



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

**Consultation Paper
on Possible Reforms to the
Prospectus Regime
in the Companies Ordinance**

Hong Kong
August 2005

Foreword

The Securities and Futures Commission (“SFC”) invites market participants and interested parties to submit written comments on the proposals discussed in this paper and on related matters that impact upon the proposals, by no later than **30 November 2005**.

Any persons wishing to comment on the proposals should provide details of any organization whose views they represent. Please note that the names of those commenting and the contents of their submissions may be published on the SFC website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement overleaf.

You may wish that the SFC should not publish your name. If this is the case, please state that you wish your name to be withheld from publication when you make your submission.

Written comments may be sent:

By mail to: Corporate Finance Division
Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong
Attn: CO Phase 3 Consultation

By fax to: (852) 2810-5385

By online submission at: <http://www.sfc.hk>

By e-mail to: cfconsult@sfc.hk

Additional copies of this Consultation Paper may be obtained from the above address. This Consultation Paper is also available on the SFC website at <http://www.sfc.hk>.

Glossary of legislation referred to in this Consultation Paper

CA	Corporations Act (Australia)
CAO 2004	Companies (Amendment) Ordinance 2004
CO	Companies Ordinance
FSMA	Financial Services and Markets Act (UK)
SFA	Securities and Futures Act (Singapore)
SFO	Securities and Futures Ordinance

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1. This Personal Information Collection Statement (“PICS”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the Commission’s use of your Personal Data, and your rights under the Personal Data (Privacy) Ordinance, Cap. 486 (“PDPO”).

Purpose of Collection

2. The Personal Data provided in your submission to the Commission in response to this Consultation Paper may be used by the Commission for one or more of the following purposes:
 - to administer the relevant provisions² and codes and guidelines published pursuant to the powers vested in the Commission;
 - in performing the Commission’s statutory functions under the relevant provisions;
 - for research and statistical purposes; and
 - for other purposes permitted by law.

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3. Personal Data may be disclosed by the Commission to members of the public in Hong Kong and elsewhere, as part of the public consultation which is the subject of this Consultation Paper. The names of persons who submit comments on this Consultation Paper together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the Commission’s website and in documents to be published by the Commission during the consultation period or following its conclusion.

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4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this Consultation Paper. The Commission has the right to charge a reasonable fee for processing any data access request.

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance.

² Defined in Schedule 1 to the SFO to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the CO so far as those Parts relate directly or indirectly to the performance of functions relating to prospectuses, the purchase by a corporation of its own shares, or a corporation giving financial assistance for the acquisition of its own shares etc..

Retention

5. Personal Data provided to the Commission in response to this Consultation Paper will be retained for such period as may be necessary for the proper discharge of the Commission's functions.

Enquiries

6. Any enquiries regarding the Personal Data provided in your submission on this Consultation Paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:
The Data Privacy Officer
Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

Consultation Paper on possible reforms to the Prospectus Regime in the Companies Ordinance

BACKGROUND

1. This Consultation Paper invites public discussion and comments on possible reforms to the law relating to the public offering of shares and debentures contained in Parts II and XII of the Companies Ordinance (Cap. 32) (“CO”).
2. This Consultation Paper launches the final phase of a three-part review and reform exercise designed to modernise the regime for the public offering of shares and debentures, which has been in place since the 1980s and updated in the meantime only in a piecemeal fashion. The overriding purpose of this process is to encourage the raising of capital and the issuance of securities and investments in Hong Kong by adjusting and refining the legal framework to facilitate offers while ensuring satisfactory standards of investor protection. The goal is to create a legal framework that accommodates the financial market’s needs in the 21st Century, caters for issuers and investors alike and supports Hong Kong’s continuing role as an international financial centre.
3. Phase 1 of the review and reform exercise was completed in March 2003 when three SFC guidelines and two class exemptions were issued³. The three SFC guidelines, respectively:
 - facilitate the issue of publicity and summary disclosure materials designed to enhance public awareness of offers;
 - facilitate the issue of shares or debentures on a “repeat” or “programme” basis so as to allow market participants to seize market opportunities and lower transaction costs;
 - facilitate prospectus registration by accepting for registration purposes bulk print proof prospectuses and faxed copies of experts’ consent letters.

The class exemptions disapply specific prescribed prospectus content requirements for listed and unlisted debt issues. The common characteristic of the Phase 1 initiatives is of facilitative measures introduced within the legal framework of the CO prospectus regime applying at that time.

4. Phase 2 was completed in December 2004 when Schedule 1 and Part 1 of Schedule 4 of the Companies (Amendment) Ordinance 2004 (“CAO 2004”)

³ For further particulars of these reforms, see SFC Press Releases dated 21 February 2003 and 28 March 2003 on the SFC’s website www.sfc.hk under tab “General and Enforcement News”.

containing prospectus-related amendments came into effect. The principal reforms were to:

- specify the types of offers which can be made outside the prospectus regime;
- widen the SFC's powers to grant exemptions under sections 38A and 342A of the CO and require the SFC to publish particulars of exemptions granted;
- establish a regime for advertisements relating to prospectuses;
- specify how a prospectus consisting of one document may be amended and how a prospectus may consist of more than one document;
- specify that, for the purposes of prospectus civil and criminal liability, an untrue statement in relation to a prospectus includes a material omission; and
- specify that the "snapshot" of a company provided by a prospectus should take into account the nature of the shares or debentures being offered and the nature of the company, and the nature of persons likely to consider acquiring them.⁴

The initiatives in Phase 2 were "quick-fixes" in that they were generally relatively less complex subjects for reform and were largely a response to market demand. These characteristics ensured that the initiatives could be developed, consulted upon, and introduced into the Legislative Council within a shorter period than would usually be required. Indeed, timing constraints led to an early division of possible reform initiatives into distinct Phase 2 and Phase 3 (described below) streams and caused some initiatives proposed originally for Phase 2 to be deferred to Phase 3.

5. Phase 3 has been billed as a comprehensive review of the CO prospectus regime and is designed to bring Hong Kong's laws in this area up to date. This Consultation Paper contains 21 Proposals for public discussion and comment. Some Proposals are narrow and specific in scope (and in some cases almost "housekeeping"); others are conceptual in nature and described in outline only. The 21 Proposals are described briefly in paragraph 12 below and in more detail in the **Appendix**.

⁴ For further particulars of these reforms, see SFC Press Releases dated 10 March 2003, 12 June 2003 and 3 December 2004 on the SFC's website www.sfc.hk under tab "General and Enforcement News". Schedule 1 and Part 1 of Schedule 4 of the Companies (Amendment) Ordinance 2004 can be accessed via www.info.gov.hk under tab "Gazette" in "General Information" as Ord. No. 30 of 2004 in Legal Supplement No. 1 gazetted on 23 July 2004.

6. This Consultation Paper should be regarded as a “concept release” designed to promote discussion and feedback. A number of the Proposals are complex and challenging. Although this Consultation Paper may outline or suggest a possible way forward, this should not be read as implying that we are committed to a particular outcome. In many cases there are clearly a range of possible solutions and we are not in a position to identify which is the most appropriate course to follow. Public and market feedback on the Proposals will guide us as to how best to move forward more specifically with those initiatives that survive this initial round of consultation. It is possible that a number of the Proposals will need to be revised in light of this feedback and one or more may be abandoned. In due course more specific proposals and draft legislation will be issued for further comment. Some of these more specific proposals may proceed towards the legislative stage of the reform process under different time-lines, reflecting their relative complexity or difficulty in implementation. It is not possible to predict whether or when any specific legislative proposals that may emerge in due course will become law. Given the potential complexity associated with some of the Proposals, it would be prudent to assume that it will take some time (perhaps two or more years) to complete the reform process in relation to the Proposals.
7. Wherever possible we have provided a comparison of equivalent or similar legislation in the UK, Singapore and Australia, the three jurisdictions whose laws in this area are most closely comparable to Hong Kong’s. The SFC staff involved in writing this Consultation Paper carried out much of the detailed study of the corresponding regimes. However, this work was assisted by a research document prepared for the SFC by CityU Professional Services Limited, a consultancy associated with City University of Hong Kong⁵. Although the combination of our own research and third party input provides much assurance that the international comparison is accurate, there remains a chance that it omits or mis-describes a relevant feature of one of these regimes. While we have sought to ensure the comparison is accurate as at 1 July 2005, we apologise for any errors and welcome any correction that is appropriate in comments provided on any Proposal.
8. The international comparison is important for two reasons. First, it illustrates that if legislative changes are to be made in due course in Hong Kong to accommodate some or all of the initiatives described in the Proposals, this would generally bring Hong Kong’s CO prospectus regime into line with standards already prevailing in one or more of these three markets. Any such closer alignment of Hong Kong’s prospectus regime with any or all of these jurisdictions should facilitate Hong Kong’s participation in cross-border offerings. Although much of Hong Kong’s law is modelled on English or

⁵ The research document entitled “*A Comparative Study of Laws and Regulations relating to Public Offering of Securities in Australia, Singapore and the UK*” was prepared by Professor Anton Cooray and Stefan Lo, Lecturer, of School of Law, City University of Hong Kong and Professor Christopher Ryan of Department of Law, City University, London (with input on an early draft by Professor Edward Tyler, formerly of the School of Law, City University of Hong Kong) and is dated 30 July 2004.

other UK law, in the 30 or so years since the UK joined the European Union many aspects of UK law have been aligned with the laws of its European Union neighbours. Continuing to align with UK law in these circumstances may facilitate cross-border offerings into Europe. Also, Australia and Singapore's regimes are particularly similar in many respects, and alignment with these may create the basis for closer integration of Asian securities markets.

9. Secondly, the presence of similar features in the overseas jurisdictions demonstrates that the subject matter of the Proposals was not only debated in these jurisdictions but was appropriate for enactment into their legislation. This provides ample reassurance that the initiatives described in the Proposals are worthy of debate in Hong Kong.
10. However, the international comparison must be treated with care. It is important to understand that the illustrations of comparable features in the legislation of these three jurisdictions amounts to no more than an extract of the wider legal and regulatory framework that governs the behaviour of participants and the investing public in their securities markets. Without a detailed understanding of this wider framework it is not possible to know whether the drafting of legislative provisions was influenced by one or more other features of the wider framework, or how other local characteristics interact with or impact on it. Also, since the wider legislative framework in each of these markets has developed over time to reflect its own particular characteristics and challenges, some divergence between regimes is inevitable.
11. While the international comparison is a guide to aspects of overseas practices and may contribute to the debate that we are initiating in Hong Kong, it is not a reliable guide as to how the legislative framework in Hong Kong will change if the initiatives in the Proposals are pursued. Any specific proposal for law reform in Hong Kong that may emerge in due course will reflect the particular characteristics of the Hong Kong securities market and the wider legal and regulatory framework in which it operates.

SUMMARY OF PROPOSALS

12. A summary of the Proposals is set out below, followed by a short rationale for their inclusion in this Consultation Paper. Full details of each initiative are set out in the Appendix.
 - (1) To transfer the provisions in the CO relating to the public offering of shares and debentures to the Securities and Futures Ordinance ("SFO").
To consolidate all securities laws in a single piece of legislation.
 - (2) To shift the focus of the CO prospectus regime from "document-based" to "transaction-based", by providing that no public offer of shares or debentures shall be made unless it is contained in a

prospectus that complies with the relevant prospectus requirements or falls within a specified exemption.

To provide greater certainty in the law by regulating the act of offering rather than the document containing the offer.

- (3) To clarify that the CO prospectus regime applies to offers of options or other rights in or over shares or debentures, where the issuer of the option or other right is in the same group of companies as the issuer of the underlying shares or debentures.

To ensure that investors are given the same information whether the offer relates to shares or debentures, or options or other rights over shares or debentures.

- (4) To provide that the requirements of the CO prospectus regime apply without regard to place of incorporation of the issuer and apply to “bodies” rather than “companies”.

To ensure that companies and entities taking another legal form are subject to the same legal and regulatory treatment when making an offer of shares or debentures.

- (5) To merge the CO prospectus regime into the SFO investment advertisement regime and create a unified offering regime.

To harmonize the legal and regulatory requirements for investments with similar features, and both simplify and increase the flexibility of the offering framework generally.

- (6) To exempt from the CO prospectus regime offers made to holders of shares or debentures in the context of a takeover or merger or under a compromise or scheme of arrangement provided that the offer is in compliance with the laws and regulatory requirements of the company’s home jurisdiction and any principal stock exchange on which it is listed.

To try to ensure that Hong Kong investors in an overseas company are not excluded from offers that comply with the company’s home market standards.

- (7) To adjust the anti-avoidance mechanism by providing that an offer for sale of shares or debentures within 12 months of their initial issue requires a prospectus to be prepared by the offeror if: (i) the original issue of securities was made pursuant to a particular exemption; (ii) there are reasonable grounds for concluding that the securities were issued or acquired with the purpose of on-sale; and (iii) no exemption would be available had the issuer offered the securities directly to the offerees. To introduce a series of exceptions to the proposed new provision.

To prevent circumvention of the offering regime via offers for sale in circumstances where the transaction should be subject to full regulation.

- (8) To alter the scope of the CO prospectus liability regime to include (i) the issuer and/or offeror of the shares or debentures, (ii) the “sponsor” of an issue or offer and (iii) each person who accepts, and is stated in the prospectus as accepting, responsibility for the prospectus, and remove (iv) “promoters” and (v) persons who “authorize the issue of” a prospectus.

To improve prospectus accuracy and completeness by attaching potential liability unequivocally to those persons whose interests in the success of an offer are most closely aligned. To remove uncertainty as to the persons that have potential liability.

- (9) To extend the classes of persons who may claim compensation for a misstatement in a prospectus to subsequent purchasers who buy in the secondary market.

To enable secondary market purchasers to obtain relief.

- (10) To remove the requirement for claimants to prove that they have actually read and relied on the prospectus when making a claim for compensation.

To remove an element of the burden of proof required to be satisfied in any claim for relief in respect of a misstatement in a prospectus.

- (11) To provide that the “reasonable belief” defence in the liability provisions is subject to a requirement that such belief is founded on all reasonable inquiries having been made.

To motivate the preparers of a prospectus to use their best endeavours to ensure that a prospectus is complete and accurate.

- (12) To move the “overall disclosure standard” for a prospectus into the body of the legislation adjacent to the liability provisions and supplement this standard with prescribed content requirements in subsidiary legislation that distinguish between equity and debt offerings.

To place greater emphasis on the disclosure standard to be met by a prospectus and expressly tie it to the liability provisions in the legislation. To tailor the contents of a prospectus to the type of security being offered.

