the prospectus, provided that the prospectus includes an express statement that the person was involved only in the preparation of that part (s.1010).

- A3.16 The corporation, its promoters, stockbrokers, underwriters and others who authorised or caused the issue of the prospectus have narrower defences, including a defence where the misstatement or omission was due to the act or default of another person, and the defendant took reasonable precautions and exercised due diligence to ensure that the prospectus was adequate (s.1011). This statutory use of the expression "due diligence" suggests that due diligence enquiries will be much more widespread and thorough in the course of preparation of Australian prospectuses than was the case under the old law.

Canada

- A4.1 Although each of the ten Provinces and two territories of Canada has its own body of securities legislation, we have considered only the Province of Ontario, the jurisdiction in which a number of the leading Canadian financial markets are located. We describe briefly the relevant provisions of the Ontario Securities Act (the "Act"), the Regulations made under the Act and Policy Statements issued or adopted by the Ontario Securities Commission (the "OSC").
- A4.2 Regulations are made by the Provincial Cabinet acting as the Lieutenant Governor in Council. They are subordinate legislation, have the force of law and are equivalent to subsidiary legislation made in Hong Kong.
- A4.3 The OSC is responsible for the supervision of securities trading in Ontario. Apart from its powers to commence criminal proceedings and seek compliance orders in the event that the Act or Regulations are contravened, the OSC has broad powers to order the cessation of trading in particular securities or remove exemptions if, in its opinion, it is in the public interest to do so. Policy Statements are issued to provide guidance as to the procedures and practices which the OSC considers to be in the public interest. Failure to observe a Policy Statement could constitute a basis for the OSC to exercise its discretion against a party. Policy Statements therefore have considerable effect, if not legal force, and are generally observed as if they were Regulations.
- A4.4 The Act requires anyone who trades in securities, if the trade is also a "distribution", to file a prospectus and obtain a receipt for it from the Director of the OSC unless the distribution is exempt from the prospectus requirement by virtue of either (i) an express statutory exemption or (ii) a discretionary ruling of the OSC. The OSC will exercise its discretion to issue rulings in circumstances in which the proposed trade is consistent with the policies underlying the statutory exemptions and is not otherwise prejudicial to the public interest.
- A4.5 A "distribution" is defined to include (i) a trade in securities of an issuer that have not previously been issued, (ii) a trade by an issuer in previously issued securities that have been redeemed or purchased by or donated to the issuer and (iii) a trade in previously issued securities from the holdings of a "control block" shareholder (taken normally to mean anyone holding 20% or more of the outstanding voting securities of an issuer).
- A4.6 If a distribution is made without a prospectus in reliance on one of the statutory exemptions, certain restrictions on resale are imposed. These restrictions deem any resale of such securities to be a "distribution" requiring a prospectus unless (i) the trade is made in reliance on a further statutory exemption, or (ii) the issuer is a "reporting issuer" (generally an issuer which has previously filed a prospectus in Ontario or whose securities are listed on The Toronto Stock Exchange and which is subject to the continuous disclosure obligations contained in the Act), and, in some instances, the seller has held the securities for periods of between 6 and 18 months. If the issuer is not a reporting issuer in Ontario, securities issued on an exempt basis may be subject to resale restrictions for an indefinite period of time.
- A4.7 This system of exemptions and resale restrictions is known as the "closed system" and is analogous to the regime governing private placements in the United States. Similar regimes exist under the securities legislation of a number of other Canadian Provinces.

- A4.8 Statistics published by the OSC indicate that significant amounts of capital are raised in Ontario by means of both public offerings and private placements of securities. The exempt market is particularly suitable for smaller offerings to limited numbers of investors.
- A4.9 There is a long list of statutory exemptions. Among the more important are those provided for:
- (i) trades to prescribed classes of purchasers such as Canadian governmental authorities, chartered banks, loan and trust companies and insurance companies;
 - (ii) trades to exempt purchasers recognised as such by the OSC;
 - (iii) private placements where investors purchase as principal and the securities have an aggregate purchase price of at least C\$150,000;
 - (iv) stock dividends, bona fide corporate reorganisations and rights offerings;
 - (v) trades in securities as consideration for assets having a fair market value of at least C\$150,000;
 - (vi) "seed capital" offerings in which an issuer can solicit a maximum of 50 potential purchasers, of which not more than 25 may actually purchase the securities. Each of the purchasers must be either (A) a senior officer or director of the issuer or the spouse, parent, sibling or child of such officer or director or (B) a person who, by virtue of his net worth and investment experience or, by virtue of consultation with or advice from a registered adviser or dealer, is able to evaluate the prospective investment on the basis of information presented to him by the issuer. Purchasers under the seed capital exemption must be given substantially the same information about the issuer that a prospectus would provide and issuers can only rely upon this exemption once;
 - (vii) issues to employees of an issuer or its affiliates;
 - (viii) issues made in connection with takeover bids (which are also regulated under the Act);
 - (ix) trades between registered dealers;
 - (x) underwriting transactions;
 - (xi) hedging transactions in commodity futures contracts or commodity futures options (trading in futures contracts and options is dealt with under separate legislation);
 - (xii) issues of securities of "private companies" (defined in a similar way to the Hong Kong private company) if such securities are not being offered for sale to the public; and
 - (xiii) issues of certain other categories or securities (e.g. debt instruments of or guaranteed by the Government of Canada).

