The University of Hong Kong

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BY HAND

The Hon Audrey Eu, SC, JP
C/o Legislative Council Secretariat
3rd Floor, Citibank Tower
3 Garden Road
Central.

18 September 2003

Dear Audrey,

Companies (Amendment) Bill 2003

Thank you for inviting the Faculty of Law to comment on the above bill. I enclose a copy of our submission for consideration by the Bills Committee. I do not propose to attend the meeting scheduled for 2 October as I believe that the comments are self-explanatory. However, please feel free to let me know if committee members have any queries or if I can otherwise be of further assistance. My telephone number is 2859 2977 and my email address is "aylchan@hkucc.hku.hk".

Yours sincerely,

Alice Y.L. Chan

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Encl.

cc. Dean, Faculty of Law

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Comments on the Companies (Amendment) Bill 2003 (the "Bill")
For consideration by the Bills Committee of the Legislative Council

Notes:

1. This article only covers those provisions of the Bill relating to prospectuses, that is, Schedule 1 to the Bill and Schedule 2 to the Bill to the extent that it has an impact on the prospectus content requirements.

*2. Unless otherwise specified, references in this article to sections and schedules are to sections of and schedules to the Companies Ordinance (whether existing ones or those proposed under the Bill) and in this article "**Ordinance**" means the Companies Ordinance (Cap 32).*

3. For some general background on, and an explanation of, the relevant provisions of the Bill, members of the Bills Committee may like to refer to the attached article written by the author for the Hong Kong Lawyer journal.

4. The comments set out herein represent the views of the author only and not of the Faculty of Law of the University of Hong Kong as a whole.

I. Offers not subject to the prospectus regime (*Section 2(1) & Seventeenth Schedule*)

Twelve types of exempt offers are set out in the proposed new Seventeenth Schedule, most of which are derived from, and follow closely the scope of, the exempt offers set out in Schedule 11 to the UK Financial Services and Markets Act 2000 ("**FSMA**"). The author would like to comment on the following four:

(a) ***Paragraph 3*** – this paragraph provides that an offer is exempt if the total consideration payable for the securities offered does not exceed HK$5 million. This seems to be a relatively high threshold given that the net proceeds raised by some companies listed on the Hong Kong Stock Exchange on their IPOs were in the region of HK$20 million. The corresponding threshold in FSMA was 40,000 euros (approximately HK$337,000) and it is clear that the exemption was intended for really small offerings, for example, to fund a company whose members share a common hobby such as photography or fishing.

Paragraph 4 of the same schedule provides that an offer is exempt if the minimum denomination of, or the minimum consideration payable by any person for, the securities being offered is not less than HK$500,000. It is interesting to note that in the equivalent to this minimum threshold under FSMA is 40,000 euros, that is, the same amount as the threshold for small offering exemption under Paragraph 3.

As a matter of drafting, it is better to specify that the thresholds are HK$500,000 or, as the case may be, HK$5 million "or its equivalent in another currency" as it is possible that foreign currencies such as United States dollars and the euro may be raised in a securities offering in Hong Kong. Alternatively, as dollar amounts are also used in other parts of the Bill, it may be desirable to add a new subsection to

Section 2 (*Interpretation*) to the effect that, unless the context requires otherwise, all references in the Ordinance to amounts in Hong Kong dollars include its equivalent in another currency.

(b) ***Paragraph 7*** **–** this paragraph effectively provides that an offer of free shares to shareholders of a company is exempt. It is not clear why rather complicated wording was used in the Bill. The equivalent exemption in FSMA simply refers to an offer where "the securities are shares and are offered free of charge to all or any of the holders of shares in the issuer". It is not clear whether the wording in the Bill was intended to cover other situations or circumstances. If the same purpose can be achieved then clear and simple wording is to be preferred over more complicated formulations.

(c) ***Paragraph 8*** **–** this paragraph effectively provides that an offer made to employees and former employees of a company (such as under an employee share option scheme) is exempt.

However, the exemption is expressed to cover "consultants" and "former consultants" who provide services to the issuer (or another group company) pursuant to a contract for services. The services are those that are commonly rendered by (i) an employee of the issuer, or (ii) an employee of a company belonging to the class of companies which predominantly carry out the same kind of business as the issuer. This is potentially a very wide extension and may lead to difficulties in interpretation. The concept of consultants was not present in the equivalent exemption in FSMA.

First, what services are "commonly" rendered by an employee is a subject matter for debate. To give an example, some listed companies have an in-house legal counsel or compliance officer to ensure compliance with stock exchange listing rules and other applicable regulations. There are also listed companies which engage law firms or accountancy firms to perform such functions. Are services of this nature "commonly" rendered by an employee or are they "commonly" provided by outside professionals? Similar questions can be raised in relation to the composition of "the class of companies which predominantly carry out the same kind of business".

Secondly, it is likely that the legal entity which the issuer instructs and contracts with is a company (which most consultants operate under to take advantage of the limited liability) or a partnership (as is the case for most law firms). It is not clear whether the term "consultant" used in the Bill would cover all the directors and officers of the company or, as the case may be, all the partners and associates of the firm or only those individuals personally involved in providing the services.