- (13) To provide that a prospectus for rights issues and issues of shares or debentures that are uniform with listed shares or debentures should comply with reduced (rather than negligible) content requirements.

To ensure that existing and prospective holders of shares and debentures are given a minimum level of information when the company offers new securities. Reduced (rather than negligible) disclosure is appropriate because there is already information in the market about the company.

- (14) To introduce an enabling provision in the CO prospectus regime to allow “incorporation by reference” of information located outside the prospectus, provided the omitted information is identified in the prospectus and easily accessible.

To encourage shorter prospectuses by relaxing the requirement for all relevant information to be in the document, without compromising the availability of more detailed or technical information to those who want it.

- (15) To require publication of pre-IPO research reports and commentary by the issuer of an IPO prospectus if the research enters the public arena. Alternatively, to prohibit the issue of written pre-IPO research reports by analysts connected with the sponsors, managers or underwriters of an IPO.

To reduce or eliminate dissemination in public of non-prospectus information during the offer period.

- (16) To require the issuer of a prospectus to publish a supplemental or replacement prospectus if it becomes aware of a significant change affecting prospectus disclosures, and then also to extend the offer period, notify investors of the availability of the supplemental prospectus, and provide a right to withdraw their applications and be repaid in full.

To ensure investors are informed during the offer period of any significant development affecting prospectus disclosures and are given the right to withdraw their applications.

- (17) To remove the 3-day waiting period before allotments of shares or debentures of a class already listed. To ask whether in the case of other offers the 3-day period should be extended to provide prospective investors with a longer period in which to read the prospectus.

To increase flexibility for issuers and facilitate immediate allotment where the shares or debentures already have an established secondary market. To provide an environment which allows and encourages prospective investors to read the prospectus relating to an offer.

- (18) To provide that an application form or procedure for shares or debentures may not be distributed or implemented by any person

unless it is accompanied by or contained in a prospectus which complies with the prospectus provisions or is exempted from them.

To ensure that investors subscribing or purchasing through an intermediary receive the prospectus making an offer of shares or debentures.

- (19) To repeal the requirements relating to statements in lieu of prospectus.

To remove a redundant regime.

- (20) To introduce a separate regulatory regime to regulate offers to employees and their dependants, including a requirement for a declaration of solvency and going concern by the directors and auditors of the company.

To consult on a suggestion of the Bills Committee responsible for the scrutiny of the CAO 2004 intended to prevent exploitation of employees' interests.

- (21) To provide that an issue or sale of securities in contravention of the law should be void or voidable.

To consult on a suggestion of the Bills Committee responsible for the scrutiny of the CAO 2004 intended to increase investor protection.

GENERAL REMARKS

13. The initiatives described under the 21 Proposals came together from a variety of sources. Some were identified following comments by market practitioners as to practical difficulties faced in interpreting or seeking to comply with the current CO prospectus regime. Others were proposed by the Bills Committee reviewing the Companies (Amendment) Bill 2003 that was enacted in due course as the CAO 2004. The remainder emerged from the SFC's monitoring of legal and regulatory developments in overseas jurisdictions and a recognition that for Hong Kong to maintain its position as an international financial centre the legal and regulatory standards in Hong Kong must compare with those in leading markets. A few initiatives recognize that Hong Kong has a sophisticated and vibrant securities market and seek to address local peculiarities that may be undermining safeguards built into the current regime or to accommodate market development in a flexible and responsive way.
14. The Proposals appear in no particular order and are written as if each were a self-contained topic. This is deliberate and intended to simplify the description of the possible initiatives. The reality is that many of the Proposals are inter-related to a greater or lesser degree. Although it will be necessary in due course to understand how the regime as a whole will change if particular initiatives are implemented, it is too early to attempt this now. While we have tried to highlight what we see as key elements and material

consequences of the initiatives discussed under each of the Proposals, it is likely that comments and discussion in response to this Consultation Paper will identify issues that were not considered when we assembled and studied the initiatives. This feedback may cause some initiatives to be materially changed or possibly abandoned when more specific proposals are made in due course. We would hope to provide a clearer picture of the way in which the legal framework may evolve when the responses to this Consultation Paper have been analysed and the Consultation Conclusions Paper is issued.

15. We wish to stress that the Phase 3 reform initiative is confined to a review of the CO prospectus regime. Thus, this Consultation Paper is not concerned with the framework governing the listing of securities on The Stock Exchange of Hong Kong Limited ("SEHK") administered by SEHK under its *Rules Governing the Listing of Securities* ("SEHK Listing Rules"); nor is it concerned with reform of the regimes relating to collective investment schemes or investment advertisements in Part IV of the SFO, or with any other part of the SFO. We do not currently envisage making changes to aspects of Part IV of the SFO unless they are directly affected by a Proposal. However, we welcome all comments on the Proposals that identify consequences under other parts of the CO, SFO or other Hong Kong legislation that may be material or relevant to the Phase 3 reform exercise.
16. Finally, we welcome all specific suggestions for reform of other features of the CO prospectus regime not covered in a Proposal. All suggestions that strike a balance between market facilitation and investor protection will be evaluated (where appropriate following further discussion with the party concerned), commented upon in the Consultation Conclusions Paper and, where applicable and possible, incorporated into the Phase 3 reform exercise.

APPENDIX

1. Proposal 1 - Transfer CO prospectus regime to SFO

- 1.1 The CO is concerned primarily with the formation, operation and dissolution of Hong Kong incorporated companies. Non-Hong Kong incorporated companies that establish a place of business in Hong Kong are required to register under the CO and submit returns to the Registrar of Companies but are otherwise catered for in the CO only in a number of specific contexts. The CO also contains detailed provisions dealing with the public offering of shares in and debentures of Hong Kong companies, and the public offering in Hong Kong of shares in and debentures of non-Hong Kong incorporated companies. In this Consultation Paper these latter provisions only are described as the **CO prospectus regime**.
- 1.2 The SFO consolidates all Hong Kong legislation relating to financial products, the securities and futures market and the securities and futures industry⁶. Part IV of the SFO includes provisions concerned with the issue of advertisements, invitations or documents containing invitations to the public regarding securities, regulated investment agreements and collective investment schemes. The general approach of Part IV is to prohibit the issue of such advertisements unless the issue is authorized or exempted⁷. Among others, Part IV provides exemptions in the case of prospectuses for shares or debentures, extracts from or abridged versions of prospectuses, and documents expressly carved out of the definition of "prospectus" in the CO, so as to avoid or limit duplication with the CO prospectus regime. The Part IV regime also provides an express power for the SFC to authorize collective investment schemes and advertisements, invitations or documents containing invitations to the public regarding securities and regulated investment agreements, in each case subject to any conditions it may think appropriate. In the case of collective investment schemes and certain other investment arrangements, SFC authorization is conditional on the scheme or arrangement complying with any applicable SFC code outlining a regulatory framework applicable to that scheme or arrangement⁸. In this Consultation Paper, these statutory provisions

⁶ The title to the SFO states that it is "*An Ordinance to consolidate and amend the law relating to financial products, the securities and futures market and the securities and futures industry, the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry, the protection of investors, and other matters incidental thereto or connected therewith, and for connected purposes.*"

⁷ See section 103(1) of the SFO for the text of the prohibition and subsections (2) and (3) for particulars of the exemptions.

⁸ See, among others, the *Code on Unit Trusts and Mutual Funds*, the *Code on Real Estate Investment Trusts*, and the *Code on Investment-Linked Assurance Schemes*. These and other SFC codes vary in length, content and level of detail, reflecting the notion of tailoring the regulatory requirements to the type of investment arrangement or instrument described in them. However, common themes permeate all codes, including: the need for parties performing functions in relation to a managed investment arrangement or instrument to satisfy suitability criteria and perform particular functions in a specified way; the setting of controls over investment policy and minimum standards for transactions; the content of constitutional and structural documentation, offering documentation and advertising materials; and minimum requirements for reporting to investors on financial and other matters on a periodic, event-based or ongoing basis.

and the related administrative arrangements are described as the SFO investment advertisement regime.

- 1.3 We consider that laws relating to the public offering of securities by companies can be distinguished from and operate independently of laws relating to formation, operation and dissolution. Accordingly, we see no particular disadvantage in moving the legislation relating to the public offering of shares and debentures (i.e., the CO prospectus regime) out of the CO. Furthermore, transferring the CO prospectus regime into the SFO and thereby consolidating all securities laws in a single piece of legislation will produce opportunities to conform the regulatory philosophy and remove technical differences and inconsistencies between the CO and SFO. The resulting legislative framework should reduce complexity and lower compliance costs.
- 1.4 We propose that the CO prospectus regime should be moved to the SFO. We would envisage that the CO prospectus regime (or provisions broadly similar, as explained below) would form a discrete part of the SFO, such that the new CO prospectus regime would be readily distinguishable from the SFO investment advertisement regime⁹. Notwithstanding the outcome of this Proposal, for the sake of convenience this paper will continue to use the expression "CO prospectus regime" to refer to the current and possible future regime and to distinguish it from the SFO investment advertisement regime. The Proposals that follow in this Consultation Paper concern specific changes to the CO prospectus regime; if pursued these will constitute the differences we envisage existing between the current CO prospectus regime and the new one, in the event of any transfer of the regime into the SFO.

2. **Overseas practices**

- 2.1 Both the United Kingdom ("UK") and Singapore have segregated the legislation dealing with offerings of securities from that dealing with core company law. In Australia, the securities offering provisions and company law are found in one piece of legislation, the Corporations Act ("CA").

Question 1

Do you think that the CO prospectus regime should be moved to the SFO?

⁹ See Proposals 4 and 5 for initiatives that may alter the scope of the proposed new CO prospectus regime. For example, under Proposal 4 the new CO prospectus regime may be framed so as not to distinguish between Hong Kong and non-Hong Kong incorporated companies and therefore what is now in Parts II and XII of the CO would be merged into a single regime in which the relevant requirements would apply to all companies without regard to place of incorporation. More fundamentally, under Proposal 5 there may cease to be a distinct CO prospectus regime for offers of shares and debentures. Such offers would instead be brought within an expanded SFO investment advertisement regime.

3. Proposal 2 - Shift of focus to “transaction-based”

3.1 The CO prospectus regime adopts a “document-based” approach, which focuses on the existence of a document containing an offer or invitation to the public. Two core prohibitions in the CO prospectus regime concern:-

- (a) the issue of an application form without a prospectus¹⁰, and
- (b) the issue of a document containing an offer or calculated to invite an offer where the document does not comply with the requirements for prospectuses in the CO¹¹.

3.2 As the CO prospectus regime is document-based, the regime does not apply to public offers of shares or debentures made otherwise than with a document. Some offers are structured with a verbal component in order to make use of this technical distinction and thereby take the offer outside the CO prospectus regime. By contrast, the SFO investment advertisement regime captures both written and verbal advertisements and invitations¹².

3.3 We propose to shift the focus of the CO prospectus regime from a document-based approach to a transaction-based approach by providing that no public offer of shares or debentures shall be made unless it is contained in a prospectus that complies with the relevant requirements of the regime or falls within a specified exemption. This would provide for greater certainty in the law by regulating the act of offering rather than the document containing the offer, reduce the number of transactions that are structured to fall outside the regime, and increase investor protection. It would also bring the CO prospectus regime into line with the SFO investment advertisement regime, which regulates advertisements and invitations whether made in writing or otherwise.

4. Overseas practices

4.1 In contrast to Hong Kong, each of the UK, Singapore and Australia operates on a transaction-based approach which regulates the making of offers of securities by requiring that a prospectus or disclosure document complying with the relevant requirements must be lodged or registered with the relevant regulatory authority before an offer of securities can be made, unless such offer falls within a specified exemption.

Question 2

Do you think that the focus of the CO prospectus regime should change from a “document-based” approach to a “transaction-based” approach, such that all offers of shares and debentures will need to comply with the requirements of the regime unless they fall within an exemption?

¹⁰ See sections 38(3) and 342(3) of the CO.

¹¹ See sections 38(1B) and 342(1) of the CO.

¹² See section 102 of the SFO for definitions of “issue”, “advertisement” and “invitation”.

5. Proposal 3 - Scope of the regime: options or other rights

5.1 The CO prospectus regime is silent on the treatment of offers of options or other rights in or over shares or debentures but is generally assumed to extend to them. We propose that the CO prospectus regime should be clarified to expressly provide for such offers. This raises the question whether the application of the CO prospectus regime to such offers should be confined to instances where the issuer of the option or other right is in the same group of companies as the issuer of the underlying shares or debentures; to do so would mean that offers of options or other rights over shares or debentures of an unrelated company would fall into the SFO investment advertisement regime rather than the CO prospectus regime¹³.

6. Overseas practices

6.1 In Australia, an offer of securities needs disclosure unless it falls within a specified exemption¹⁴. "Securities" for the purposes of Chapter 6D of the CA includes a right or interest in, or an option to acquire, a share or debenture of a body¹⁵. An offer of an option over securities is not taken to be an offer of the underlying securities. The CA expressly provides that if a disclosure document is needed for an offer of the option and there is no further offer involved in exercising the option, the issue or sale of the underlying securities on the exercise of the option does not need a disclosure document¹⁶.

6.2 In Australia, a prospectus for an offer to grant or transfer an interest in or option over securities will need to contain information on the rights and liabilities attaching to the interest or option and the underlying securities. This ensures that investors can assess the value of both the interest or option and the underlying securities. Information will be required about the capacity of the person offering options to complete the contracts so that investors can assess the counterparty risk. However, the prospectus will only be required to contain information on the body issuing the underlying securities where the person making the offer will have access to the information or in the case of an indirect issue or sale with the purpose of on-sale¹⁷.

6.3 In the UK, section 85 of the Financial Services and Markets Act 2000 ("FSMA") states the general rule that a person may not make an offer of transferable securities to the public in the UK unless a prospectus approved by the Financial Services Authority has been published. "Transferable securities"

¹³ Accordingly, unless they are technically "shares" or "debentures", options and other rights over securities issued in the ordinary course of business (for example, physically settled derivative warrants and equity linked investments falling within Chapter 15A of the SEHK Listing Rules) would not be regulated under the CO prospectus regime. Although many instruments are likely to fall within the SFO investment advertisement regime an exemption may permit offers to be made without prior authorization.

¹⁴ See sections 706 and 707 of the CA.

¹⁵ See sections 700 and 761A of the CA.

¹⁶ See section 702 of the CA and note 1 thereto.

¹⁷ See section 710(1), item 2 of the CA.

include shares, bonds and other forms of securitised debt and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange, or giving rise to a cash settlement¹⁸.

