# Companies (Amendment) Bill 2003
# Reply to Financial Services and the Treasury Bureau and Securities and Futures Commission

This article is the author's reply to the response (the "**Response**") of the Financial Services and the Treasury Bureau and Securities and Futures Commission sent on 24 October 2003 responding to the author's comments on the Bill.

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

This is the first time Hong Kong is introducing specific exemptions from the prospectus regime. Although the exemptions generally follow those in other developed common law jurisdictions, the precise wording is different and the effect of their application to Hong Kong, with its unique economic situation and investor culture, is unknown. It would therefore be prudent for the Legislative Council to err on the side of caution, since if the hole in the net is open too wide it would be a lot more difficult to try and narrow it later compared to the other way around.

(a) ***Paragraph 3***

It is common consensus that, in order for Hong Kong to maintain its position as an international financial centre, its laws and regulations must facilitate time and cost efficient securities issues to attract issuers. On the other hand, if the degree of investor protection is insufficient then investors will shun Hong Kong and this will adversely affect its aim to become a major international fund raising venue.

It should be borne in mind that the parties who usually respond to "public consultations" on corporate finance or securities matters are investment banks, law firms, accountancy firms and corporate issuers (or their representative bodies such as chambers of commerce). It is not difficult to see that they all have a common interest in making securities issues as easy, fast and cheap as possible and they have no duty to take into account investor protection. Investors' (particularly retail investors') interests are seldom represented in the responses to such consultations. It is therefore dangerous for regulatory authorities to rely solely or predominantly on the results of such consultations when determining policies, limits and thresholds. The fact that the range suggested by the "market" for paragraph 3 is between HK$5 million and HK$10 million does not necessarily mean that the final threshold has to be within that range.

With respect to the costs of issue, if the issue is not subject to the prospectus regime then the associated costs (such as legal, accounting and valuation costs) should be fairly lower, if not substantially lower, than an issue that has to comply with the prospectus regime. The author does not have the benefit of the figures supplied by the "market" and hence is not able to comment on the appropriateness of the threshold relative to costs.

With respect to the AUD2 million threshold under the Australian Corporations Act 2001 ("**ACA**") cited in the Response, the author believes that that is not a fair or appropriate comparison to make. That threshold only applies to "personal offers" and a personal offer is defined in the ACA to mean:

(a) an offer that may only be accepted by the person to whom it is made; and
(b) an offer made to a person who is likely to be interested in the offer, having regard to previous contact between the offeror and the offeree (and two other factors).

Therefore, the real limit under that exemption is the personal offer requirement. Under the Bill, the exemption will apply to any offer to the public at large.

In any event, it is the author's view that the actual threshold amounts adopted in other countries are not directly relevant due to different real purchasing power levels and retail investor behaviour. However, it may be useful to analyse the relativity of those thresholds. That is why in the initial comments the author also referred to the exemption based on the minimum consideration payable by a person for the securities offered (ie paragraph 4 of the Seventeenth Schedule). The table below sets out the correlation between the small offering threshold and the large minimum consideration threshold for the three countries discussed:

| | **Small offering threshold** | **Large consideration threshold** | **Ratio between the thresholds** |
|---|---|---|---|
| UK | 40,000 euros | 40,000 euros | 1:1 |
| Australia | AUD2 million* | AUD500,000 | 1:4 |
| Hong Kong | HK$5million | HK$500,000 | 1:10 |

** applies only to personal offers and not offers to the public*

It can be seen from the table that of the three places Hong Kong is the most lenient either in respect of the small offering exemption or the large consideration exemption. As it is the author's view that the $500,000 threshold for the large consideration exemption is reasonable, it follows that the $5 million threshold for small offering exemption is too high.

The author acknowledges that there is no magic number and whatever the final figure of the threshold there would be a degree of subjectivity and arbitrariness. It is the Legislative Council's duty to set one that it considers appropriate for Hong Kong.