Perhaps the concept was introduced in the Bill to cater for the trend of outsourcing, but if this was the reason then the issue is why independent business entities which are simply contracting with the issuer (and which have derived their profits from the contractual terms) should be grouped under the exemption that was directed at employees. There are valid reasons for drawing a distinction between employees and independent contractors, and the distinction is incorporated in different laws and regulations. Furthermore, most of the commercial arguments for including "consultants" would be equally applicable to, say, major suppliers and customers of the issuer.

(d) ***Paragraph 11(a)(ii)*** – sub-paragraph (a)(i) provides that an offer to exchange shares in the same company which does not result in an increase in share capital is exempt. The author does not have any comment on this. However, sub-paragraph (a)(ii) provides that an offer to exchange debentures in the same company which does not result in an increase in the aggregate principal amount outstanding is also exempt. There is no exemption in relation to debentures in the equivalent head in FSMA. The dangers to the investing public of the exemption as currently drafted in the Bill are obvious and can be illustrated by a simple example.

A company has HK$800 million in principal of retail bonds outstanding which will be due in two months' time. The bonds had an original tenor of 3 years and an effective interest rate of 2% per annum payable quarterly. The bonds were secured by real properties which were worth 1.5 times the aggregate principal value of the debentures when they were issued. The company now offers to exchange those bonds for new ones with an aggregate principal amount of HK$800 million. The new bonds will have a tenor of 5 years and an effective interest rate of 2% per annum payable half-yearly. The bonds will be secured by the same real properties which are now worth 0.9 times of the aggregate principal value of the bonds due to fallen market prices.

Based on the current wording of sub-paragraph (a)(ii), the exchange offer falls outside the prospectus regime (as there is no increase in the aggregate principal amount of the debentures) and the issuer does not have to issue a prospectus and provide the detailed information required in the Ordinance, in particular, in relation to the updated financial position of the company and the value of the properties offered as security. The average retail investor may not appreciate the risks involved in exchanging the new bonds - to him they may appear the same as the old ones as the interest rates are the same and they are secured by the same properties.

Another example of a significant change in risk profile of bonds which an average retail investor may not appreciate without clear explanation is an exchange of unsecured senior debt for subordinated debt. The retail investor may be tempted to accept the exchange as the interest rate offered may be higher than the old one, even though it may not fully reflect the risks involved in subordinated debt.

Technically speaking the above argument applies also to share exchanges where shares carrying different rights and risks may be offered. However, share exchanges involving retail investors in Hong Kong are likely to be subject to the Rules Governing the Listing of Securities (the "Listing Rules") on The Stock Exchange of Hong Kong Limited and the Code on Takeovers and Mergers and have the benefit of the protection provided in those regulations.

For the sake of completeness, the equivalent exemption in FSMA applies to shares and "investments of a specified kind relating to shares", and "specified" in this context means specified in an order made by the Treasury.

II. SFC's powers of exemption and amendment (*Sections 38A & 360*)

Under the current section 38A, the SFC may exempt compliance with certain prospectus content requirements on the ground that compliance is either irrelevant or unduly burdensome. Under the Bill, the SFC is given much wider powers of exemption and amendment, including an additional ground for exemption: that the exemption will not prejudice the interest of the investing public.

By way of illustration of the SFC's broadened exemption power, paragraph 46 of the Third Schedule requires that a valuation report contained in a prospectus "shall not be made by a company which … has either a paid up capital of less than $1 million or the assets of which do not exceed liabilities by $1m or more as shown in the company's last balance sheet". There are legitimate reasons behind such requirements, two of which are to ensure that the valuer is substantive company with sufficient business turnover (as an indication of reputation and experience) and a certain level of assets to meet potential liabilities owed to the issuer.

If the issuer is a large property developer, then requiring it to engage a property valuer who meets these requirements is clearly not irrelevant or unduly burdensome. $1 million is hardly a large sum of money by current Hong Kong standards, compared to the 1930s when the Ordinance was enacted. (In fact it is strange that the amount had not been raised at all over the years and the Bills Committee may wish to consider whether an increase is necessary to protect retail investors.) The SFC thus has no discretion to grant a waiver of such requirement. However, under the Bill, the SFC may be able to grant the waiver on the basis that the individuals managing the valuer have sufficient experience or expertise personally or that the sums involved are so large that $1 million of net assets will not be of much assistance to the issuer if a claim has to be made against that valuer (compared to another valuer which satisfies paragraph 46 by a small margin), and so allowing their appointment will not prejudice the interest of the investing public.

Furthermore, it is proposed that many more requirements may be exempted by the SFC and they are set out in Table 1 below. In addition, the SFC may amend (with no limit on the scope) the list of requirements that may be exempted by order published in the Gazette.

Table 1: Requirements which may be exempted by SFC

Current

- language and Third Schedule requirements (*section 38(1))*
- application forms may not be issued without prospectus (*section 38(3))*
- allotment may not be made if minimum subscription not received and return of subscription moneys within 30 days *(sections 42 (1) & (4))*
- shares must be issued within 30 days of issue of prospectus (*section 44A(2))*

Proposed under the Bill

- warning statement on prospectus (*Section 38(1A))*
- provision of information relating to guarantor corporation (*Sections 38(7))*
- restrictions on the sale to the public of shares/debentures acquired pursuant to an exempted offer (*Section 38AA(1))*
- prospectus for registration must be signed by all directors and have attached thereto experts' consents and material contracts etc. (*Section 38D(3))*