- 6.4 In Singapore, under the Securities and Futures Act (“SFA”) an offer to the public of units¹⁹ of shares in or debentures of a corporation for subscription or purchase, or an invitation to do so, can only be made with a compliant prospectus.

Question 3

Do you think the CO prospectus regime should expressly apply to offers of options or other rights, in cases where the issuer of the option or other right is in the same group of companies as the issuer of the underlying shares or debentures?

7. Proposal 4 - Scope of the regime: bodies

7.1 The CO prospectus regime:-

- (a) deals separately with Hong Kong-incorporated companies and non-Hong Kong-incorporated companies and in some respects subjects them to different requirements (e.g. prospectus signing requirements for registration purposes²⁰); and
- (b) applies only to offers of shares and debentures of a “company” within the meaning of the CO.

7.2 We consider that investor interests would be enhanced under a framework that requires all public offers having particular characteristics to conform to a prescribed standard without regard to the place of incorporation or legal form of the issuer. We see little justification for the CO prospectus regime being restricted to certain types of issuer only, as this challenges the principle that an offering regime should provide a level playing field for all issuers.

7.3 We propose that all offers of shares or debentures in Hong Kong of a statutory, corporate or non-corporate body wherever incorporated or formed should be subject to the requirements of the CO prospectus regime. Offers by certain types of bodies (for example, sovereign states, supranational organisations and statutory bodies) may fall within an exemption from the CO prospectus regime. We invite suggestions on the types of bodies to be exempted and the rationale supporting any such proposal.

¹⁸ See section 102A(3) of the FSMA and the Investment Services Directive (no. 93/22/EEC).

¹⁹ See section 240 of the SFA and the definition of “unit” in section 239(1) of the SFA. In relation to a share or debenture, “unit” means any right or interest, whether legal or equitable, in the share or debenture, and includes any option to acquire any such right or interest in the share or debenture.

²⁰ See sections 38D and 342C of the CO.

8. Overseas practices

8.1 In Australia, offers of the following securities are subject to the fundraising provisions of the CA²¹:-

- (a) a share in a body; or
- (b) a debenture of a body; or
- (c) a legal or equitable right or interest in such share or debenture; or
- (d) an option to acquire, by way of issue, such share or debenture.

The reference to “body” reflects a legislative initiative undertaken in 2000 to remove the implication that the law may only apply to securities of incorporated bodies.

8.2 In Singapore, the SFA expressly provides that the prospectus provisions apply to entities formed or incorporated inside or outside Singapore²². The SFA also provides that a reference to the debentures of a corporation includes a reference to debentures of the government of any state or any other entity²³. Offers to the public of debentures, or units of debentures, made by or guaranteed by the Singaporean Government are expressly exempted from the prospectus provisions of the SFA²⁴.

8.3 In the UK, the FSMA contains an exemption for offers to the public of non-equity transferable securities issued or guaranteed by the government, or a local or regional authority, of any EEA State (which include the UK government and UK local authorities)²⁵.

Question 4

Do you think that it is appropriate:-

- (a) to standardise the requirements of the CO prospectus regime without regard to the place of incorporation of the issuer; and*
- (b) to provide that the CO prospectus regime should apply to “bodies” rather than companies?*

9. Proposal 5 – Unification of regimes: regulatory harmonisation

9.1 The CO prospectus regime captures an offer of shares or debentures of a company incorporated under the CO or an offer of shares or debentures in

²¹ Chapter 6D of the CA. See the definition of “securities” in sections 700 and 761A of the CA.

²² See section 2(1) of the SFA and section 4(1) of the Companies Act, for the definition of “corporation”.

²³ See section 239(7) of the SFA.

²⁴ See section 279 of the SFA.

²⁵ See section 85(5) of, and Schedule 11A to, the FSMA.

Hong Kong of a non-Hong Kong incorporated company. The scope of the CO prospectus regime is therefore confined to:-

- (a) entities having the legal form of such a company; and
- (b) offers of shares or debentures of such a company.

9.2 Accordingly, public offers of:-

- (a) securities other than shares and debentures of a company; and
- (b) securities (including shares and debentures) of a non-corporate body,

will not be regulated under the CO prospectus regime but will usually fall within the SFO investment advertisement regime.

9.3 “Debenture” is defined in section 2 of the CO as including “*debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not*”. The inclusive nature of the definition and particularly the reference to “any other securities” (rather than, for instance, “any other debt securities”) causes difficulty for market practitioners. Case law offers limited assistance on the interpretation of “debenture” as a wide range of instruments creating or acknowledging a debt have been held to be debentures.

9.4 Against this background, the potential exists for issuers to bring within the CO prospectus regime any investment arrangement or instrument that they structure as a debenture. Although the CO prospectus regime certainly applies when equity or debt capital is being raised from the public, we have witnessed a trend in recent years to register CO prospectuses in connection with other types of investment arrangements or instruments. Many of these are not designed to raise capital for the issuer but are issued in the ordinary course of business of the issuer for revenue generation purposes. They usually provide investors with the opportunity to invest in a financial product that contains an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer. While such arrangements or instruments cannot reasonably have been in contemplation when the law was enacted, if they constitute debentures within the meaning of the CO then as a technical matter they fall within the CO prospectus regime.

9.5 The CO prospectus regime prescribes in some detail a series of requirements for public offers of shares and debentures. Among others, these include provisions regulating the information content of prospectuses, translation requirements, registration formalities and the way in which offers must be conducted. The SFC has a power to exempt an issuer or a prospectus from some of these requirements, but the power is constrained in a number of respects²⁶. By contrast, the SFO investment advertisement regime is

²⁶ The exemption power is set out in sections 38A and 342A of the CO. The power may be exercised on an ad hoc or class basis, subject to complying with certain transparency, public consultation and gazettal formalities. The exemption power relates to particular provisions in the CO prospectus regime

considerably more flexible. This provides simply for an SFC authorization of collective investment schemes and materials containing an advertisement or invitation relating to securities, regulated investment agreements or collective investment schemes. In some cases SFC product codes²⁷ have been issued as guidelines to facilitate an application for authorization under section 104(1) or 105(1) of the SFO. While these codes prescribe disclosure and other structural safeguards designed to enhance investor protection, the requirements are tailored to take into account the nature of the product and may (where appropriate) be waived upon application to the SFC. The codes are expressly stated not to have the force of law. Although they are issued or amended following public consultation, new codes or amendments may be brought into effect without legislative action.

- 9.6 The CO prospectus regime and SFO investment advertisement regime were designed to regulate investment arrangements and instruments with quite different characteristics. The framework of the CO prospectus regime suggests that it was intended to cover only equity or debt capital raising by companies seeking to develop their business and commercial activities. By contrast, the design of the SFO investment advertisement regime makes it suitable for regulating a wider variety of investment arrangements and instruments where regulatory flexibility is necessary.
- 9.7 The investment arrangements and instruments for which each regime is designed may give rise to different risk and reward exposure for an investor. Thus, in the case of equity or debt capital raising, the investor's exposure is to the financial performance and prospects of the company issuing the shares or debentures. For financial products, in addition to exposure to the issuer's (or guarantor's) creditworthiness, the investor is also exposed to the performance of the underlying asset, opportunity or risk. The different characteristics of investment arrangements and instruments justify differences between the regulatory framework of the applicable regime. Investment arrangements and instruments providing investors with broadly similar risk and reward exposure should be subject to equivalent regulatory treatment, regardless of their particular legal form. Similarities in risk and reward exposure justify similar disclosure and comparable levels of investor protection and regulatory oversight or intervention.
- 9.8 The inconclusive case law on the definition of "debenture" creates the potential for some investments to be regulated under either the CO prospectus regime or the SFO investment advertisement regime. As the two regimes are quite different, room exists for market distortion and regulatory arbitrage. The adverse consequence of regulatory arbitrage in circumstances where the legal

and may be exercised where the SFC considers that the exemption will not prejudice the interest of the investing public and compliance would be irrelevant or unduly burdensome or is otherwise unnecessary or inappropriate.

²⁷ SFC product codes have been issued for a variety of investment arrangements and instruments offered to the public, including unit trusts and mutual funds, hedge funds and real estate investment trusts. See Note 8 in paragraph 1.2 above.

or regulatory frameworks are not designed to accommodate a particular instrument is inadequate investor protection.

- 9.9 We believe that it is desirable to harmonise the legal and regulatory treatment of investment arrangements and instruments having similar characteristics and invite views on how best to achieve this. The question of how to achieve harmonisation arises because there are two different legal and regulatory regimes. This raises the more fundamental question of the need for two different regimes. If appropriate flexibility is built in, it should be entirely possible to regulate all investment arrangements and instruments currently falling within the CO prospectus regime and the SFO investment advertisement regime within a unified regime.
- 9.10 Flexibility in a new unified regime could be achieved and retained into the future via a number of legislative and regulatory models. Without knowing the level of support for a unified regime we have not explored the alternatives; however, given its flexibility, it is likely that all investment arrangements and instruments could be brought within a modified form of the SFO investment advertisement regime. Perhaps the minimum constituents for a flexible unified regime would be a statutory disclosure standard applying to all regulated²⁸ investment arrangements and instruments (such as along the lines of that in paragraph 3 of the Third Schedule to the CO²⁹), backed by a statutory liability provision that imposes civil and criminal penalties in the event of a failure to meet the standard prescribed. Regulated offers (i.e. those not falling within an exemption) may require authorization, and authorization may depend on compliance with provisions of an SFC product code tailored to accommodate the particular characteristics of the relevant investment arrangement or instrument. Objective differences in product characteristics (such as between a managed and unmanaged investment, or even equity and debt) will justify different levels of regulatory intervention in the product's structure, management, documentation and distribution. SFC guidelines could overlay the SFC product codes in order to address issues common to the regime as a whole and provide a mechanism to deal with any borderline cases that do not fit naturally within an existing product code. Compliance with any applicable SFC product code and guidelines should assist the issuer to achieve SFC authorization of the offer, but would not provide assurance that the offer meets the statutory disclosure standard. The issuer would still need to be satisfied that the offer contains all relevant information that investors may reasonably require. We welcome comments on the merits or otherwise of introducing a unified regime, as a route to achieving a greater degree of legal and regulatory harmonisation.

²⁸ As is the position under the CO prospectus regime and SFO investment advertisement regime, under a unified regime some offers would be exempted from compliance with some or all aspects of the regulatory framework.

²⁹ Paragraph 3 of the Third Schedule to the CO requires that a CO prospectus shall contain: "*Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and debentures and the financial condition of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered, and the nature of the company, and the nature of the persons likely to consider acquiring them.*"

9.11 Finally, no matter what the outcome on the issues discussed above, we invite views on whether the definition of “debenture” where it appears in the CO prospectus regime and the SFO investment advertisement regime should be clarified by replacing the reference to “*other securities*” with “*other debt securities*”.

10. Overseas practices

10.1 Australia provides for separate regimes regulating offers of securities³⁰ (which include shares and debentures³¹) and “financial products” which are set out in different parts of the CA³². The definition of “financial products” comprises four elements³³: (a) a broad functional definition outlining the key features of all financial products, which was intended to capture all products without the need for legislative amendment; (b) a list of products that are specifically included; (c) a list of products that are specifically excluded notwithstanding that they fall within the general definition of “financial products” or within a class of products that are specifically identified as “financial products” under the CA (because either a product is already regulated under an alternative regime, or the regulatory framework is not relevant to it); and (d) to provide for flexibility³⁴, enabling provisions to include products by regulation and to allow the Australian Securities and Investments Commission to exclude products.

10.2 In the UK, public offerings of securities are governed by the FSMA³⁵. The securities covered are extremely broad³⁶, and include shares and debentures.

10.3 In Singapore, provisions dealing with offers to the public of shares and debentures³⁷ are set out in Division 1 of Part XIII of the SFA whilst provisions dealing with offers to the public of collective investment schemes are set out in Division 2 of Part XIII of the SFA.

³⁰ See paragraph 8.1 above for the definition of “securities” for this purpose under Chapter 6D of the CA.

³¹ Debenture is defined in section 9 of the CA to mean a chose in action that includes an undertaking by the body to repay as a debt money deposited with or lent to the body. The chose in action may (but need not) include a charge over property of the body to secure repayment by the body. Certain choses are however expressly excluded from the definition, including: undertakings to pay money under a cheque; undertakings by an authorized deposit-taking institution to repay money deposited with it; and undertakings to pay money under a promissory note having a face value of at least A\$50,000.

³² See Chapter 6D for securities and Division 3 of Part 7.1, Chapter 7 for financial products.

³³ See sections 762A-765A of the CA.

³⁴ See sections 764A(1)(m) and 765A(2) of the CA.

³⁵ See sections 84 and 85 of the FSMA. See also the Prospectus Rules made by the Financial Services Authority.

³⁶ See Note 18 above.

³⁷ Section 239(1) of the SFA defines “debenture” as including “*debenture stock, bonds, notes and any other debt securities issued by a corporation or any other entity, whether or not constituting a charge on the assets of the issuer.*” 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 having a maturity period of not more than 12 months) are expressly excluded from the definition. The definition also provides for an enabling power on the part of the Monetary Authority of Singapore to introduce regulations to exclude a prescribed document or class of documents from the definition.

Question 5A

Do you think there should be a unified regime for all regulated investment arrangements and instruments currently falling within the CO prospectus regime and the SFO investment advertisement regime?

Question 5B

Do you think it is useful to clarify the meaning of "debenture" along the lines suggested in paragraph 9.11 above?

11. Proposal 6 - New safe harbour: takeover and merger offers and schemes of arrangement

- 11.1 Offering documentation in relation to 12 specific categories of offer set out in the new Seventeenth Schedule to the CO is excluded from the definition of "prospectus" in section 2 of the CO³⁸. These exemptions broadly reflect those existing in the equivalent statutory provisions of Australia, the UK and Singapore³⁹. One such exemption relates to an offer made in connection with a takeover or merger that is in compliance with the Hong Kong Codes on Takeovers and Mergers and Share Repurchases⁴⁰. By contrast, an offer made in connection with a takeover or merger complying with the laws and regulations of another jurisdiction (most often those of the home jurisdiction of the target company), will not be exempted under the CO. Nor is an exemption available for an offer contained in a scheme of arrangement that is approved by a court in the home jurisdiction of the company concerned.
- 11.2 The globalisation of business and commerce and ready access to information via the Internet are increasingly exposing Hong Kong investors to investment opportunities in the securities markets of other jurisdictions. In seeking to diversify their investment portfolios, some investors hold shares or debentures in entities that are not listed or traded in Hong Kong. Such persons would be disadvantaged if the requirement for a prospectus were to discourage the relevant company, or the person making the takeover or merger offer, from allowing them to participate.
- 11.3 Exclusion of Hong Kong investors from an offer is the usual result in circumstances where the number of Hong Kong investors does not justify the cost of complying with the CO prospectus requirements. In such cases, Hong Kong investors may receive the offer documentation but are not entitled to take up the offer. Arrangements may be made for the notional entitlements or interests of Hong Kong investors to be sold and for a cash payment to be made

³⁸ The exemptions in the new Seventeenth Schedule to the CO were introduced by the CAO 2004 (see sections 1 and 24 of Schedule 1 of the CAO 2004 for further details).

