Paper No. CA1-4/03

Bills Committee on
Companies (Amendment) Bill 2003

Schedule 1 – Amendments to the Companies Ordinance relating to prospectus

Resale restrictions on shares/debentures acquired under offers specified in the Seventeenth Schedule

BACKGROUND

At the meeting of the Bills Committee on 17 October 2003, the Administration and the Securities and Futures Commission (SFC) were asked to review proposed new sections 38AA and 342AB in view of the following concerns of Members -

(a) whether there is any overlap between these proposed new sections and the existing section 41(2) and if so, the appropriate manner to deal with the overlap;

(b) how the proposed sections are compared with those of other jurisdictions; and if the practices/approaches adopted by other jurisdictions are found to be different, why an approach similar to that of Singapore is adopted;

(c) whether the current drafting of new sections 38AA(4) and 342AB(4) is appropriate, particularly in regard to the intended scope of persons to be regulated under the new provisions; and

(d) whether the current drafting of new sections 38AA(1) and 342AB(1) is sufficient to achieve the intended regulatory objective if under the current drafting of the provisions, a sale or offer for sale of shares in or debentures of a company made without any documentation is not subject to these sections.

PURPOSE OF THE PROPOSED RESALE RESTRICTION

2. The proposed new sections 38AA and 342AB are anti-avoidance measures aimed at preventing abuse of the exemptions ("safe harbours") introduced under Part I of the proposed Seventeenth Schedule. The concern was that issuers and acquirors of shares/debentures offered under a safe harbour could operate under an understanding whereby multiple

acquirors would effectively be acting in agreement with the issuer to offer the shares/debentures to the public at large by using the safe harbours repeatedly in respect of the same shares/debentures.

3. The existing section 41 has a different purpose. Where a company allots or agrees to allot shares in or debentures of the company with a view to them being offered for sale to the public, section 41 deems the document by which the offer for sale is made as a prospectus – the offer document must then comply with all the provisions relating to prospectuses under the Companies Ordinance (CO).

4. In view of Members' concerns raised at the Bills Committee meeting on 17 October, the Administration and SFC have re-examined in detail the necessity for a resale restriction in respect of each of the 12 types of safe harbours under Part I of the Seventeenth Schedule, taking into account investor protection provided for under CO (together with the proposals under the Companies (Amendment) Bill 2003) and practices in overseas jurisdictions. After careful re-examination and in light of Members' comments, we believe that the intended policy objectives of the proposed sections 38AA and 342AB would have been achieved by existing provisions in CO and the Securities and Futures Ordinance (SFO); or other proposed safeguards in the Bill, and hence may be dropped. The reasons are set out in paragraphs 5 to 16 below.

Section 1 – offer to professional investors within the meaning of the Securities and Futures Ordinance (SFO)

5. The requirement for a prospectus is designed to protect a retail investor. A more sophisticated market professional would not need the same level of protection. There is therefore no need to introduce resale restrictions on this type of offer. The prospectus regulatory regime (including provisions relating to investor protection) under CO will be triggered if shares/debentures are sold to persons other than professional investors.

Section 2 – offer to not more than 50 persons

6. Using this safe harbour to offer shares/debentures to a significant number of retail investors would involve the use of a number of offer documents, each one aimed at a specified group of no more than 50 persons. This is unlikely to be a practical proposition – in part because of its complexity but also because of the difficulty in segregating groups of 50 targetted investors or creating a pyramid of intermediaries as part of an

overall scheme. In any event, any attempt to do so would not be an offer to 50 persons or less, and hence would not be eligible for the safe harbour proposed in this section. In other words, the prospectus regulatory regime as provided for under CO will be triggered.

Section 3 – offer in respect of which the total consideration payable does not exceed a specified amount (proposed to be $5,000,000 in this Bill)

7. Since each offer made under this safe harbour cannot exceed a specified amount, further offers of the same shares/debentures by acquirors cannot exceed this limit. This in itself allays concerns about potential abuse of the safe harbour.