- material contracts to be made available for public inspection for 14 days (*Section 38D(3A))*
- requirement for certified translations of material contracts (*Section 38D(4))*
- no allotment until third day after first issue of prospectus (*Section 44A(1))*
- application for shares/debentures not revocable until after fifth day of opening of subscription lists etc. (*Section 44A(6))*
- allotment void if permission for listing not applied for or granted within certain time periods (*Section 44B(1))*
- issuer liable to repay money received within 8 days if permission for listing not applied for or granted within the prescribed time periods; if issuer fails to do so its directors are liable to repay the money with interest (*Section 44B(2))*
- provisions relating to amendment of prospectus issued by Hong Kong incorporated companies (*Part 1 of the Twentieth Schedule)*
- provisions relating to programme prospectuses issued by Hong Kong incorporated companies (*Part 1 of the Twenty-first Schedule)*

Moreover, section 360 is proposed to be amended to give the SFC power to amend the Third, Seventeenth, Eighteenth, Nineteenth, Twentieth, Twenty-first and Twenty-second Schedules (effectively all the substantive provisions relating to the prospectus regime) by order published in the Gazette, again with no limit on the scope of amendment.

In view of the above, the question is whether it is worth the time and effort analysing, debating and fine tuning the relevant statutory provisions when they could be waived or amended without approval of the Legislative Council.

III. Construction of offerings to the public (*Section 48A*)

Section 48A purports to provide, without much success, some interpretation of the term “offer to the public”. Subsection (1) states that “… offering shares or debentures to the public shall…. be construed as including a reference to offering them to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner….”.

Subsection (2) excludes from the prospectus regime any offer or invitation which “can properly be regarded, in all the circumstances, as not being calculated to result, directly or indirectly, in the shares or debenture becoming available to persons other than those receiving the offer or invitation, or otherwise as being a domestic concern of the persons making and receiving it”.

A new subsection (3) is proposed under the Bill which declares that “the provisions of the Seventeenth Schedule shall not be construed to prejudice the generality of this section”. As discussed above, the Seventeenth Schedule sets out specific types of offers that are exempt from the prospectus regime.

However, it is the author’s view that the current draft wording of subsection (3) defeats the whole purpose of introducing the Seventeenth Schedule, which is to provide certainty that offers falling within that schedule will not be subject to the prospectus regime under the Ordinance. For example, an offer to not more than 50 persons is an exempt offer under Seventeenth Schedule, but subsection (3) states that subsection (1) continues to apply, which means that such an offer could still be construed as being an offer to the public and hence caught by the prospectus regime.

The author believes that subsection (3) should only refer to subsection (2) and not the entire section 48A. The effect of such a formulation is that an offer which does not fall within one of the heads in the Seventeenth Schedule may nonetheless be construed as not being an offer to the public if it satisfies the criteria set out in subsection (2), for example, that it is a domestic concern between the persons making and receiving the offer.

IV. Overall standard of disclosure in prospectuses (*Paragraph 3, Third Schedule*)

The overall standard of disclosure for a prospectus is that it must contain 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 the issue of the prospectus. This general requirement is set out in paragraph 3 of the Third Schedule.

Under the Bill, it is proposed that the overall standard be amended by adding the following at the end: "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". It seems that the qualification is seeking to lay down some criteria for the courts when they are assessing whether the "reasonable person" test is satisfied. However, it is not clear as to what "the nature of the company" means – whether it is referring to the company's legal make up and structure (such as place of incorporation and capital structure) or to its business, management and future prospects. If it was the latter, then it would be better to set them out as part of the overall standard where it refers to the "financial condition and profitability" of the company. This was also the approach adopted in the Listing Rules (see Rule 11.07). If it was the former then arguably it is already covered by "valid and justifiable opinion of the shares and debentures" and "nature of the shares or debentures".

In all likelihood the proposed qualifications to the overall standard will be relied on by issuers or their advisors to argue for a lower level of disclosure when faced with allegations that the amount of information in a prospectus is inadequate or insufficiently clear. So perhaps the more fundamental question is: are such additional qualifications necessary or in the interests of the public? - in view of all the new exemptions in the Seventeenth Schedule, which means that any offering which remains caught under the prospectus regime is likely to involve retail investors.

V. Definition of "subsidiary undertaking" (*Twenty-Third Schedule*)

The Bill introduced the concepts of "parent undertaking" and "subsidiary undertaking" mainly in relation to the preparation of group accounts. However, by virtue of the proposed new section 2B(3), all references to a "subsidiary" in the Third Schedule (which sets out the prospectus content requirements) will be deemed to include a subsidiary undertaking.

The definition of subsidiary undertaking closely follows the corresponding definition under the UK Companies Act 1989 – but with one major difference which will be explained below. Under the Bill, there are three scenarios whereby an entity will be deemed to be a "subsidiary undertaking" of another entity (the "parent undertaking"), namely:

(a) the subsidiary undertaking is a body corporate and is a subsidiary of the parent undertaking by virtue of section 2(4) – (7);

(b) the subsidiary undertaking is not a body corporate and the parent undertaking:
   - (i) holds a majority of the voting rights in the subsidiary undertaking;
   - (ii) is a member of the subsidiary undertaking and has the right to appoint or remove a majority of its board of directors; or
   - (iii) is a member of the subsidiary undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the subsidiary undertaking; or

(c) the parent undertaking has the right to exercise a dominant influence over the subsidiary undertaking by virtue of provisions in the subsidiary undertaking's constitutional documents or of a control contract.