³⁹ See sections 85(5) and 86 of, and Schedule 11A to, the FSMA (for the UK); section 708 of the CA (for Australia); and Subdivision (4) of Division 1 of Part XIII of the SFA (for Singapore).

⁴⁰ Paragraph 4.1 of the Introduction to the Codes states that the Codes apply to takeovers, mergers and share repurchases affecting public companies in Hong Kong and companies with a primary listing of equity securities in Hong Kong.

instead. More generally, in cases where the arrangement or compromise will bind all shareholders or debenture holders, it is particularly important that Hong Kong investors are able to receive materials describing the proposal and are given the opportunity to influence the outcome. It is difficult to justify the application of laws or regulations designed to provide investor protection where their very application may have the opposite effect. In cases where the offer is directed at and personal to existing shareholders only, the possible impact on the wider investing public will be limited.

- 11.4 While it is possible that one of the 12 categories of exemption in the new Seventeenth Schedule may provide relief in some cases, we invite views on the possible introduction of a new exemption for an offer made to holders of shares or debentures of a company in the context of a takeover or merger or under a compromise or arrangement between a company and such holders provided that such offer is in compliance with the laws and regulatory requirements of the company's home jurisdiction and of any principal stock exchange on which the relevant shares or debentures are listed.

12. Overseas practices

- 12.1 In Singapore, an offer made in connection with a takeover offer or a proposed compromise or arrangement that is made in compliance with the laws, codes and other requirements of the relevant entity's country of incorporation is an exempt offer⁴¹. In the UK, transferable securities offered in connection with a takeover by means of an exchange offer or a merger, if a document is available containing information which is regarded by the Financial Services Authority as being equivalent to that of a prospectus, taking into account the requirements of European Community legislation, are exempt from the prospectus regime⁴². Australia exempts only takeover offers and offers in connection with a compromise or arrangement made under the CA⁴³.

Question 6

Is it appropriate to create an exemption from the CO prospectus regime in respect of an offer or arrangement of the kind described in paragraph 11.4?

13. Proposal 7 - Anti-avoidance mechanism

- 13.1 Section 41 of the CO⁴⁴ is designed to address the possible avoidance of the CO prospectus regime by issuers separating the issue and distribution of new shares or debentures by allotting to one or a small number of persons with the

⁴¹ See sections 273(1)(b) and 273(1)(c) of the SFA.

⁴² See section 85(5)(b) of the FSMA and Rule 1.2.2(2) and (3) of the Prospectus Rules made by the Financial Services Authority.

⁴³ See section 708(18) of the CA.

⁴⁴ Section 41 of the CO deems a document by which offers of shares or debentures for sale are made to the public to be a prospectus issued by the company if such company allots with a view to all or any of such shares or debentures being offered for sale to the public.

intention that the allottees then sell the shares or debentures to third parties in a wider distribution.

- 13.2 The scope of this anti-avoidance provision is not clear and it may be hindering transactions that are not objectionable from a regulatory standpoint. For example, we understand that it may catch a disposal in the secondary market of listed shares or debentures taken up by underwriters pursuant to an underwriting commitment in a public offer.
- 13.3 If the suggestion to move to a “transaction-based” regime (see Proposal 2 in paragraph 3 above) is pursued, any public offer of shares or debentures will be regulated unless it falls within a specified exemption. In this context, it will be necessary to consider whether selling shares or debentures acquired under any such exemption would give rise to regulatory concerns. Such an anti-avoidance measure may only be necessary in respect of a small number of specified exemptions.
- 13.4 To deal generally with the concerns described above, we propose that the CO prospectus regime should contain an anti-avoidance mechanism that provides that an offer for sale of shares or debentures within 12 months of their initial issue requires a prospectus to be issued by the offeror where:
- (a) the issuer issued such shares or debentures pursuant to a relevant exemption;
 - (b) there are reasonable grounds for concluding that the issuer issued the shares or debentures, or the person to whom they were issued acquired them, with the purpose of selling or transferring them; and
 - (c) no exemption would have been available if the issuer had offered the shares or debentures directly to the offerees.
- 13.5 The proposed anti-avoidance mechanism would prevent indirect issues of shares or debentures to investors who require the protection of a regulated offer. However, it should not impede all offers of shares or debentures acquired pursuant to an exemption and we invite suggestions of appropriate exclusions. We invite comments, in particular, on whether the proposed anti-avoidance provision should specifically not capture the following secondary offers:-
- (a) an offer for sale of shares or debentures where:
 - (i) the issuer offered the relevant shares or debentures on the basis of a prospectus;
 - (ii) the issuer issued the relevant shares or debentures to an underwriter named in that prospectus pursuant to underwriting arrangements; and

- (iii) the relevant shares or debentures are in a class of shares or debentures which is listed, or to be listed, on SEHK⁴⁵;
- (b) an offer for sale of shares where:
 - (i) the issuer issued the relevant shares to existing shareholders pursuant to the bonus issue or scrip dividend exemption provided in the CO prospectus regime⁴⁶; and
 - (ii) the relevant shares are in a class of shares that is listed on SEHK⁴⁷;
 - (c) an offer for sale of shares or debentures where:
 - (i) the issuer issued the relevant shares or debentures to employees pursuant to the employee scheme exemption provided in the CO prospectus regime⁴⁸; and
 - (ii) the relevant shares or debentures are in a class of shares or debentures that is listed on SEHK⁴⁹;
 - (d) an offer for sale of shares where the relevant shares were issued pursuant to the exercise of an option or other right which was issued on the basis of a prospectus⁵⁰;
 - (e) an offer for sale of shares or debentures where the relevant shares or debentures were issued as part of a takeover or merger or other compromise or arrangement falling within the proposed exemption referred to in paragraph 11.4 above⁵¹;
 - (f) an offer for sale of shares or debentures where the relevant shares or debentures were issued pursuant to the exemption in the CO prospectus regime relating to an offer regulated by the Hong Kong Codes on Takeovers and Mergers and Share Repurchases⁵²; and

⁴⁵ For each of the offers for sale referred to in paragraphs 13.5(a) to (c), the exemption is justified because up-to-date information is available to the market through the continuous disclosure obligations of the issuer under the relevant listing rules.

⁴⁶ See section 7 of Part 1 of the Seventeenth Schedule to the CO.

⁴⁷ See Note 45.

⁴⁸ See section 8 of Part 1 of the Seventeenth Schedule to the CO.

⁴⁹ See Note 45.

⁵⁰ The exemption is justified because information regarding the rights and liabilities attaching to the underlying shares will have been disclosed in the prospectus containing the offer of the relevant option or other right. See Proposal 3 in paragraph 5 above.

⁵¹ As the shares or debentures were initially acquired as part of a compromise or arrangement made in compliance with all relevant laws and regulatory requirements of the home jurisdiction of the issuer and of any principal stock exchange on which the shares or debentures are listed, applicable disclosure obligations provided for in that jurisdiction would have been satisfied.

⁵² See section 6 of Part 1 of the new Seventeenth Schedule to the CO. As the initial offer is subject to specific alternative disclosure requirements in the Hong Kong Codes on Takeovers and Mergers and Share Repurchases, applicable disclosure obligations would have been satisfied.

- (g) an offer for sale of shares or debentures where the relevant shares or debentures were issued by an exempt body referred to in paragraph 7.3 above⁵³.

14. Overseas practices

- 14.1 The anti-avoidance mechanism discussed above is broadly based on the anti-avoidance regime adopted in Australia⁵⁴. As regards Singapore, the SFA contains a provision that is similar to section 41 of the CO⁵⁵. In the UK, the definition of an “offer of transferable securities to the public” in section 102B of the FSMA includes the placing of securities through a financial intermediary. This means that any subsequent resale of securities, which were previously the subject of one or more exemptions, should be regarded as a separate offer.

Question 7A

Do you consider that an anti-avoidance mechanism as described in paragraph 13.4 should be adopted in Hong Kong? If you agree that there should be an anti-avoidance mechanism but do not agree with the wording proposed, please suggest alternative wording.

Question 7B

Do you agree with the carve-outs from the anti-avoidance mechanism described in paragraph 13.5? If you consider other carve-outs are necessary please justify your suggestions.

15. Proposal 8 - Persons liable for a prospectus

- 15.1 As liability is the cornerstone of prospectus accuracy it is essential that it should attach unequivocally to specified persons. Currently, section 40 of the CO imposes civil liability for any untrue statement⁵⁶ in a prospectus on the following persons:
- (a) directors of the company at the time of the issue of the prospectus and those named in the prospectus as having agreed to become directors;
 - (b) “promoters” (which means parties promoting the company who are involved in the preparation of the prospectus but not including “any

⁵³ Given that the initial offer is exempt because of the status of the body, we see no reason why a prospectus should be required for the on-sale of shares or debentures acquired pursuant to the initial offer.

⁵⁴ See section 707 of the CA.

⁵⁵ See section 257 of the SFA.

⁵⁶ “Untrue statement”, in relation to any prospectus, includes a material omission from the prospectus for the purposes of sections 40 and 40A of the CO. See section 41A(2) of the CO.

person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company”)⁵⁷; and

(c) every person “who has authorized the issue of the prospectus”⁵⁸.

15.2 Section 40A of the CO imposes criminal liability for untrue statements in a prospectus on “any person who authorized” its issue⁵⁹.

15.3 We consider that the law should define more clearly the persons who should properly be held responsible for prospectus disclosures. While the directors and senior management are closely involved in the assessment of the company’s financial position and prospects and the formulation of the plan to raise capital, the same also applies to the “sponsors” of an issue. The sponsor is appointed for the sole purpose of securing new capital and a listing for the company and has a significant economic interest in the success of an offer. The sponsor advises the company on the entire transaction (often including identification of suitable assets to be included in the listing vehicle, selection of professional advisers, and determination of form and content of the prospectus and other regulatory documentation) and drives it forward to completion. After the directors and senior management of the company, the sponsor is usually the next most knowledgeable person concerning the company and its business and the next best placed to obtain relevant information. From its own knowledge or by inquiry the sponsor is well placed to include in the prospectus the information that investors and their professional advisers would reasonably require to make an informed investment decision.

15.4 Divergent interests between the company and prospective investors may lead to inadequate or inaccurate disclosure. In the case of listed securities, the SEHK Listing Rules have recently imposed a series of very specific due diligence standards to be met by sponsors⁶⁰ and through its “*Consultation Paper on the Regulation of Sponsors and Compliance Advisers*” issued in June 2005 the SFC is consulting the public on a proposal to introduce specific entry and ongoing licensing criteria for sponsors which reinforce the due diligence obligation⁶¹. Both of these initiatives aim to enhance investor protection by raising the standards practised by sponsors. Given their ability to influence the transaction, conduct due diligence and verify the accuracy and completeness of disclosure, and because their interest in the success of the offer is so closely aligned with that of the directors and senior management of the company, there is justification to add sponsors to the parties liable for the prospectus. To do so would not only increase the accuracy and completeness

⁵⁷ See section 40(5)(a) of the CO.

⁵⁸ An expert who has given consent to the inclusion in the prospectus of a report made by him is not regarded as having authorized the issue of the prospectus except in respect of the contents of his report. See the proviso to section 40(1) of the CO.

⁵⁹ An expert who has given consent to the inclusion in the prospectus of a report made by him is not regarded as having authorized the issue of the prospectus. See section 40A(2) of the CO.

⁶⁰ See among others Chapter 3A and Practice Note 21 of the SEHK Listing Rules.

⁶¹ For further particulars of these initiatives, see SFC Press Release dated 29 June 2005 on the SFC’s website www.sfc.hk under tab “General and Enforcement News”.

of prospectuses but cause sponsors to select among possible listing candidates only those which could safely be brought to market. Potential candidates for listing would need to focus on the quality of their disclosure and governance and objectively demonstrate their suitability for listing. In due course this would improve the quality of the market and increase its attractiveness to issuers and investors alike.

- 15.5 In matters of legal and regulatory liability, certainty as to the scope of the regime is essential and is in the public interest. We propose to remove the existing liability under the prospectus regime of “promoters” and those who “authorize the issue of a prospectus”. The range of persons that may be promoters is unclear; while the law provides some guidance by excluding professionals engaged to assist the company, as well as persons who were not party to the preparation of the prospectus, the law or the courts have not exhaustively defined the category of promoter and its scope is unclear. Uncertainty concerning whether the term captures sponsors led to the proposal in paragraph 15.4.
- 15.6 The same is also true of persons who “authorize the issue of a prospectus”. This expression creates uncertainty as to whether major shareholders, guarantors and other persons indirectly associated with the offering will have responsibility for the prospectus. Since the answer to the question whether any person has authorized the issue of a prospectus is likely to be a question of fact and depends on the circumstances of the case, some offers are carefully structured to limit the potential persons who could be said to have authorized the issue of the prospectus. By contrast, although it is market practice for information memoranda and prospectuses making offers of shares and debentures to include a responsibility statement⁶² given by specific persons (usually the issuer and/or guarantor of the offer, and sometimes by their directors) there is no statutory basis for this, and as a technical matter it is unclear whether these persons have authorized the issue of the prospectus. Where these two elements of uncertainty mean liability to investors for compensation for an untrue statement in a prospectus may be confined to a thinly capitalised single purpose vehicle that has very limited assets available to meet any claim, and where incentives or deterrents to ensure prospectus accuracy are limited, investor interests are prejudiced.
- 15.7 We propose to extend civil liability for misstatements in prospectuses to:

- (a) the issuer and/or offeror⁶³ of the shares or debentures;

⁶² For example, it is market practice in the case of offers of unlisted retail notes for the prospectus to include the following statement: “*The directors of the Issuer collectively and individually accept full responsibility for the accuracy of the information contained in this Prospectus and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief this Prospectus contains no untrue statement (including a statement which is misleading in the form and context in which it is included and including a material omission).*”

⁶³ “Issuer” in this context should include a reference to the offeror/vendor of the shares or debentures in an offer for sale because the current section 41 (which attaches liability to the vendors in an offer for sale) would be repealed if a regulatory framework containing the anti-avoidance mechanism described in Proposal 7 in paragraph 13 above is pursued. See UK approach (Rules 5.5.3 and 5.5.7 of the

- (b) the sponsors⁶⁴ of the issue; and
- (c) each person who accepts, and is stated in the prospectus as accepting, responsibility for, or for any part of, the prospectus,

and remove liability for promoters and those who “authorize the issue of” a prospectus. Experts consenting to the inclusion of their name in the prospectus will continue to be liable only in respect of untrue statements attributed to them in the prospectus. In all cases, the defences to liability contained in sections 40(2) and (3) of the CO will continue to be available to the extent applicable⁶⁵.