(b) ***Paragraph 7***

The author does not agree that a scrip dividend is not free of charge to shareholders. As a matter of general company law, shareholders do not have the right to demand a dividend from the company. Their right to a final dividend only arises when the dividend is duly declared and approved. An interim dividend is only due when paid, so it is trite law that a shareholder is not entitled to sue on an unpaid interim dividend. Therefore any dividend, whether in cash or in kind, is free of charge to the shareholders as no fresh consideration is provided by the shareholders for the dividend itself. One can only argue that a shareholder is forgoing something if the shareholder is entitled to that something. If the company only declares a scrip dividend then the shareholders are never entitled to a cash dividend and therefore could not "forgo" that "in return for shares".

The author could think of three scenarios where it makes commercial sense for an issuer to offer free shares to its shareholders and they are:
(a) as scrip dividend or bonus shares;
(b) an offer of shares in a subsidiary on the spin-off of that subsidiary for a separate listing on a stock exchange; and
(c) an offer of shares in a subsidiary on the winding up of that subsidiary.

It is highly unlikely that the wording of the UK Financial Services and Markets Act ("**FSMA**") was not intended to cover scrip dividends or, if the intention was to cover scrip dividends, that the UK legislature would not have changed the wording had there been any doubt as to whether it is sufficient to achieve the intention.

Even though the author thinks that it is not necessary, one way to address the concern raised in the Response is to say "the securities are shares and are offered free of charge to all or any of the holders of shares in the issuer, including scrip dividends".

© ***Paragraph 8***

Of all the exemptions under the Bill as currently drafted, the author thinks that the one that is most open to abuse is this one because of the inclusion of "consultants".

It is clear that the intention behind this exemption is to cover genuine employees and former employees of the issuer (and of its group companies) and their families. If a company wants the exemption to apply to persons other than employees then it is up to that company to justify that the other persons to whom the securities are offered are in effect employees or in the nature of employees, albeit not in a strictly employer-employee relationship with it. That should be done on a case by case basis after the SFC has had a chance to review the situation of the particular issuer. The SFC has wide exemption powers under the Bill and this would be an appropriate case for the SFC to exercise its discretion.

It would indeed be arbitrary, and undesirable, to introduce a vague concept of "consultant" to cater for a particular industry, when it can be easily taken advantage of by companies that simply want to avoid complying with the law. The corresponding exemption in FSMA was limited to "genuine employees". The ACA was even more restrictive, limiting the exemption to "executive officers" only. There is no dispute that the insurance industries in the UK and Australia are large, and any argument for introducing such a concept in Hong Kong should be equally applicable to those jurisdictions. However, it was not considered necessary to extend the exemption to "consultants" in those places, and the author suspects that one reason for not doing so was its potential for abuse no matter how the drafting is done. Due to time constraints the author is not able to examine the relevant exemption for other developed common law jurisdictions, and would welcome any input in this regard.

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

The effectiveness of the negative vetting process is a question which members of the Legislative Council are in the best position to answer. The author does not have enough time or resources to compile any statistics as to how many pieces of proposed subsidiary legislation, in particular subsidiary legislation relating to securities and finance, have been amended as a result of the negative vetting process.

The Response referred to the requirement under section 360(7) for the SFC to publish a draft of any proposed order to amend or exempt. In the interest of completeness, the author would like to point out that section 360(9) provides that the SFC need not comply with that requirement if the SFC considers that (a) compliance is inappropriate or unnecessary; *or* (b) any delay involved in complying would not be in the interest of the investing public *or* in the public interest.

Perhaps the main concern from an investor protection point of view is not as much over the amendment of the schedules or exemption of whole classes of companies or prospectuses (which are the ones that have to be published in the gazette and are more likely to catch the public's attention), but rather the exemptions which may be granted to individual issuers (which do not have to be made public). The Response did not really explain the reasoning for the wider individual exemption powers, which include an additional ground for exemption and a rather long list of requirements that may be exempted (as set out in the table in the author's initial comments on the Bill).