Different tests

Apart from the "dominant influence" test, the criteria for determining if an entity is a subsidiary undertaking of another entity depends on whether or not it is a body corporate. If it is, then the criteria set out in paragraph (a) above will be used, whereas if it is not then the criteria set out in paragraph (b) above will be applicable. Paragraph (b) (as interpreted by the other provisions of the Twenty-third Schedule) is much broader in scope than paragraph (a) and thus would catch more entities.

For example, with respect to paragraph (a) above, section 2(4)(a) provides, amongst other things, that if a company controls the composition of the board of directors of another company then the latter company is a subsidiary of the first-mentioned company. Section 2(5) stipulates that a company controls the composition of the board of directors of another company if it has the power to appoint or remove all or a majority of the directors of that other company. With respect to paragraph (b) above, section 4(a) of the Twenty-third Schedule provides that the right to appoint or remove a majority of the board of directors means the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all, matter. In other words, the Twenty-third Schedule takes into account unequal or weighted voting rights of different directors whereas section 2(4) does not. So if a company is entering into a joint venture under which it appoints a minority in number of the management body of the joint venture but its representatives have more than half of the voting rights, then it can avoid the joint venture being deemed its subsidiary undertaking by using a body corporate as the joint venture vehicle.

It is the author's view that one uniform test, namely the criteria set out in paragraph (b) above, should apply to both bodies corporate and non-bodies corporate. Under UK Companies Act the same test is applicable irrespective of the legal nature of the entity and the wording of paragraph (b), which follows word for word the corresponding paragraph under the UK Companies Act, contemplates the subsidiary undertaking being a body corporate (eg. "board of directors", "shareholders").

Requirement of "member"

With respect to paragraphs (b)(ii) and (b)(iii) above, the requirement that the parent undertaking be a "member" of the subsidiary undertaking is a potential loophole, as the authors of Gore-Browne on Companies, a leading UK company law textbook, have noted:

> "It should be noted that the test specified in s. 736(1)(c) *[the equivalent section to paragraph (b)(iii) above]* requires that the alleged holding company must (in addition to controlling a majority of voting rights by agreement) 'be a member of it' (ie of the subsidiary). This requirement would seem to allow an obvious way to evade s. 736(1) in this respect. Dominant voting power can be exercised, even if this amounts to control of more than 50 per cent of the voting power, so long as the company which is in a position to exercise this power is not 'a member' of record." *(at para. 1.5.1, page 1.021)*

With respect to the equivalent section to paragraph (b)(ii) above, the authors of Gore-Browne on Companies have commented as follows:

> "As with s. 736(1)(c) the requirement of being 'a member of it' (in addition to the power over appointment and removal of a majority of directors) provides a lacuna in this test of holding and subsidiary company relationship, which can be readily exploited by appropriate arrangements." *(at para. 1.5.2, page 1.022)*

The Hong Kong legislature should take the opportunity to tighten the drafting of the relevant provisions instead of simply transplanting the corresponding wording from the UK statute.

VI. Definition of "prospectus" (*Section 2(1)*)

This is a drafting comment. The existing definition defines a prospectus to mean, amongst other things, any document "offering any shares or debentures of a company to the public…". A "company" is defined to mean "a company formed and registered under this [Companies] Ordinance". There is clearly a loophole in the drafting of the definition as offering shares in foreign companies to the public in Hong Kong ought to be subject to the same regulatory regime as offering shares in a Hong Kong incorporated company. That loophole is generally plugged in Part XII of the Ordinance by referring to "a company incorporated outside Hong Kong, whether the company has or has not established a place of business in Hong Kong" in all the necessary places.

The Bill seeks to address the issue by providing that a prospectus, amongst other things, is any document "offering shares in or debentures of a company *(including a company incorporated outside Hong Kong, and whether or not it has established a place of business in Hong Kong)* to the public…" (the author's emphasis). The author's view is that the word "company" should not be used as it already has a defined meaning. It would be preferable to use the phrase "body corporate or corporation" in lieu of the word "company". The words are used in other parts of the Ordinance, including the Third Schedule which sets out the specific content requirements of a prospectus. If the suggested phrase is adopted then the sentence in italics will not be required. Section 2(3), which deems a reference in the Ordinance to a body corporate or a corporation to include a company incorporated outside Hong Kong, can then be amended by adding "whether or not it has established a place of business in Hong Kong". The author does not think that the suggested amendment to section 2(3) will have any unexpected effect on the other sections of the Ordinance.

Conclusion

Overall speaking, in respect of the prospectus regime in Hong Kong the amendments proposed in the Bill are a step in the right direction. They are generally appropriate as an interim measure pending the comprehensive review of the regime expected to commence in the last quarter of 2003. They have also addressed most of the specific requests of market participants, the stated objective of the Bill in this context. However, the demands of market participants, comprising mainly investment banks and frequent issuers and their lawyers and accountants, may not coincide with the interest of the often silent and unrepresented retail investors in securities.

In the field of securities regulation, it is usually a balancing exercise – first balancing the protection of the interests of the investing public and the cost and burden of compliance to issuers, and secondly balancing the need to be flexible to keep up with rapid market developments and the dangers of giving the regulators too much power and discretion.