- 15.8 We also invite views on whether to subject the same classes of persons to both civil and criminal liability for misstatements in prospectuses, with experts liable only in respect of untrue statements in their reports. The absence of criminal prospectus liability where civil liability exists may undermine the motivation to ensure that the prospectus is complete and accurate.
- 15.9 The question whether to impose civil and criminal liability on particular persons will need to be revisited in the light of conclusions to be reached on proposals for (i) statutory listing rules to be made by the SFC under section 36 of the SFO described in the “*Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules*” issued by the SFC in January 2005⁶⁶ and (ii) a statutory liability regime described in the “*Consultation Paper on Proposed Amendments to the Securities and Futures Ordinance to give Statutory Backing to Major Listing Requirements*” issued by the Financial Services and the Treasury Bureau (also in January 2005). These proposals would introduce a framework for SFO enforcement action in the event of breach of statutory listing rules made by the SFC under section 36

Prospectus Rules made by the Financial Services Authority where the offeror of the transferable securities, if it is not the issuer of the securities, is responsible for the prospectus (excluding the case where the offeror is making the offer in association with the issuer and the prospectus was drawn up primarily by the issuer or persons acting on its behalf). Furthermore, where an offeror shareholder makes an offer for sale and the issuer had allotted to the offeror with no intention of resale there are good reasons why the issuer and its directors should not be liable. In Australia, it seems that only the offeror is liable even if the company allotted with the intention of resale because the responsibility for drawing up the disclosure document rests with the person making the offer of securities (see section 727 of the CA which states that a person must not make an offer of securities that needs disclosure to investors unless the offer is included in or accompanied by a disclosure document).

⁶⁴ “Sponsor” for these purposes would mean: (in the case of an offering of equity securities to be listed on SEHK) any person acting as “sponsor” within the meaning of the SEHK Listing Rules; (in the case of an offering of equity securities to be listed overseas) any person performing a similar role; and (in the case of an offering of debt securities) any manager or arranger appointed for the purposes of the offer.

⁶⁵ See Proposal 11 in paragraph 21 below for a discussion on a proposed modification to the defences available to those who are liable for a prospectus.

⁶⁶ The SFC’s proposals would implement the Government’s decision to codify certain important disclosure requirements in the SEHK Listing Rules into subsidiary legislation. The proposed amendments would cover three areas: (i) disclosure of price-sensitive information and specific events, (ii) disclosure/publication of annual and periodic reports, and (iii) disclosure and shareholders’ approval requirements for notifiable transactions and connected transactions.

of the SFO⁶⁷. For example, it is conceivable that the new SFO enforcement regime would overlap to some extent with parts of sections 40 and 40A of the CO in cases where a prospectus is issued by a company whose shares will be listed on SEHK⁶⁸. The CO provisions for misstatements in prospectuses may need to distinguish between listed and unlisted securities. Alternatively, the SFO and CO regimes could be aligned by harmonising the statutory listing rules and the CO provisions in the case of listed offerings, or by defaulting to the proposed SFO enforcement regime for both listed and unlisted offerings.

16. Overseas practices

- 16.1 In Australia and Singapore, specific persons are stated as being liable to compensate investors for loss suffered as a result of a misleading statement or omission in a prospectus, including the offeror of the securities, each director of the offeror if the offer is made by a body, the underwriters to an offer, and a person named in the prospectus with his consent as having made a statement included in the prospectus (but only in respect of the inclusion of that statement)⁶⁹.
- 16.2 In Singapore, the same classes of persons are also subject to criminal liability for misstatements and omissions in a prospectus⁷⁰ whilst in Australia, any person who aids and abets the making of the offer could be criminally liable⁷¹.
- 16.3 In the UK, civil liability attaches to, amongst others, the issuer of the securities, the directors of the issuer (in the case of equity securities only), the offeror of the securities (except where the offeror is making the offer in association with the issuer and the prospectus was drawn up primarily by the issuer or persons acting on its behalf), each person who accepts, and is stated in the prospectus as accepting, responsibility for the prospectus as well as persons who have authorised the contents of the prospectus⁷². Criminal liability attaches to a

⁶⁷ Among other things, the Government's proposals aim to: (i) extend the market misconduct regime in Parts XIII and XIV of the SFO to cover breaches of the statutory listing rules made by the SFC, (ii) empower the Market Misconduct Tribunal to impose, in addition to existing sanctions such as disqualification orders and disgorgement orders, new civil sanctions namely public reprimands and civil fines on the primary targets, i.e., issuers, directors and officers, for breaches of the statutory listing rules made by the SFC, and (iii) empower the SFC to impose civil sanctions, namely public reprimands, disqualification orders, disgorgement orders and civil fines, on the primary targets for breaches of the statutory listing rules under an amended Part IX of the SFO.

⁶⁸ The extent of any overlap would depend on the content of the statutory listing rules to be made under the SFO. For listed companies, liability for failure to disclose would hinge on the standards to be prescribed in the statutory listing rules.

⁶⁹ See section 729 of the CA in Australia and section 254 of the SFA in Singapore. In Singapore, the Securities and Futures (Amendment) Act 2005, passed by the Singapore Parliament in January 2005 and currently expected to take effect in the third quarter of 2005, provides for both civil and criminal liability to be extended to the "issue manager" of an offer of securities (i.e., equivalent to the "sponsor" of an initial public offering in the Hong Kong context).

⁷⁰ See section 253 of the SFA.

⁷¹ See section 11.2 of the Criminal Code dealing with accessorial liability for contraventions of federal offences.

⁷² See Rules 5.5.3 and 5.5.4 of the Prospectus Rules made by the Financial Services Authority. (As part of the implementation process relating to the provisions introduced by the EU Prospectus Directive, the requirement for directors of an issuer to take statutory responsibility for prospectuses in respect of

person who knowingly or recklessly makes a statement that is false in a material particular for the purpose of inducing or is reckless as to whether it may induce another person to deal in securities⁷³.

- 16.4 The concepts of “promoter” and persons “who authorize the issue of” a prospectus were removed from the Australian regime in 2000 because of the uncertainty surrounding those terms.

Question 8A

Do you think that prospectus civil liability should be extended to the issuer and/or offeror of the shares or debentures and the sponsor of an issue (each within the meaning of paragraph 15.7), as well as to persons who accept, and are stated in the prospectus as accepting, responsibility for the prospectus? Are there any other parties involved in the prospectus preparation or public offering process who in your view should also be subject to the civil liability regime?

Question 8B

Do you think that liability under the prospectus regime of “promoters” and persons who “authorize the issue of” a prospectus should be removed?

Question 8C

Do you think that the same classes of persons should be subject to both civil and criminal liability for misstatements in prospectuses (with experts liable only in respect of untrue statements in their reports)?

17. Proposal 9 – Misstatements: Persons who may claim compensation

- 17.1 Under section 40(1) of the CO, claims for compensation for loss sustained by reason of an untrue statement in a prospectus can be made by “persons who subscribe for any shares or debentures on the faith of the prospectus”. Section 40(7), when read with the new Twenty-second Schedule to the CO, clarifies and extends the class of persons who can make a claim for compensation to the following:
- (a) persons who subscribe for or purchase shares or debentures pursuant to an offer in a prospectus;
 - (b) persons who by means of an agent acquire shares or debentures pursuant to an offer in a prospectus;

retail (defined under the Prospectus Directive as having a denomination of less than 50,000 euros) non-equity securities has been removed as from 1 July 2005.)

⁷³ See section 397 of the FSMA.

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

- (i) the issuer or vendor of the shares or debentures; and
- (ii) intermediaries appointed for the purposes of an offer.

17.2 Even though the classes of persons entitled to claim compensation have been extended in the Twenty-second Schedule to the CO, such classes remain limited to persons who acquire in the primary market. However, an untrue statement or a material omission in connection with an offering may only come to light after secondary trading has begun and may consequently adversely affect secondary market purchasers. It is not clear why secondary market purchasers who suffer loss as a result of an untrue statement in a prospectus should not be entitled to compensation. We propose that they should be allowed to bring a civil claim under section 40 of the CO.

18. Overseas practices

18.1 In Australia, where a person suffers loss because an offer of securities is made under a disclosure document which contains a misleading or deceptive statement, or there is an omission from the disclosure document, he may recover his loss from, amongst others, the offeror, the directors of the offeror (if such offeror is a body) and the underwriters⁷⁴. Singapore adopts the same regime⁷⁵. In the UK, any person responsible for the prospectus is liable to pay compensation to a person who has acquired securities to which the document applies and suffered loss in respect of them as a result of an untrue or misleading statement in, or omission from, such document⁷⁶. There appears to be no express restriction in any of these jurisdictions to primary market subscribers or purchasers.

Question 9

Do you consider that a secondary market purchaser should be able to bring a claim for compensation for loss resulting from an untrue statement in a prospectus?

19. Proposal 10 - Misstatements: reliance on the prospectus

19.1 Section 40 of the CO (as read with the Twenty-second Schedule) allows any person who subscribes for shares or debentures "on the faith of the prospectus" to bring a claim for compensation for loss resulting from an untrue statement in the prospectus. In order to found a civil liability claim, an investor has to prove that his loss resulted from an untrue statement in the

⁷⁴ See section 729 of the CA.

⁷⁵ See section 254 of the SFA and Note 66 above.

⁷⁶ See section 90 of the FSMA.

prospectus. He must also prove that he relied on the prospectus, which may mean he is put to proof that he has actually read it.

- 19.2 We consider that provided a causal connection between loss sustained and an untrue statement in a prospectus is established it should not be necessary to prove actual reading of or reliance on the prospectus. Investors that suffer a loss on their investment will usually be among the shareholders of the company at the time the untrue statement comes to light and this may be some time after the prospectus ceases to be the only information used to price the company's securities. If an untrue statement in a prospectus is the cause of a loss on investment it should not matter whether the investor purchased his securities in reliance upon the prospectus, a subsequent disclosure by the company, news commentary, a research report, or a recommendation by a broker or financial adviser. While the need to prove that the loss was caused by an untrue statement in the prospectus may become more difficult to satisfy with the passage of time and the emergence of post-prospectus information, we do not think that the law should exclude the possibility of such an action.
- 19.3 This approach would be consistent with Proposal 9 – to extend the classes of persons who can make a claim for compensation to secondary market purchasers.

20. **Overseas practices**

- 20.1 There does not appear to be any requirement for claimants to prove that they have actually read and relied on the offering document in each of Australia, Singapore and the UK.

Question 10

Do you consider that the requirement for claimants to prove that they have actually read and relied on the prospectus when making a claim for compensation under section 40 of the CO should be repealed?

21. **Proposal 11 - Defence for those liable: due diligence**

- 21.1 The defence available under section 40(2)(d)(i) of the CO in respect of civil liability involves reasonable belief on the part of the defendant that an untrue statement in the prospectus not purporting to be made on the authority of an expert was true. Experts have a similar defence contained in section 40(3)(c) of the CO in respect of statements that they were competent to make and reasonably believed to be true.
- 21.2 The defence contained in section 40A(1) of the CO in respect of criminal liability also involves reasonable belief on the part of the defendant that an untrue statement in the prospectus was true.
- 21.3 We propose to clarify that the reasonable belief defence contained in sections 40(2)(d)(i), 40(3)(c) and 40A(1) of the CO should be subject to the

requirement that such belief must be founded on all inquiries which were reasonable in the circumstances having been made. The purpose of the due diligence defence is to motivate those preparing a prospectus to use their best endeavours to ensure that a prospectus is complete and accurate.

- 21.4 This approach would be consistent with Proposal 8 – to impose liability for untrue statements in a prospectus upon those who are well placed to determine the accuracy and completeness of the prospectus

22. Overseas practices

- 22.1 In each of Australia, Singapore and the UK, a due diligence standard built into the reasonable belief defence is the norm⁷⁷.

Question 11

Do you believe that the reasonable belief defence contained in sections 40(2)(d)(i), 40(3)(c) and 40A(1) of the CO should be subject to the requirement that such belief must be founded on all inquiries which were reasonable in the circumstances having been made?

23. Proposal 12 - Disclosure standard and contents of prospectus

- 23.1 Prospectus disclosure addresses the imbalance of information between issuers of shares or debentures and potential investors. The CO prospectus regime is underpinned by prescribed content requirements set out in the Third Schedule to the CO, including a requirement in paragraph 3 of the Third Schedule that could be described as “the overall disclosure standard”. Formerly expressed concerns that this standard did not permit issuers to tailor their disclosures according to the nature of the securities being offered should be addressed by Section 22(a) of Schedule 1 of the CAO 2004. This amends paragraph 3 of the Third Schedule by requiring (and allowing) issuers considering prospectus disclosure to take into account the nature of the shares or debentures being offered, the nature of the company and the nature of the persons likely to consider acquiring them⁷⁸.
- 23.2 Notwithstanding this change, some market participants have observed that there is still uncertainty as to the status of the overall disclosure standard since neither it (nor indeed any other paragraph in the Third Schedule) is expressly tied to the civil and criminal liability provisions in the CO prospectus regime.

⁷⁷ See section 731 of the CA in Australia, section 255 of the SFA in Singapore, and Schedule 10 of the FSMA in the UK.

⁷⁸ Following the change introduced in the CAO 2004, paragraph 3 of the Third Schedule reads: “Sufficient particulars and information to enable a reasonable person to form as a result thereof 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, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them”.

Separately, we recognize and accept that the detailed content requirements in the Third Schedule are antiquated and need to be modernised.

23.3 We propose to move “the overall disclosure standard” into the body of the CO prospectus regime adjacent to sections 40 and 40A of the CO. The relevant provision would require that a prospectus should contain all such information that investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of:

(a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the shares or debentures; and

(b) the rights attaching to the shares or debentures,

taking into account the nature of the shares or debentures being offered and the nature of the issuer, and the nature of the persons likely to consider acquiring them.