- A4.10 The Director of the OSC is not to issue a receipt for a prospectus if (among other things) it appears to him that the prospectus does not comply with the Act or if it contains any statement, promise, estimate or forecast that is misleading, false or deceptive, or if it contains a misrepresentation. In such circumstances, the OSC may order that the securities in question shall not be traded. The Act, together with the Regulations and Policy Statements, prescribe in detail the required contents of prospectuses.
- A4.11 There is both civil and criminal liability under the Act for misrepresentations in prospectuses. In addition, in certain exempt transactions in which offering memoranda are used, the seller is required to give purchasers contractual rights of action against the issuer for either rescission or damages, which may be exercised if the offering memorandum contains a misrepresentation.
- A4.12 Under the heading "Trading in Securities Generally", the Act contains a number of provisions relating to the marketing of securities, including restrictions on "cold calling" and the giving of assurances about the future value of securities.
- A4.13 Unless the articles of incorporation or a unanimous shareholders agreement of a corporation otherwise provide, there are no rights of pre-emption in Ontario giving shareholders the first right to acquire new securities to be issued by a corporation.
- A4.14 With the possible exception of U.S. federal securities legislation, the primary and secondary legislation in Ontario, together with a large body of Policy Statements, constitute what is probably the most elaborately detailed code regulating the distribution of securities of any of the jurisdictions we have considered. While some of the exemptions, particularly that for "seed capital", are helpful indications, we do not think that regulations of such a detailed nature would form a suitable model for Hong Kong.

Singapore

- A5.1 The Singaporean system for regulating public offers stems from the same root as the Hong Kong system and there are many similarities. However there are also a number of significant differences, the most important of which are referred to below.
- A5.2 Under the Companies Act, a person is not to issue, circulate or distribute any form of application for shares or debentures of a company without a prospectus, a copy of which has been registered with the Registrar of Companies. For this purpose an advertisement offering or calling attention to an offer or intended offer is treated as if it were a prospectus. The obligation does not apply if the offer or invitation is not made to the public, or is specifically exempted.
- A5.3 The definition of "prospectus" is similar to that in the Hong Kong Companies Ordinance and means a document inviting applications or offers from the public to subscribe or purchase any share debentures or "units" therein, or offering them to the public for subscription or purchase.
- A5.4 The Act states that any reference to "the public" includes a reference to offering them to any section or the public, whether selected as clients of the offeror or in any other manner.
- A5.5 There are several classes of exempted offer. While being treated as "offers to the public", these are nonetheless exempt. They include offers or invitations:
- (i) to enter into underwriting agreements;
 - (ii) made to a person whose ordinary business it is to buy or sell shares or debentures as principal or agent;
 - (iii) made to existing members or debenture holders;
 - (iv) made in connection with a takeover scheme (takeovers are regulated by the Act);
 - (v) made in connection with an employees' share scheme;
 - (vi) made to certain specified institutions or persons, including banks, insurance companies, pension funds and persons licensed as investment advisers;
 - (vii) made to not more than 50 persons, each of whom is a "sophisticated investor". This last phrase means a person who is:
 - (a) acquiring the shares or debentures for not less than S\$200,000; or
 - (b) an individual whose net assets exceed S\$1 million or whose annual income exceeds S\$200,000; or a corporation whose net assets exceed S\$5 million; or
 - (c) an officer of the offering company or a near relative of his.
- A5.6 The Singapore scheme is therefore like Hong Kong's in that offers to the public are regulated, whereas those of a private character are not. Like the Hong Kong legislation, "the public" is not comprehensively defined, but the exemptions are more widely drawn than in Hong Kong. The "sophisticated investor" exemption was added early in 1990 and is an important departure.

- A5.7 In two respects, however, the regulatory provisions in Singapore go further than in Hong Kong. First, the prospectus requirements of the Act also apply to offers of units in a unit trust under a separate regulatory regime imposed by the Companies Act. Secondly, invitations to the public to deposit or lend money to a company also require a prospectus, which must be registered with the Registrar of Companies, but this obligation does not apply to banks or other classes of corporation designated by the Minister.
- A5.8 A prospectus must comply with detailed requirements laid down in the Act, and its contents are prescribed in a schedule, which is in terms not dissimilar from those in the Third Schedule to the Hong Kong Companies Ordinance, save that there is no general requirement in Singapore that a prospectus must contain sufficient information to enable the investor to assess the merits of the investment. The Minister may vary or amend the Schedule prescribing the contents of prospectuses by a simple notification in the Gazette.
- A5.9 The Registrar of Companies must refuse to register any prospectus if (among other things) it contains any statement which in his opinion is misleading.
- A5.10 The Securities Industry Act of 1986 contains anti-fraud provisions. No person is to make any statement or disseminate information that is false or misleading and is likely to induce the sale or purchase of securities; and no person is to make or publish any statement, promise or forecast that he knows to be misleading, false or deceptive, or which is made recklessly, in an attempt induce another person to deal in securities.
- A5.11 The definition of "securities" includes debentures, stocks or bonds of a Government or a body corporate, any right or option in respect of any such debenture, stock, share or bond. The definition excludes futures contracts, bills of exchange, promissory notes and certificates of deposit issued by a bank.
- A5.12 There is no definition in the Securities Industry Act of "debenture", but this is defined in the Companies Act so as to exclude cheques, letters of credit, orders for the payment of money, bills of exchange, or promissory notes having a face value of not less than S\$100,000 and a maturity of not more than twelve months. Regulations may be made excluding certain classes of instrument from the definition of debenture.
- A5.13 The Singapore scheme is the one that most closely resembles Hong Kong. The principal differences are the introduction of the "sophisticated investor" to whom offers may be made without regulatory control; and the extension of regulation to unit trusts and deposits of cash. Singapore, however, retains the uncertain concept of "offer to the public" as the main distinction between regulated and unregulated offers.