If the Bills Committee considers it useful the author would be pleased to assist the Bills Committee further on any aspect of the Bill relating to the prospectus regime.

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[Article for Hong Kong Lawyer]

Prospectus Regime Update: The Companies (Amendment) Bill 2003

The legal framework which regulates the offer of the shares and debentures in Hong Kong (commonly known as the "prospectus regime") is set out in Part II and Part XII of the Companies Ordinance (the "CO") for Hong Kong incorporated companies and overseas incorporated companies respectively. Despite significant developments in the securities market that framework has remained largely the same since the enactment of the CO. Over the years there have been various additions and amendments to the relevant provisions, which in some cases have resulted in inconsistencies between provisions. Market participants have long called for a comprehensive review and update of the framework to bring it in line with those of other international financial centres and to provide better guidance on the application of the provisions.

The Securities and Futures Commission ("SFC") and the Financial Services and Treasury Bureau acknowledged the need for an overhaul of the prospectus regime and in March 2003 jointly published a Consultation Paper on Proposed Amendments to the Companies Ordinance to Facilitate Offers of Shares and Debentures (the "Consultation Paper"). The Companies (Amendment) Bill 2003 (the "Bill") was promptly gazetted on 28 March and the first reading of the Bill took place on 25 June. At the time this article was written in early August the SFC has yet to publish any comments given by the public on the Consultation Paper. A bills committee has been set up at the Legislative Council to examine the provisions of the Bill.

The Bill represented the second phase of a three-phased approach described in the Consultation Paper – amending the CO "in response to specific requests from market participants". It is in this context that we should be looking at the provisions of the Bill. The SFC had promised a "comprehensive review" as the third phase and indicated that it aimed to put forward proposals for public consultation by September 2004. This article focuses on some of the major amendments put forward in the Bill. Unless otherwise stated, all references in this article to sections and schedules are to sections of and schedules to the CO.

Exempt offers

Under the current prospectus regime, any prospectus, notice, circular, brochure, advertisement, or other document is deemed to be a "prospectus" if (a) it offers any shares or debentures to the public for subscription or purchase or (b) it is calculated to invite offers by the public to subscribe for or purchase any shares or debentures. Once a document is deemed to be a "prospectus" it has to comply with the fairly onerous requirements under the CO as to content and registration. It is also unlawful to issue any form of application for shares or debentures unless the form is issued with a prospectus which complies with the CO prospectus requirements.

It is therefore important for practitioners, when advising clients or structuring transactions, to be able to determine with reasonable certainty if a document can be construed as containing an offer to the public. "The public" is not defined in the CO and the term is defined in the Interpretation and General Clauses Ordinance (Cap 1) to "include any class of the public". Furthermore, section 48A, which purports to provide some interpretation of the term, offers little help. Section 48A(1) states that "… offering shares or debentures to the public shall…. be construed as including a reference to offering them to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner….".

Section 48A(2) excludes from the prospectus regime any offer or invitation which "can properly be regarded, in all the circumstances, as not being calculated to result, directly or indirectly, in the shares or debenture becoming available to persons other than those receiving the offer or invitation, or otherwise as being a domestic concern of the persons making and receiving it". "Domestic concern" is not defined and again the vagueness of the wording offers little assistance to practitioners.

Based on some informal guidance given by the SFC and the Registrar of Companies more than a decade ago, some practitioners have used 50 as the maximum number of persons who may be approached without an invitation or offer being treated as made to the public. Apart from lacking in any statutory basis, a simple numerical approach has also attracted the following judicial comment:

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

The Bill proposes to bring some certainty to the position by excluding from the definition of "prospectus" documents relating to certain types of offer specified in Part 1 of a new Seventeenth Schedule. Exempt offers include:

- an offer under which the total consideration payable for the shares or debentures offered does not exceed $5 million
- an offer where (in the case of shares) the minimum denomination or the minimum consideration payable by any person is not less than $500,000 or (in the case of debentures) the minimum principal amount to be subscribed or purchased is not less than $500,000
- an offer to not more than 50 persons
- an offer of bonus shares or scrip dividend to existing shareholders
- an offer of shares or debentures in a company made by that company (or a group company) to current and former directors, employees, officers or consultants of that company (or of a group company) or their dependents on terms that only such persons can acquire the shares or debentures
- an offer to members of a club or association where the proceeds of the offer are to be applied for the affairs of that club or association
- an offer in respect of (i) an exchange of shares in the same company which does not result in an increase in share capital; or (ii) an exchange of debentures of the same company which does not result in an increase in the aggregate principal amount outstanding
- an offer to "professional investors" as defined in Schedule 1 to the Securities and Futures Ordinance (Cap 571) ("SFO"). In this context, professional investors

include any bank, financial institution, insurance company and provider of investment services which is regulated in or outside Hong Kong. In addition, pursuant to Securities and Futures (Professional Investor) Rules, the following persons are also professional investors:

- a trust corporation with total trust assets of not less than $40 million
- an individual, either alone or jointly with his spouse and children, with a portfolio of not less than $8 million (and "portfolio" means cash, securities and certificates of deposit issued by banks)
- a corporation or partnership with either (i) a portfolio of not less than $8 million; or (ii) total assets of not less than $40 million
- a pure investment holding company wholly-owned by an individual who is himself a professional investor.