23.4 This test places the onus on the preparers of a prospectus to provide information known to them and information that it would be reasonable for them to obtain by making inquiries. This is consistent with the initiative to make available a due diligence defence to persons who are subject to the prospectus liability regime⁷⁹. By focusing on the reasonable requirements of investors and their advisers, an overall disclosure standard is responsive to changes in market expectations and practices over time.

23.5 We also invite views on whether the CO prospectus regime should be amended to prescribe specific content requirements differentiating between shares and debentures to cater for inherent differences in the nature of the investment. As the investment considerations of equity and debt investors are different in some respects, the content requirements for prospectuses in respect of equity offerings and debenture offerings should reflect this. The prescribed content requirements should be capable of adjustment to reflect changing circumstances, and we therefore consider that they should take the form of subsidiary legislation gazetted by the SFC and subject to negative vetting by the Legislative Council. Since the content requirements prescribed for listing documents in the SEHK Listing Rules are rather more up to date than those in the Third Schedule, the new prescribed content requirements could be modelled to some degree on the relevant parts of those Rules. However, a prospectus that complies with the prescribed content requirements will not thereby automatically satisfy the overall disclosure standard referred to in paragraph 23.3. It will be necessary for the issuer to ask itself whether the prospectus does indeed contain all information that investors may reasonably require.

23.6 The International Disclosure Standards for Cross Border Offerings and Initial Listings of Equity Securities by Foreign Issuers issued by the International

⁷⁹ See Proposal 11 in paragraph 21 above.

Organization of Securities Commissions (“IOSCO”) in September 1998 establish a benchmark disclosure standard for public equity offerings. These standards are not expressed in statutory form but act as a code of common international disclosure standards. IOSCO is currently developing a set of general disclosure principles for public debt offerings which will provide an analysis of how the International Disclosure Standards for equity offerings can be relevant to public offerings and listings of “plain vanilla” debt securities issued by corporate issuers. We invite comments on whether the IOSCO International Disclosure Standards represent a useful model on which Hong Kong’s prospectus disclosure requirements could be based.

- 23.7 The discussion on whether and how to prescribe specific content requirements will need to be revisited in the light of conclusions reached in due course on proposals for a detailed set of statutory listing rules to be made by the SFC under section 36 of the SFO described in the “*Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules*” issued by the SFC in January 2005⁸⁰. It is conceivable that the specific content requirements prescribed for the CO prospectus regime would distinguish between listed and unlisted securities, and prospectuses for unlisted securities may also follow to some degree the final statutory listing rules⁸¹.

24. Overseas practices

- 24.1 Each of Australia, Singapore and the UK imposes a general disclosure obligation on issuers of prospectuses in primary legislation, similar to the one proposed in paragraph 23.3 above. The general disclosure obligation in each of these jurisdictions except Australia is supplemented either by detailed content requirements in subsidiary legislation (in the case of Singapore⁸²) or in the Prospectus Rules made by the Financial Services Authority (in the case of the UK⁸³).

⁸⁰ The SFC’s proposals would implement the Government’s decision to codify certain important disclosure requirements in the SEHK Listing Rules into subsidiary legislation. The proposed amendments would cover three areas: (i) disclosure of price-sensitive information and specific events, (ii) disclosure/publication of annual and periodic reports, and (iii) disclosure and shareholders’ approval requirements for notifiable transactions and connected transactions.

⁸¹ See also the discussion in paragraph 15.9 above concerning overlap in the CO and SFO liability regimes.

⁸² See section 243 of the SFA and the Securities and Futures (Offers of Investments) (Shares and Debentures) Regulations 2002 (as amended).

⁸³ See section 87A (1), (2) and (4) of the FSMA. As part of the implementation of the EU Prospectus Directive in the UK on 1 July 2005, the contents of prospectuses will be determined by information provided in appendix 3 to the Prospectus Rules, which are based on a “building block” approach whereby issuers combine the information in several annexes based on the nature of the securities and the type of issuer, to determine the disclosure requirements of the prospectus being drawn up. Such disclosure requirements were derived from IOSCO disclosure standards and the Consolidated Admission and Reporting Directive.

Question 12A

Do you consider that an overall disclosure standard along the lines proposed in paragraph 23.3 should be given prominence and tied specifically to the liability provisions?

Question 12B

Do you think that the overall disclosure standard should be supplemented by prescribed content requirements in subsidiary legislation differentiating between equity and debt offerings?

Question 12C

Do you think that the International Disclosure Standards for Cross Border Offerings and Initial Listings of Equity Securities by Foreign Issuers issued by IOSCO serve as a useful model on which to base Hong Kong's prospectus disclosure standards?

25. Proposal 13 – Disclosure for Rights Issues

- 25.1 Sections 38(5) and 342(5) of the CO disapply the prospectus content requirements in sections 38(1) and 342(1) respectively, including those requirements in the Third Schedule to the CO, for a prospectus offering shares or debentures to existing members or debenture holders of the company, and a prospectus offering shares or debentures which are or are to be uniform in all respects with shares or debentures previously issued and for the time being listed on SEHK.
- 25.2 We feel that it is not appropriate for these transactions to be entirely exempt from disclosure regulation in this way. 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 the information they need to assess the offer will usually be less than that needed to assess an initial public offering or IPO. A similar case can be made for issues of securities of a class already listed. The SEHK Listing Rules impose disclosure requirements in the case of rights issues relating to listed shares⁸⁴, and there is no reason why legislation should take a materially different approach.
- 25.3 The rather unsatisfactory nature of the current position is compounded by the fact that in disapplying all content requirements (not least paragraph 3 of the Third Schedule, which contains “the overall disclosure standard”) it is not clear quite how liability for omissions (under sections 40 and 40A) of the CO could attach to a prospectus relating to a rights issue.

⁸⁴ Unlike for shares, Chapter 25 of the SEHK Listing Rules does not specify that the rights offer document for debentures may omit specific items of information set out in Appendix 1C. See SEHK Listing Rules 25.06 and 25.08.

25.4 We propose that reduced (as distinct from negligible) disclosure obligations prescribed in subsidiary legislation should apply to: (i) prospectuses for rights issues of shares and debentures (on the basis that they are offers to existing members or debenture holders of the company who can be taken to be sufficiently knowledgeable about the affairs of the company to evaluate the merits and risks of the offer); and (ii) prospectuses for offers of shares or debentures that are of a class already listed (because material information should be available in relation to such securities through the continuous disclosure rules in the SEHK Listing Rules). In both cases, the overall disclosure standard referred to in paragraph 23.3 would apply.

26. Overseas practices

26.1 Neither the UK nor Australian regimes appears to have carve-outs for rights issues of shares. The CA in Australia, however, provides that an offer of a body's debentures for issue does not need disclosure if the offer is made to one or more existing debenture holders⁸⁵.

26.2 Currently in Singapore an unlisted rights issue (whether or not renounceable in favour of persons other than existing members/debenture holders) is not treated as an offer to the public requiring a prospectus⁸⁶. A listed renounceable rights issue offer is deemed to be an offer to the public requiring an offer information statement⁸⁷. The content requirements for an offer information statement are not as detailed as those for a full-blown prospectus. An offer to the public of shares or debentures that have not been previously issued and are, or are to be, uniform in all respects with shares or debentures previously issued and listed on a stock exchange may be made with an offer information statement and the prospectus requirements of the SFA do not apply to such offer for a period of six months from the date of lodgement of the offer information statement with the Monetary Authority of Singapore and the stock exchange⁸⁸. With the entry into force of the Securities and Futures (Amendment) Act 2005 (currently expected to be in the third quarter of 2005), an unlisted rights issue will continue to fall outside the offering regime of the SFA. An offer of securities issued by a listed entity, whether pursuant to a rights issue or otherwise, will be permitted with an offer information statement. The Monetary Authority of Singapore has the power to exclude complex securities from this exemption.

Question E3

Do you consider that rights issues and issues of shares or debentures which are uniform in all respects with listed shares or debentures should not be entirely exempt from the content requirements of the prospectus regime?

⁸⁵ See section 708(14) of the CA.

⁸⁶ See section 239(6)(b)(ii) of the SFA.

⁸⁷ See section 256 of the SFA.

⁸⁸ See section 277 of the SFA.

27. **Proposal 14 - Incorporation by reference**

27.1 The CO prospectus regime does not permit incorporation by reference (i.e. the incorporation in the prospectus of information located outside the prospectus). The legislation provides that a prospectus must satisfy or be exempted from the content requirements prescribed in the CO. In some cases, the disclosures require a large amount of information to be provided in the prospectus. This may result in documentation that is not readily comprehensible or user-friendly. Prospectus length and complexity are of particular concern to investors who do not customarily read technical information. We consider that the law should facilitate the presentation of information to retail investors in a manner best suited to their needs, while more technical information should be available to institutional and other interested investors, securities analysts and other professionals who wish to avail themselves of this information.

27.2 Allowing incorporation by reference under certain conditions may enable some issuers to substantially shorten prospectuses whilst ensuring that investors receive fair notice of matters that are important to them. Those investors who wish to study the additional materials referred to in the prospectus would be able to view and obtain these through a readily accessible central repository.

27.3 We propose to introduce an enabling provision into the CO prospectus regime under which information lodged with a central online document repository can be incorporated into a prospectus if:

- (a) the prospectus includes sufficient information about the contents of the incorporated information (including a statement as to whether it is of a type primarily of interest to professional advisers) or a summary of the incorporated information, to allow investors to decide whether to obtain a copy; and
- (b) the prospectus includes a statement that the issuer will provide a copy of the incorporated information free of charge on request.

In order to have sufficient assurance that information incorporated by reference is reliable, it would be necessary to impose upon any such information the same standard of civil and criminal liability as applies to prospectuses.

27.4 Implementation of this proposal will, however, depend upon the establishment in Hong Kong of a central online document repository, possibly similar to EDGAR in the United States. There would also seem to be no reason why the same facility should not be extended to the SFO investment advertisement regime.

28. **Overseas practices**

28.1 In Australia, incorporation by reference is permitted provided that a description of the incorporated document (including, where the information is

of a type primarily of interest to professional advisers, a statement to that effect) is contained in the prospectus. In any other case, incorporation by reference is allowed provided that sufficient information about the contents of the incorporated document (for the purpose of allowing investors to decide whether to obtain a copy of the document) is contained in the prospectus⁸⁹. In Singapore, incorporation by reference is not contemplated under the law. In the UK, as part of the implementation of the EU Prospectus Directive on 1 July 2005 incorporation by reference is permitted in limited circumstances. Issuers may incorporate information in a prospectus by reference to one or more previously or simultaneously published documents only if such documents have been approved by or filed with or notified to the Financial Services Authority, and is presented in an easily analysable and comprehensible form. Documents that may be incorporated by reference into prospectuses include instruments of incorporation and accounts filed with the Financial Services Authority under the Consolidated Admission and Reporting Directive⁹⁰.

Question 14

Do you agree that a provision should be introduced in the CO prospectus regime to enable incorporation by reference (subject to certain conditions) upon the establishment of a central online document repository?

29. **Proposal 15 – Pre-deal research**

- 29.1 As part of this review of the regulatory framework for offers of shares and debentures we have considered the practice of publishing research before the issue of the prospectus relating to a company's initial public offering (or IPO). The issue of pre-IPO research by "connected analysts"⁹¹ has been a feature of the Hong Kong securities market for many years. This practice provides a valuable and concise source of information designed to enable a prospective investor to make an investment decision with respect to the company undertaking an IPO. Pre-IPO research will contain more background on the industry sector and macro environment (including analysis of competitors and comparative valuations) than the company's prospectus, highlight the company's strengths and weaknesses and offer the analyst's opinion and insight. Pre-IPO research is especially valuable in markets where there are few locally listed comparables and information on unlisted companies is scarce.

⁸⁹ Section 712 of the CA.

⁹⁰ See Rule 2.4 of the Prospectus Rules made by the Financial Services Authority.

⁹¹ For the purposes of this Consultation Paper "connected analysts" means analysts who are employed by a sponsor, manager or underwriter to the offering (or by a related company). As there will usually be little or no public information relating to the prospective issuer and its business during the pre-IPO stage, connected analysts are generally the only persons with access to the information required to publish research reports.

- 29.2 Hong Kong securities legislation does not expressly deal with pre-deal research reports. However, if such a report is “calculated to invite offers”⁹² by the public to subscribe for or purchase shares or debentures it would constitute a prospectus under the CO prospectus regime and be regulated in the same way as a conventional prospectus. Where a pre-deal research report does not constitute a prospectus within the meaning of the CO, it may nevertheless constitute an investment advertisement and its distribution is likely to be subject to potential statutory liability. Although research reports may be exempt from the prohibition on the issue or distribution of investment advertisements in section 103(1) of the SFO⁹³, they may be subject to the criminal and civil liability provisions of sections 107/108 and 277/298 of the SFO for any falsehood or misrepresentation contained in them or communicated in a related sale or purchase transaction.
- 29.3 Current practice in Hong Kong relating to pre-IPO research differs among investment banks and intermediaries involved in the IPO process. While many believe it to be an important component of the process of bringing a company to market⁹⁴, all issuers of pre-deal research apply controls to their research function, and some confine the communications concerning a listing applicant between connected analysts and their clients to visual presentations and verbal exchanges only. These differences are dictated by business, legal and regulatory, and ethical and philosophical⁹⁵ considerations, and reflect the material impact of civil litigation, criminal prosecution and enforcement, and disciplinary initiatives by regulators in recent years on the role and conduct of research analysts and their relationship with the investment banking team arranging the IPO. Notwithstanding the different practices, most investment banks value the function performed by connected analysts in an IPO, and the following paragraphs describe the broad processes applied to pre-IPO research, as we understand them.
- 29.4 The analyst would, based on information provided by the company or contained in the draft prospectus, devise his own valuation model for the

⁹² The SFC understands that “calculated to invite offers” is taken to mean “likely to invite offers”.

⁹³ Sections 103(2)(a) and 103(3)(k) may provide an exemption for research reports, on the basis that they are issued by licensed intermediaries or relate to securities to be sold only to professional investors.

⁹⁴ Those supporting the use of pre-deal research argue that it plays an important role in price formation and results in an informed institutional investor base; this leads to IPOs being accurately priced and assured of solid institutional support. Without institutional investor support from an early stage in the planning process, many IPOs would not get off the ground, and the capital markets would look very different. These favourable circumstances necessarily flow through to and benefit retail investors and the economy as a whole. They also argue that institutional investors are familiar with the analytical and judgmental processes underlying pre-deal research and recognize that these distinguish the reliability of information in pre-deal research reports from that in the conventional prospectus. They are therefore well placed to understand the different status of the information in the research report in the context of the offer.