There is no doubt that one of the regulatory objectives of any securities regulator must be to secure an appropriate degree of protection for the investing public and that when exercising its powers and discretion it should take into account its regulatory objectives and functions. However, it is fair to say that no developed country would rely on this without putting in safeguards, in the relevant legislation or elsewhere, which the legislature and the public deem to be appropriate and sufficient. Here again the author would defer to members of the Legislative Council to decide whether or which of the proposed exemption and amendment powers are appropriate.

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

In the author's view, to achieve the necessary certainty the market seeks, section 48A(1) and the Seventeenth Schedule have to be made mutually exclusive. This is because all the types of offer described in the Seventeenth Schedule are offers to a section of the public eg. members of a club, employees and shareholders of a company, professional investors. However, section 48A(1) states that any reference in the Companies Ordinance to offering shares to the public is construed as including a reference to offering them to any section of the public. It is therefore possible, as a matter of simple logic, that an offer described in the Seventeenth Schedule may constitute an offer to the public.

On the other hand, it is difficult to see how the Seventeenth Schedule could limit the application of section 48A(1) to offers not described in that schedule. Although the drafting is a little clumsy, but the following could be a compromise:

"s.48(3) For the avoidance of doubt, subsection (1) shall not apply to the offers specified in Part 1 of the Seventeenth Schedule, and the Seventeenth Schedule shall not prejudice the generality of this section with respect to offers not specified in that schedule."

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

The author supports the idea of having different levels of disclosure for debt issues and equity issues, but does not agree that the proposed amendment to paragraph 3 is necessary or appropriate to achieve that purpose.

Debt issue prospectuses are already exempt from a lot of the Third Schedule disclosure requirements by virtue of the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions)(Amendment) Notice 2003 which came into effect in May 2003.

Furthermore, when the courts apply the "reasonable person" test currently in paragraph 3, it is hard to envisage that they will not take into account the nature of the securities offered (ie whether they are debt, equity-linked or equity), the nature of the potential investors, prevailing market practices as to disclosure and the information that the majority of investors in the relevant type of securities generally look for.

The Response stated that the purpose of the proposed amendment is "to allow the regulator to tailor disclosure requirements to a particular offer". However, paragraph 3 is only a statement of the general or overall standard and it is difficult to see how the regulator can "tailor" a prospectus through that paragraph. It is much more effective for any such "tailoring" to be done through waivers of the specific disclosure requirements in the Third Schedule. The SFC already has power to do so under the current legislation for requirements that are deemed irrelevant or unduly burdensome to comply with, and there is a proposed third ground for exemption. Furthermore, investors should not be "overloaded with information irrelevant to the making of informed investment decisions" since the SFC would have exercised its powers to exempt the provision of such information.

It is much more likely that paragraph 3 will be relied on by an aggrieved investor when trying to seek redress from the issuer. The proposed amendment may affect a court's interpretation of that paragraph and hence its decision as to whether or not the relevant prospectus satisfied the standard set out therein. It is the author's view that there is a serious possibility that an issuer may rely on the proposed amendment and successfully argue for a lower overall standard of disclosure. That does not seem to be the intention of the draftsman.

The proposed amendment does not seem to offer the SFC much more flexibility than it already has in setting different disclosure levels for debt and equity issues. On the other hand, there is a risk that investor protection may be undermined.

## V. Definition of “subsidiary undertaking” (Twenty-Third Schedule)

The author noted that the Response did not deal with the author’s comments on this issue.

## VI. Definition of “prospectus” (Section 2(1))

The author only wishes to raise another possible issue in the drafting of the revised definition of “prospectus”. As currently drafted the definition only catches the offer of shares in or debentures of a “company”. This is probably sufficient in relation to shares, but debentures could be issued, and are very often issued, by non-companies such as sovereigns, governments and governmental authorities. Whilst it may be appropriate to exempt offers made by the country’s own government etc (and FSMA also contains such a class exemption), there is no reason why, for example, a foreign sovereign bond issue offered to the public in Hong Kong should not comply with the prospectus regime.

**Alice Chan**
**Lecturer**
**Department of Professional Legal Education**
**University of Hong Kong**

***4 November 2003***