Apart from the first two grounds of exemption listed above, all the other grounds may be combined so that if part of the offer satisfies one ground and the rest of the offer satisfies another ground, the entire offer will be exempt. Using the example given in the Consultation Paper, documents making an offer to professional investors and to not more than 50 other persons will not constitute prospectuses.

The grounds of exemption are roughly modeled on those set out in Schedule 11 to the Financial Services and Markets Act 2000 of the UK. They are much broader than the "professionals exemption" under the existing section 343(2), which deems an offer by an overseas incorporated company to persons whose ordinary business is to buy or sell shares or debentures, whether as principal or agent, not to be an offer to the public. The professionals exemption has also been made applicable to Hong Kong incorporated companies through the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice 2001 (as amended in both 2002 and 2003) (the "2001 Exemption Notice").

The proposed new sections 38AA and 342AB contain restrictions on the sale to the public of shares and debentures acquired pursuant to an exempted offer and provide that the SFC may publish guidelines relating thereto.

The definition of "prospectus" will also be clarified under the Bill to put it beyond doubt that the prospectus regime applies to offers of shares and debentures in any company, whether or not it is incorporated or registered in Hong Kong and whether or not it has a place of business in Hong Kong.

SFC's exemption and amendment powers

Under the current section 38A, the SFC may exempt compliance with certain prospectus content requirements on the ground that compliance is either irrelevant or unduly burdensome. The requirements which may be exempted are set out in the box below..

Certain content requirements are exempted in respect of all prospectuses by virtue of the 2001 Exemption Notice. These include, apart from the "professionals" exemption referred to above, the exemption from setting out valuation reports of operating leases of properties and exemption from certain Third Schedule requirements in respect of offers of listed and unlisted debentures.

Currently there is no provision for the exemption of any of the registration requirements set out in section 38D. In February 2003 the SFC issued "Guidelines on application for a relaxation from the procedural formalities to be fulfilled upon registration of a prospectus under the Companies Ordinance" which do not have the force of law. The guidelines permit the registration of a prospectus using the bulk print proof of the same (to be followed by the definitive prospectus) and of a facsimile copy of an expert's consent letter (to be followed by the original). Following the issue of the guidelines the Registrar of Companies amended the Requirements for Documents Guidelines 2001 to take into account such relaxations.

Under the Bill, section 38A will be amended to give the SFC wider powers to exempt a particular prospectus, a class of companies and a class of prospectuses from the CO prospectus requirements. An additional ground for exemption is introduced, which is that the exemption will not prejudice the interest of the investing public. As noted above, the existing ground is that compliance with the relevant requirement(s) would be either irrelevant or unduly burdensome.

By way of illustration of the SFC's broadened exemption power, paragraph 46 of the Third Schedule requires that a valuation report contained in a prospectus "shall not be made by a company which … has either a paid up capital of less than $1 million or the assets of which do not exceed liabilities by $1m or more as shown in the company's last balance sheet". There are legitimate reasons behind such requirements, two of which are to ensure that the valuer is substantive company with sufficient business turnover (as an indication of reputation and experience) and a certain level of assets to meet potential liabilities owed to the issuer.

If the issuer is a large property developer then requiring it to engage a property valuer who meets these requirements is clearly not irrelevant or unduly burdensome. $1 million is hardly a large sum of money by current Hong Kong standards, compared to the 1930s when the CO was enacted. (In fact it is strange that the amount had not been raised at all over the years.) The SFC thus has no discretion to grant a waiver of such requirement. However, under the Bill, the SFC may be able to grant the waiver on the basis that the individuals managing the valuer have sufficient experience or expertise personally or that the sums involved are so large that $1 million of net assets will not be of much assistance to the issuer if a claim has to be made against that valuer (compared to another valuer which satisfies paragraph 46 by a small margin), and so allowing their appointment will not prejudice the interest of the investing public.

Furthermore, it is proposed that many more requirements may be exempted and they are set out in the box below. In addition, the SFC may amend (with no limit on the scope) the list of requirements that may be exempted by order published in the Gazette.

[box]
Requirements which may be exempted by SFC

Current

- language and Third Schedule requirements (*section 38(1))*
- application forms may not be issued without prospectus (*section 38(3))*
- allotment may not be made if minimum subscription not received and return of subscription moneys within 30 days *(sections 42 (1) & (4))*
- shares must be issued within 30 days of issue of prospectus (*section 44A(2))*

Proposed under the Bill

- warning statement on prospectus (*Section 38(1A))*
- provision of information relating to guarantor corporation (*Sections 38(7))*
- restrictions on the sale to the public of shares/debentures acquired pursuant to an exempted offer (*Section 38AA(1))*
- prospectus for registration must be signed by all directors and have attached thereto experts' consents and material contracts etc. (*Section 38D(3))*
- material contracts to be made available for public inspection for 14 days (*Section 38D(3A))*
- requirement for certified translations of material contracts (*Section 38D(4))*
- no allotment until third day after first issue of prospectus (*Section 44A(1))*
- application for shares/debentures not revocable until after fifth day of opening of subscription lists etc. (*Section 44A(6))*
- allotment void if permission for listing not applied for or granted within certain time periods (*Section 44B(1))*
- issuer liable to repay money received within 8 days if permission for listing not applied for or granted within the prescribed time periods; if issuer fails to do so its directors are liable to repay the money with interest (*Section 44B(2))*
- provisions relating to amendment of prospectus issued by Hong Kong incorporated companies (*Part 1 of the Twentieth Schedule)*
- provisions relating to programme prospectuses issued by Hong Kong incorporated companies (*Part 1 of the Twenty-first Schedule)*

Moreover, section 360 will be amended to give the SFC power to amend the Third, Seventeenth, Eighteenth, Nineteenth, Twentieth, Twenty-first and Twenty-second Schedules by order published in the Gazette, again with no limit on the scope of amendment.