⁹⁵ Some recognize that if there are material differences in the level or nature of information in the research reports and the conventional prospectus, then one of the documents is incomplete, misleading or wrong. Others struggle with the notion that by issuing pre-deal research only to qualified institutional investors they are introducing an undesirable disparity in the quality of information and level of service provided to their clients.

company and then apply that model to prepare forecasts for the next 3-5 years. This research is communicated by the analyst to his clients by way of a written report or through verbal presentations and conversations. Commonly "pre-marketing" or "investor education" follows, during which the analyst would discuss the company's forthcoming IPO and the analyst's valuation and forecasts with clients and prospective investors. The investors' views concerning the valuation are usually fed back by the analyst to the investment banking team and factored into the determination of a realistic price or price-range for the IPO. The dissemination of research and the investor education process occur late in the IPO process, often just a short time before the publication of a "red-herring" or "pathfinder" prospectus and launch of the roadshow.

- 29.5 In response to regulatory and investor concerns as to the independence of connected analysts, it is now common for there to be detailed procedures and other measures to safeguard the analyst's independence and to address potential conflicts of interest arising from the analyst's function in the IPO. Once preparation of the research report has begun these measures may involve the interposition of a "control room" (usually in the investment bank's legal or compliance department) to vet all information crossing the "Chinese" wall between connected analysts and the investment banking team. Where conversations take place between connected analysts and the investment banking team, they are commonly held in the presence of a legal or compliance department "chaperone".
- 29.6 It is common for investment banks to seek to assure themselves of the factual accuracy of their research by arranging for the analysts to contact the company to verify factual matters or for the banks' external lawyers to check the research report against the draft prospectus for factual inaccuracies. Some banks allow their investment banking team to read the draft report and inform the company of the connected analysts' views. The investment banking team would usually not be permitted to discuss the draft report with the connected analysts and would not be allowed to influence the connected analysts' views. This contact is again usually monitored by the "control room" to ensure that no comments from the company or the investment banking team regarding the research and company valuation, and nothing other than particulars of factual inconsistencies, are passed on to the analysts.
- 29.7 Steps such as those described above are designed to reassure clients and prospective investors as to the independence and objectivity of pre-IPO research by connected analysts. These are supplemented by measures to prevent the leakage of information in research reports and address the risk that research reports may technically be prospectuses. Thus, research guidelines issued by external lawyers acting for the investment banks involved in the IPO recommend a range of practices to provide assurance that the applicable legal and regulatory requirements are met. Hong Kong follows the overseas practice of observing a research "black-out", when the connected analysts subject themselves to a quiet period between the publication of their research reports and the registration of the definitive IPO prospectus. Also, the dissemination of research reports will be controlled, for example through the

maintenance of a list of recipients, the use of serially-numbered copies, and the imposition of restrictions on recipients, including prohibitions on disclosure of reports or contents of research to third parties.

29.8 The research function of investment banks gives rise to a range of legal and regulatory issues. In 2004, the SFC consulted the market on issues relating to the structure and treatment of the research function within investment banks and the independence of analysts. These can be seen as matters bearing on the fitness and properness of licensed persons under the SFC's *Code of Conduct for Persons Licensed by or Registered with the SFC*. The consultation conclusions and relevant amendments to the Code of Conduct were published in November 2004 and the new requirements came into effect on 1 April 2005. This Consultation Paper, by contrast, is concerned solely with proposals for changes to the CO prospectus regime. In the context of the CO prospectus regime the publication of pre-IPO research reports in Hong Kong gives rise to the following concerns:-

- (a) an IPO prospectus is required to provide all particulars and information that a prospective investor may reasonably require in order to form a valid and justifiable opinion of the company and the securities being offered. This information is given within a strictly controlled framework to ensure it is accurate and may be relied upon. The directors of the company take responsibility for the accuracy of this information. If the safeguards described in paragraphs 29.5 – 29.7 inadvertently fail or are breached, pre-IPO research reports produced by connected analysts could become a vehicle for the company to disseminate material information relating to an offer (such as a longer-range profit forecast) without formal prospectus liability⁹⁶;
- (b) information outside the prospectus does not form part of the offer and the directors assume no responsibility for it under the CO prospectus regime. This framework is undermined if information that will be in the prospectus leaks ahead of the publication of the prospectus (because the leaked information is not presented in context) and particularly if non-prospectus information is published (because the information is not provided by the company, may not be adopted or endorsed by the company, and is therefore unreliable in the context of the offer). Extracts of non-prospectus information from pre-IPO research reports leaked to the media prior to or during the offer period may present a view of the company which is not supported by the prospectus, and may condition the market before the prospectus is published. Retail investors are not in a position to distinguish between

⁹⁶ As alluded to in paragraph 29.2 above, if a pre-deal research report is issued entirely independently of the offering, liability for misleading statements and material omissions is likely to rest only with the investment bank issuing the report (not with the directors and company issuing the prospectus) under the SFO (not the CO). The presence of two different sources of information relating to an offer and two different liability regimes obscures the status and reliability of the information in the market.

prospectus and non-prospectus information and this will confuse their perception of the offer⁹⁷.

- (c) given the key role it plays in the IPO process and that it is written by the investment banks bringing the company to market, there must be a risk that a research report is “calculated to invite offers” and is accordingly a prospectus to which the CO prospectus regime should apply⁹⁸.

29.9 We invite discussion and views on the approach to be taken in order to address the concerns raised in paragraph 29.8 above. While the concerns in paragraph 29.8(a) may be reduced or removed where the content of the analyst’s report is not at all influenced by the company or the investment banking team, the steps taken to check the accuracy of the research report or consistency with the prospectus, and the feedback from the “investor education” stage may obscure or undermine this picture. Also, the original source of the material, the connected nature of the analysts, and the timing of issue and use of pre-IPO research reports all tend to support the case that the report is a selling document, giving rise to the concern in paragraph 29.8(c).

29.10 Given the ease with which research reports circulate in a printed or electronic format, the greater credibility afforded to written communication, and the appetite among prospective investors and the media in Hong Kong for information relating to upcoming offers, it is likely to be impractical to restrict the dissemination of research reports to an institutional investor base able to distinguish appropriately the research report from the prospectus. The possibility of deliberate leakage of research to ensure market conditioning ahead of the IPO also cannot be discounted because of the collective interest that the company, its investment banks and prospective investors have in ensuring a successful IPO. Despite the steps taken by those seeking to comply with the legal and regulatory framework, experience in recent years suggests that leakage of pre-IPO research is an almost inevitable feature of Hong Kong IPOs. This would suggest that the concern expressed in paragraph 29.8(b) will be very difficult to address in practice.

29.11 There are likely to be a number of ways to address one or more of the problems described above, and we welcome suggestions as to what these may be. In recent commentary on this subject in the media it was argued that the solution to this problem lies in mandating publication of all pre-IPO research

⁹⁷ Those supporting the use of pre-deal research argue that institutional investors are familiar with the analytical and judgmental processes underlying pre-deal research and this knowledge enables them to distinguish the status and reliability of information in pre-deal research reports and in the conventional prospectus. They are therefore well placed to understand the different status of the information in the research report in the context of the offer. The same cannot be said, with any confidence, of retail investors who do not see a copy of the research reports and are widely exposed to unattributable journalism published in the media.

⁹⁸ The case for this argument increases where the safeguards described in paragraphs 29.5 – 29.7 fail or are breached and the investment banking team is in a position to influence the research into a form designed to sell the offering. Even in the absence of any such compliance failure, the mere fact that the research is issued in connection with the offering by analysts affiliated with those promoting the offering tends to support an argument that research must be designed to sell the offering.

reports so that all investors have the benefit of the analysis contained in them. We are not sure that this is the answer. Routine publication of pre-IPO research will have profound liability implications for the issuer of the research and may discourage its publication. Also formalising the status of pre-IPO research in this way runs counter to a fundamental principle underpinning the CO prospectus regime, that offers of shares and debentures are made solely on the basis of the registered prospectus and there should not be other relevant (or conflicting) information presented to prospective investors that is not contained in the registered prospectus. Finally, formalising the issue of pre-IPO research reports may severely test the safeguards described in paragraphs 29.5 – 29.7 and increase the risk that these will become a vehicle for the company to disseminate material information relating to an offer without formal prospectus liability.

- 29.12 To promote comments and discussion on this topic, we highlight two possible responses. First, to ensure that investors are left in no doubt as to the status of information appearing in the media in the context of the formal offer, the introduction of a regime that requires that (i) where any such information emanates from pre-IPO research reports then all pre-IPO reports by connected analysts dealing with the relevant matter shall be published immediately to the market at large accompanied by appropriate disclosure as to the independent nature of the material, the procedures undertaken to ensure its accuracy and reliability, and the identity of the person or persons legally responsible for its contents and (ii) irrespective of its source, the company shall be required to record and address, in a section of the prospectus or (where the prospectus has already been issued) in a supplemental prospectus, all information in the media that does not appear in the company's prospectus.
- 29.13 The second possible response is a ban on written pre-IPO research reports by connected analysts. Verbal communications with institutional clients over the telephone or in meetings and use of visual media in a non-printable format such as flipcharts would not be affected, and in a "transaction-based" regime (as contemplated by Proposal 2) this would form the basis of an exemption.
- 29.14 We particularly invite views on the implications of these two possible approaches for the current IPO process. Consideration could be given to whether formalising the use of "red-herring" or "pathfinder" prospectuses (i.e. a near-final draft of the prospectus which conventionally only omits pricing and related financial information) and permitting their dissemination to institutional investors at an earlier stage than is now the norm may serve to alleviate some of the consequences of a ban on written pre-IPO research by connected analysts. (We note in passing that this may open the way for written pre-IPO research to be issued by analysts that are entirely independent from the proposed offer.) Finally, we invite views on whether the difficulties surrounding the issue of pre-IPO research reports described above arise in the case of pre-deal research issued with respect to follow-on offers to the public by issuers that have a listing and comply with requirements on continuous disclosure of material information.

30. Overseas practices

- 30.1 In Australia, advertising or promotional activity during the pre-IPO stage is heavily regulated⁹⁹. Section 734(2) of the CA contains the general prohibition against advertising or publicity for securities offers which require a disclosure document¹⁰⁰. Pre-deal research reports profiling the issuer whose securities are to be offered (in respect of which disclosure is required under the CA) can be issued by independent persons¹⁰¹ subject to certain conditions being met without contravening the advertising restrictions in the CA.
- 30.2 In Singapore, independent pre-deal research reports¹⁰² in respect of offerings of shares or debentures are exempted from the general prohibition against advertisements and publicity statements contained in section 251 of the SFA¹⁰³, but pre-deal research reports prepared by connected analysts are subject to the advertising prohibitions in the SFA, much as in the Australian model. The Securities and Futures (Amendment) Act 2005 (currently expected to come into force in the third quarter of 2005) will permit pre-deal research reports by connected analysts to be sent to institutional investors not later than 14 days prior to the date of the lodgement of the prospectus where the offer is made concurrently in Singapore and one or more other countries, and where pre-deal research is permitted in the other country or one of the other countries¹⁰⁴. The legislation includes provisions to restrict circulation of such reports to the intended audience.
- 30.3 In the UK, pre-deal research reports are prohibited by the financial promotions regime under the FSMA unless they are issued or authorised for issue by an authorised person or fall into specified exemptions (e.g. distribution to investment professionals, or high net worth companies or overseas recipients)¹⁰⁵.

⁹⁹ See section 734 of the CA.

¹⁰⁰ There is also a prohibition in section 734(1) of the CA on advertising personal small scale offerings which do not require a disclosure document pursuant to the exemption in section 708(1) of the CA. A person is prohibited from advertising or publishing a statement that directly or indirectly refers to such offers. The exemptions under sections 734(4) to 734(7) only apply to the prohibition under section 734(2) and not section 734(1).

¹⁰¹ Section 734(7)(e) of the CA expressly permits independent reports referring to a proposed securities offer to be published before a prospectus is lodged subject to certain conditions. For example, the report must not be published by certain named categories of persons connected in some way with the issuer or who has an interest in the success of the securities offer, and the person publishing the report must not receive or be entitled to receive a benefit or consideration from any person interested in the securities offer before or after the report is published. See also ASIC Policy Statement [PS 158] "*Advertising and publicity for offers of securities*" issued on 17/12/2000.

¹⁰² This means a research report published by someone who is not connected to the offeror and who does not have an interest in the success of the offer.

¹⁰³ See section 251(9)(e) of the SFA. This exemption does not apply if any person gives consideration or any other benefit for publishing the report: see section 251(11) of the SFA.

¹⁰⁴ See proposed section 251(9)(g) of the Securities and Futures (Amendment) Act 2005.

¹⁰⁵ See section 21 of the FSMA. There are exemptions from the financial promotions regime for communications made to investment professionals (as defined under Article 19 of the FSMA (Financial Promotion) Order 2005), certified high net worth individuals (as defined under Article 48 of the Order), high net worth companies, unincorporated associations or partnerships under Article 49 of the Order and overseas recipients under Article 12 of the Order.

Question 15A

What are your views on (i) a requirement to publish leaked pre-IPO research by connected analysts coupled with commentary by the company in the prospectus on information that does not already appear in the prospectus; and (ii) a prohibition on the issue of written pre-IPO research reports by connected analysts? If you think there is an alternative way to address the concerns in paragraph 29.8, please describe it.

Question 15B

Do you consider that pre-deal research in the case of a follow-on offering gives rise to the concerns described in paragraph 29.8 such that it should be treated in the same way?

31. Proposal 16 - Supplemental prospectus and right of withdrawal

- 31.1 Before the commencement of the CAO 2004 there was no provision in the CO prospectus regime for the issue of supplemental prospectuses. The CAO 2004 introduced a framework permitting a prospectus to be amended or supplemented by an addendum or replaced by a new prospectus, with such addendum or new prospectus being treated as a separate prospectus requiring registration¹⁰⁶. The legislation currently neither requires the issuer to publish a supplemental prospectus nor gives applicants a right to withdraw their applications. However, if a development is sufficiently material to warrant the publication of a supplemental prospectus, then it is hard to resist the conclusion that these consequences should follow.
- 31.2 In order to ensure that up-to-date and accurate information is available to investors prior to making their investment decision (or, alternatively, prior to the allotment or issue of the shares or debentures), we propose that the law should impose an obligation on issuers of prospectuses to publish an addendum or replacement prospectus if, before the close of the offer period (or, alternatively, before the shares or debentures are allotted or issued), they become aware of a significant change affecting any of the prospectus disclosures, or a significant new matter arises which would have been required to be disclosed in the prospectus. "Significant" for the purposes of this proposal will mean significant in terms of making an informed assessment of the kind referred to in paragraph 23.3 above.