Prospectus content requirements

In addition to the specific requirements such as valuation reports and accountant's reports, a prospectus must contain 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 the issue of the prospectus. This general requirement or overall standard of disclosure is set out in paragraph 3 of the Third Schedule.

Under the Bill, it is proposed that the overall standard be amended by adding the following phrase at the end of the existing wording: "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". It is not clear as to what "the nature of the company" means – whether it is referring to the company's legal constitution and structure (such as place of incorporation and capital structure) or to its business, management and future prospects. If it was the latter, then it would be better to set them out as part of the overall standard where it refers to the "financial condition and profitability" of the company. This was also the approach adopted in the Rules Governing the Listing of Securities (the "Listing Rules") on The Stock Exchange of Hong Kong Limited (the "HKSE") (see Rule 11.07). If it was the former then arguably it is already covered by "valid and justifiable opinion of the shares and debentures" and "nature of the shares or debentures".

In respect of the specific requirements, sections 38 and 342 will be amended to apply the prospectus content requirements in the Third Schedule to a "guarantor corporation" in connection with an offer of guaranteed debentures to the public. A guarantor corporation means a corporation which (a) guarantees the repayment of money received from the public in connection with the offer; (b) guarantees any other obligations of the issuer under or in respect of the debentures; or (c) guarantees the payment to the issuer of an amount which the issuer intends to use to wholly or partly discharge its obligations under the debentures. The provision of information relating to guarantor corporations represents the current practice of the SFC when vetting prospectuses and the amendment serves to give this practice statutory backing.

Prospectus registration requirements

It is proposed that sections 38D and 342C will be amended so that material contracts will not have to be registered with the Registrar of Companies and will only have to be made available for inspection by the public for not less than 14 days from the issue of the prospectus at the issuer's registered office in Hong Kong. This is a sensible simplification of the registration requirements as it does not seem that much inspection of material contracts has been done via the Companies Registry. For shares which are intended to be listed on the HKSE the display of material contracts has always been a requirement under the Listing Rules (paragraph 53, Part A, Appendix 1). In addition, under the Bill, the issuer has to provide copies of the documents on display upon request on payment of reasonable expenses unless the documents are posted on a readily accessible web page on the Internet in a format which can be readily printed. However, no time limit has been prescribed for the issuer to provide the copies after a request for the same has been made.

New sections 38D(10) and 342C(9) will be added to clarify what constitutes a "certified translation" of a material contract. Furthermore, the proposed new sections 39C and 342CC will permit submission of certified true copies of documents (instead of the originals) to the Registrar of Companies in respect of documents which are required to be filed and prescribe the manner of certification.

Prospectus liability

Sections 40 and 342E impose civil liability and sections 40A and 342F impose criminal liability for any untrue statements in a prospectus and section 41A(a) deems a statement to be untrue if it is misleading in the form and context in which it is included. Under the Bill, a new subsection (2) will be added to section 41A to clarify that a material omission from the prospectus will be deemed to be an "untrue statement", thereby bringing the CO in line with the approach adopted in the SFO and the Listing Rules.

Currently, the liability for untrue statements is owed to all persons who subscribe for any shares or debentures on the faith of the prospectus. Under the Bill, such persons will be deemed to include (a) persons who acquire the securities through an agent and (b) persons who acquire the securities pursuant to arrangements made between the issuer and intermediaries appointed for the purpose of the offer. The amendment puts beyond doubt, in the light of developments in the offer structures in recent years, that purchasers of securities from placing agents and underwriters are entitled to remedy. A recent example is the Kowloon-Canton Railway Corporation retail bond offering in May 2003 where applications for the bonds may only be made by the public through certain designated "placing banks" rather than directly with the issuer KCRC.

Under section 38B(1), it is unlawful to publish by way of advertisement any extract from or abridged version of a prospectus unless, amongst other things, the advertisement has been authorised by the SFC. There is a possible loophole in that the subsection will not catch an advertisement in respect of a prospectus which does not contain any extract from or abridged version of the prospectus. The Bill proposes to expand section 38B(1) to close this potential loophole. On the other hand, an advertisement of that nature is likely to infringe one of the provisions of the SFO but it is outside the scope of this article to discuss those provisions.

Furthermore, it is not entirely clear if the statutory civil and criminal liability under sections 40 and 40A applies to untrue statements contained in an advertisement that has been authorized by the SFC under section 38B(2). The revised definition of "prospectus" in the Bill also specifically excludes from it an advertisement which falls within section 38B(2). Sections 40 and 40A will therefore be amended to make it clear that liability for untrue statements will apply to such an advertisement as if it were a prospectus, even though such an advertisement is not treated as a prospectus for other purposes.

Use of "offer awareness advertisements"

It is also proposed in the Bill to amend section 38B to permit the publication of an "offer awareness advertisement" which complies with the new Nineteenth Schedule. According to the SFC, the purpose of such advertisement is to enhance investors' awareness of the offer so as to allow them more time to arrange their financial and other affairs in anticipation of the public offer.

The advertisement should only set out basic factual and procedural information relating to the impending offer and must contain certain warning statements. It may only contain some or all of certain prescribed particulars, as follows:

- name of issuer and its place of incorporation
- description of the shares or debentures proposed to be offered
- dates on which and places at which the prospectus will be available
- details of the administrative procedures relevant to investors that are likely to assist their participation in the offer
- where applicable, a statement that the issuer is seeking a listing of the shares or debentures on a stock exchange

- legends designed to clarify the legal nature of the advertisement

The Bill provides that the SFC may publish guidelines in respect of publications under section 38B. In March 2003 the SFC had already published "Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance".

It should also be noted that for shares and debentures intended to be listed on the HKSE, Rule 9.08 and Rule 24.08 of the Listing Rules require "all publicity material released in Hong Kong relating to an issue of securities" to be vetted by the HKSE before release. This requirement will continue to apply to an advertisement which complies with all the CO requirements outlined above and which, in respect of an offer of unlisted shares or debentures, would not require prior vetting by the SFC.

Programme offers

Programme offers in this context refer to successive offers of securities made by the same issuer or group of issuers on substantially the same basic terms and conditions. The usual variables are issue specific terms like issue size, currency, tenor and interest rates in the case of debentures. In Hong Kong it is far more common to have programmes for the issue of debentures than for the issue of shares, but share issuance programmes are widely used in places like the United States.

Under the current prospectus regime, each time an offer is made under the programme a prospectus which complies with all the CO prospectus requirements is required and the prospectus must be authorised and registered. Such onerous requirements may hinder the making of timely offers in response to favourable market conditions which may exist for only a short time period and result in increased compliance cost to the issuer.

Under the Bill, the proposed new sections 39B and 342CB and Twenty-first Schedule allow a prospectus to consist of a programme prospectus and an issue prospectus, each of which may be updated and amended by an addendum. The programme prospectus is valid for 12 months from the date of issue or until the publication of the next annual report and accounts of the issuer or (if any) the guarantor corporation, whichever is the earliest. The programme prospectus, issue prospectus and any addendum read together must comply with the content requirements under the CO unless exempted. The issuer is also required to make arrangements for all such documents to be made readily available to investors and potential investors during the offer period to which an issue prospectus relates. The proposal follows the UK regime and should allow offers to be made more efficiently without compromising protection to investors.

The Bill provides that the SFC may publish guidelines relating to prospectuses consisting of more than one document. In this connection, in February 2003, the SFC had already issued "Guidelines on using a "dual prospectus" structure to conduct programme offers of shares or debentures requiring a prospectus under the Companies Ordinance".

Status of "supplemental" prospectuses

A company may on its own initiative, or may be required by relevant securities regulations or stock exchange listing rules (such as Rule 11.13 of the Listing Rules) to, publish a supplemental prospectus setting out further information or clarifying or amending information contained in a prospectus already issued. Currently there is no provision in the CO for the issue or registration of a supplement which on its own does not comply with all of the CO prospectus requirements.

Under the Bill, the new sections 39A and 342CA and Twentieth Schedule will permit the amendment of a prospectus by an addendum to the prospectus or by replacing the prospectus with a new prospectus (and will also permit the amendment of an addendum). There is also a definition of the word "amend" in section 2 to include deletion, addition and varying.

Discrepancies in treatment between Hong Kong and overseas incorporated companies

Section 155C requires a copy of a prospectus issued by a Hong Kong company to be delivered to all its shareholders within 3 weeks from the date of registration thereof, but there is no equivalent requirement for a foreign company. Under the Bill, section 155C will be amended so that a Hong Kong company whose shares are listed on the HKSE is not required to send a copy of a prospectus to all of its shareholders.

Secondly, in respect of a foreign company section 342E imposes civil liability for misstatements in a prospectus relating to an offer for subscription only, but for Hong Kong companies the statutory civil liability covers both offers for sale and offers for subscription. Under the Bill, this anomaly will be rectified by making section 342E applicable to a prospectus relating to an offer for sale as well.

Thirdly, section 342B(1A) exempts a prospectus offering debentures in a foreign company from the requirements of sections 44A and 44B but those sections apply to Hong Kong companies with respect to both shares and debentures. In addition, section 342B(1) currently only applies to offers for subscription but not offers for sale. Under the Bill, section 342B(1A) will be repealed and section 342B(1) will be amended so that sections 44A and 44B will apply to both offers for subscription and offers for purchase of debentures in a foreign company.

Conclusion

Although the amendments set out in the Bill are only an interim solution pending a comprehensive review of the prospectus regime in Hong Kong, nonetheless the Bill still represents the most significant single set of legislative amendments to the prospectus regime since the 1930s. How the amendments work in practice will also have a significant bearing on the comprehensive review.

In the field of securities regulation, it is usually a balancing exercise – first balancing the protection of the interests of the investing public and the cost and burden of compliance to issuers, and secondly balancing the need to be flexible to keep up with rapid market developments and the dangers of giving the regulators too much power and discretion. As the Bill is meant to be a response to specific requests of market participants, practitioners should not hesitate to contribute to the drafting process to ensure that it strikes the right balance and offers the clarity and certainty that the market is hoping for.

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