¹⁰⁶ See sections 39A and 342CA of, and the Twentieth Schedule to, the CO.

31.3 Views are also sought on a framework that contemplates that upon the publication of a supplemental or replacement prospectus issuers will be required to extend the offer period by a specified minimum period during which applicants will be notified of the publication and details of availability of the supplemental or replacement prospectus (or, alternatively, be given the supplemental or replacement prospectus) and have the right to withdraw their applications and be repaid in full. This will enable applicants to have an adequate opportunity to evaluate the supplemental or amended information and decide whether to withdraw their application, and where applicable, submit a new one.

32. Overseas practices

32.1 In Australia, if the offeror becomes aware of a misleading or deceptive statement in, or omission from, a prospectus, or a new circumstance has arisen which would have required disclosure, and such statement, omission or new circumstance is materially adverse from an investor's viewpoint¹⁰⁷, an applicant is given either:

- (a) a refund of his application monies or;
- (b) a supplementary or replacement prospectus and the right to withdraw his application within one month and be repaid (where securities have not been issued or transferred pursuant to the prospectus). Where the securities have been issued or transferred, the investor has the right to return the securities and to have their application money repaid¹⁰⁸.

Singapore features a broadly similar system¹⁰⁹.

32.2 In the UK, a statutory obligation is imposed on an offeror to issue a supplemental prospectus if, before the commencement of dealings (in the case of listed offers) or at any time while an agreement can be entered into in pursuance of an offer contained in a prospectus (in the case of unlisted offers), it becomes aware of a significant change affecting any matter contained in the prospectus or a significant new matter arises which would have required disclosure¹¹⁰. No statutory right of withdrawal is conferred on applicants upon the publication of a supplementary prospectus.

¹⁰⁷ Section 724 of the CA.

¹⁰⁸ Section 737 of the CA.

¹⁰⁹ Section 241 of the SFA. Upon the entry into force of the Securities and Futures (Amendment) Act 2005 (currently expected to be in the third quarter of 2005), the issuer is afforded the alternative of informing applicants by notice in writing as to how to obtain, or arrange to receive, the correcting document.

¹¹⁰ Section 87G of the FSMA.

Question 16A

Do you consider that there should be a statutory obligation on issuers of prospectuses to publish a supplemental or replacement prospectus if they become aware of a significant change affecting any of the prospectus disclosures?

Question 16B

Do you think that this obligation should apply until the close of the offer period or the actual allotment and issue of the applicable shares or debentures?

Question 16C

Do you think that issuers should:

- extend the offer period upon publication of a supplemental or replacement prospectus in order to allow applicants sufficient opportunity to evaluate the supplemental or amended information. If yes, by how many days do you think the offer period should be extended?*
- notify applicants of the publication and availability of the supplemental or replacement prospectus or give applicants a copy of the supplemental or replacement prospectus; and*
- give applicants a right to withdraw their applications and be repaid?*

33. Proposal 17 - The 3-day rule

- 33.1 Section 44A(1) of the CO requires that no proceedings shall be taken on applications for allotment of shares and debentures until the third day after the prospectus is issued. With the commencement of the CAO 2004, the time limit under the existing section 44A(1) of the CO governing allotment may be waived by the SFC pursuant to sections 38A(1) and 342A(1)¹¹¹ of the CO. Some market participants have suggested that the 3-day rule should be removed to allow maximum flexibility for issuers and to facilitate immediate allotment of shares or debentures.
- 33.2 The rationale behind the 3-day rule is to allow the press to comment on, and the general public to obtain advice on, to consider, and to apply for, the shares or debentures on offer. We consider that this requirement should be retained in the case of offers of unlisted shares or debentures and initial public offers of shares or debentures to be listed. Indeed, given the volume of information contained in prospectuses there is a strong case for extending the minimum period between the dates on which the prospectus is made available and the offer closes. In the case of public offers of unlisted debentures and offers subject to the Hong Kong Codes on Takeovers and Mergers and Share

¹¹¹ See sections 38A(4)(a) and 342A(4)(a) of the CO.

Repurchases, prospective applicants are given at least 14 days to read the offer document and make a decision on whether to invest. In this context, we invite consideration of whether permitting and regulating the public use of “red-herring” or “pathfinder” prospectuses (i.e. a near-final draft of the prospectus which conventionally only omits pricing and related financial information) for a short period before the offer opens may appropriately address or reduce concerns in this area.

- 33.3 In the case of allotment of shares or debentures of a class already listed, there may be scope for disapplying the waiting period requirement on the basis that the issuer is subject to continuous disclosure requirements under the relevant listing rules which are designed to ensure that material information is disclosed to the market.

34. Overseas practices

- 34.1 Australia¹¹² has a similar waiting period requirement in its legislation, but is applicable to unlisted/unquoted securities only.

Question 17A

Do you consider that the 3-day waiting period in the prospectus regime for allotments should be extended in the case of initial public offers of shares or debentures (whether to be listed or unlisted)?

Question 17B

Do you think that the 3-day waiting period in the prospectus regime for allotments should not apply to public offers of shares or debentures in the same class as those already listed?

35. Proposal 18 - Application forms and procedures

- 35.1 Section 38(3) of the CO prohibits the issue of any form of application for shares or debentures unless the form is issued with a prospectus that complies with the requirements of the CO prospectus provisions¹¹³. The scope of this prohibition is unclear, particularly as regards whether (i) the “form of application” is confined to one issued by the issuer of the prospectus or extends to a form issued by an intermediary and (ii) persons other than the issuer of the prospectus can commit the offence.
- 35.2 We consider that since the prospectus contains material information relating to the offer, any application form or application procedure should be accompanied by or provide access to the relevant prospectus in all circumstances. We propose to extend the scope of regulation regarding the

¹¹² See section 727(3) of the CA and Class Order 00/168 – Relief from Exposure Period: Quoted Securities.

¹¹³ See sections 38(3) and 342(3) of the CO.

distribution of application forms for shares or debentures to any type of application form or application process and to any person engaging in their distribution or implementation. The CO prospectus regime would expressly provide that all offers of shares or debentures, and all distribution or implementation of an application or invitation, will be prohibited unless such offer, application or invitation is accompanied by or contained in a prospectus which complies with the prospectus provisions or is otherwise exempted.

- 35.3 Under a framework of this kind it would be appropriate to provide for guidelines to clarify how the statutory requirement could be satisfied in specified circumstances. For example, in an Internet environment it may be reasonable to hyperlink either directly to an electronic version of the full prospectus; or where direct access in this way is not available it may be adequate to hyperlink to the home page of a website on which an electronic version of the full prospectus is posted and provide detailed navigation instructions to the webpage containing the prospectus and a warning that other information on the website does not form part of the prospectus.

36. Overseas practices

- 36.1 In Australia, the CA provides that an offer of securities for which disclosure is required under the CA (or distribution of an application form for such an offer) is prohibited unless the offer (or application form) is contained in or accompanied by the disclosure document¹¹⁴, and the securities can only be issued or transferred in response to an application form where there are reasonable grounds to believe that the form was contained in or accompanied by the disclosure document¹¹⁵.
- 36.2 Singapore adopts an approach similar to Australia, by prohibiting offers to, or invitations to, the public to subscribe for or purchase, shares and debentures, unless it is made in or accompanied by a prospectus prepared in accordance with the provisions of the SFA¹¹⁶.
- 36.3 In the UK, the relevant statutory provisions do not expressly deal with application forms but provide that an approved prospectus must be made available before an offer is made to the public¹¹⁷.

Question 18

Do you consider that the distribution of application forms or implementation of application procedures for shares or debentures by parties other than the issuer of the prospectus should be regulated along the lines suggested in paragraph 35.3 above?

¹¹⁴ See section 727(1) and (2) of the CA.

¹¹⁵ See section 723(1) of the CA.

¹¹⁶ See section 240 of the SFA.

¹¹⁷ See section 85 of the FSMA.

37. Proposal 19 - Statements in lieu of prospectus

- 37.1 Section 43 of the CO provides that a company that has not issued a prospectus on its formation, or has issued such a prospectus but has not proceeded to allot any of the shares offered to the public for subscription upon it, is prohibited from allotting any of its shares or debentures until it has registered a statement in lieu of prospectus containing the information specified in section 43(1) of the CO.
- 37.2 This provision, which is rarely used in practice, was originally introduced as an anti-avoidance measure to address the possible avoidance by companies of their prospectus disclosure obligations by disposing of large blocks of shares by means of placings, which are then on-sold by the original allottee to the public.
- 37.3 We believe that this provision is redundant since the concern that it was intended to address is covered by the existing anti-avoidance provision in section 41 of the CO, and propose to repeal it. If Proposal 7 in paragraph 13 above is pursued, and section 41 of the CO is repealed, the proposed new anti-avoidance mechanism will continue to cover this type of situation.

38. Overseas practices

- 38.1 None of the UK, Australia and Singapore has any provision similar to that in section 43 of the CO while both Australia and Singapore have anti-avoidance provisions in their respective legislation¹¹⁸.

Question 19

Do you agree that section 43 of the CO relating to statements in lieu of prospectus should be repealed?

39. Proposal 20 - Employee offers

- 39.1 Offers to employees and their dependants are often treated as a matter of “domestic concern” for the purposes of the existing section 48A of the CO. Such offers would therefore not be an offer to the public and are not regulated under the CO prospectus regime.
- 39.2 Since the commencement of the CAO 2004, offers of shares or debentures in a company to employees of such company or another group company (and their dependants) benefit from one of the exemptions set out in the new Seventeenth Schedule to the CO¹¹⁹. Offer documents in respect of such offers are excluded from the definition of “prospectus” and fall outside almost all of the CO prospectus regime.

¹¹⁸ See paragraph 14 of this Consultation Paper for a discussion of the anti-avoidance regime in each of these jurisdictions.

¹¹⁹ See section 8 of Part 1 of the Seventeenth Schedule to the CO.

- 39.3 The rationale for exempting offers to employees is premised on the existence of a special relationship between the company and the employee (and their dependants through the employee), who can reasonably be taken to have sufficient knowledge about the company so as to make a decision whether to invest. Largely exempting offers to employees and their dependants from the CO prospectus regime is in line with practices in other international markets and such exemption should be retained.
- 39.4 Suggestions were made by the Bills Committee (“Bills Committee”) responsible for the scrutiny of the CAO 2004 that there be public consultation on whether to introduce the following measures to regulate offers to employees and their dependants to avoid the risk of exploitation of their interests:-
- (a) a separate regulatory regime to govern offers to employees (and their dependants); and
 - (b) a requirement that the directors and auditors of the company whose shares or debentures are being offered must, in respect of an exempt offer to employees (and their dependants), provide a declaration as to solvency and going concern of the company.
- 39.5 We undertook to consult the market on this matter.

40. **Overseas practices**

- 40.1 The relevant legislation¹²⁰ of Australia, Singapore and the UK provide for exemptions for offers to employees and their dependants which are similar or comparable to the provisions of section 8 of Part 1 of the Seventeenth Schedule to the CO, and none of these jurisdictions provides for a separate regime regulating such offers nor impose any requirement for the provision of a declaration of solvency or going concern by the directors or auditors of the relevant company in respect of such offers.

Question 20

Do you think that:-

- (a) there should be a separate regulatory regime to regulate offers to employees and their dependants?*
- (b) we should introduce a requirement for the provision of a declaration of solvency and going concern by the directors and auditors of a company whose shares or debentures are being offered to employees or dependants?*

¹²⁰ See section 708(12) of the CA in Australia, section 273(4) of the SFA in Singapore and section 85(5)(b) of the FSMA and Rule 1.2.2(5) of the Prospectus Rules made by the Financial Services Authority.

41. Proposal 21 - Void or voidable transactions

- 41.1 Civil and/or criminal liability may attach to the issue or sale of securities in contravention of the disclosure requirements¹²¹. Suggestions were made by the Bills Committee that there be public consultation on whether to introduce the concept of rendering an issue or sale of securities in contravention of the law as a void or voidable transaction.
- 41.2 The Bills Committee's suggestion may already be addressed by section 213 of the SFO which empowers the SFC to apply to the Court of First Instance for a range of orders and other relief against any person who has contravened or may contravene any of the provisions of the SFO or the relevant provisions relating to prospectuses contained in Parts II and XII of the CO. The scope of the SFC's power in respect of persons against whom the SFC may initiate proceedings for such orders also includes persons who have aided or participated in the contravention. The range of orders that may be granted by the court includes an order declaring a contract relating to any securities to be void or voidable, an order requiring any person involved in the contravention to take such steps to restore the parties to any transaction to the position in which they were before the transaction was entered into, as well as other injunctive orders.
- 41.3 We undertook to consult the market on this matter.

42. Overseas practices

- 42.1 None of Australia, Singapore and the UK has a general provision in the law providing that an issue or sale of securities effected in contravention of the disclosure requirements would result in the issue or sale being void or voidable.
- 42.2 In Australia, the courts have powers under the CA to declare a contract void or to make other appropriate orders where a person has suffered or is likely to suffer loss or damage as a result of conduct that contravenes the fundraising provisions contained in Chapter 6D of the CA¹²².
- 42.3 In the UK, the courts have power, on application by the Financial Services Authority or the Secretary of State, to grant an order for restitution if the court is satisfied that a person has breached a relevant requirement of the FSMA or been knowingly concerned in the contravention¹²³.

¹²¹ See Proposal 8 in paragraph 15 above for a description of the liability arising for misstatements in a prospectus.

¹²² See section 1325 of the CA.

¹²³ See section 382 of the FSMA and the Financial Services Authority Handbook, Chapter 9, "Enforcement – Restitution and redress". See also section 383 of the FSMA (which empowers the court to order restitution in cases of market abuse) and section 384 of the FSMA (which empowers the Financial Services Authority to order restitution for breaches of relevant requirements and market abuse).

- 42.4 In Singapore, the courts may, on application by the Monetary Authority of Singapore, a securities or futures exchange or a clearing house, make an order restraining a person from acquiring, disposing of or otherwise dealing with any securities or trading in any futures contract, or an order declaring a contract relating to any dealing in securities or trading in futures contract to be void or voidable, if it appears to the court that a person has committed an offence under the SFA, or contravened the conditions or restrictions of a licence or the rules of the securities or futures exchange or the clearing house.¹²⁴

Question 21

Do you consider that an issue or sale of securities in contravention of the law should be rendered void or voidable transactions?

¹²⁴ See section 325 of the SFA.