Section 4 – offer in respect of which the minimum denomination of, or the minimum consideration payable by any person for, the shares/debentures, is not less than a specified amount (proposed to be $500,000 in this Bill)

8. Repeated use of this safe harbour does not give rise to any policy concern as an investor who can afford to take up such an offer should be sufficiently knowledgeable to understand the risks involved or should be able to secure professional advice if considered necessary. Resale of shares/debentures in which the minimum denomination of, or the minimum consideration payable by any person, is less than the specified amount will trigger the prospectus regulatory regime as provided for under CO.

Section 5 – offer made under an underwriting agreement

9. The conduct of underwriters is regulated by SFC through the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. In addition, underwriters and sub-underwriters for the placing tranche in an initial public offering will be dealing with institutional and professional investors. There is therefore no need to introduce resale restrictions on this type of offers.

Section 6 – offer in connection with a takeover or merger or a share repurchase which is in compliance with the Codes on Takeovers and Mergers and Share Repurchases issued by SFC

10. Since activities relating to takeover, merger and share repurchase are already regulated by SFC under the Codes on Takeovers and Mergers and Share Repurchases, there is no need to introduce resale restrictions on this type of offers.

Section 7 – offer of shares for no consideration

11. The prospectus regulatory regime in CO will be triggered if shares are sold to persons other than existing shareholders as specified in this section. The pool of potential offerees is therefore limited.

Section 8 – offer of shares/debentures to "qualifying persons" (e.g. employees of a company and their dependents)

12. The prospectus regulatory regime in CO will be triggered if shares/debentures are sold to persons other than "qualifying persons".

Section 9 – offer by a charitable institution or educational establishment

13. Shares/debentures offered by charitable institutions/educational establishments are normally only of relevance to persons with a special interest in the work of the institution or establishment concerned. There is therefore no need to impose special resale restrictions on this type of offers.

Section 10 – offer to members of a club or association

14. Shares/debentures offered to members of clubs or associations typically relate to membership. There is therefore no need to impose resale restrictions.

Section 11- offer in respect of an exchange of shares/debentures

15. The prospectus regulatory regime in CO will be triggered if shares/debentures are sold to persons other than existing shareholders/debentures holders as specified in this section. The pool of potential offerees is therefore limited.

Section 12 – offer in connection with a collective investment scheme authorised by SFC

16. Since collective investment schemes are already regulated by SFC under sections 104 – 106 of SFO and Codes issued by SFC, there is no need to introduce resale restrictions on this type of offers.

PRACTICE IN OTHER JURISDICTIONS

17. There are safe harbours in the United Kingdom, Australia and Singapore. No restriction on the repeated use of safe harbours is imposed in any of these jurisdictions. In Australia, repeated use of the safe harbours is expressly permitted in its Corporations Act. Resale of shares/debentures acquired under safe harbours to persons falling outside the exemptions within 12 months will require a prospectus. In Singapore, there is also a restriction on resale of shares/debentures acquired under exempt offers to persons falling outside the exemptions. Members may wish to refer to the paper on "Comparison of the Prospectus Regulatory Regime between Hong Kong and Overseas Jurisdictions" issued by the Administration on 22 October 2003 to the Bills Committee (LC Paper No. CB(1)84/03-04(06)) for further details. By taking out the resale restriction specified in the new sections 38AA and 342AB, the proposed regime would be largely in line with standards and practices in other major financial markets.

WAY FORWARD

18. In view of the discussion in paragraphs 5 - 16 above and the practices in other major financial markets, we believe that the resale restriction proposed in the new sections 38AA and 342AB is not necessary, and that there are sufficient safeguards for investor protection under the existing CO and SFO and other proposed provisions in this Bill. In particular, any resale of shares/debentures acquired under a safe harbour to a wider section of the public would render the offer ineligible for the safe harbour in question, and hence the safeguards provided for under the current prospectus regulatory regime in CO would apply. We therefore propose to take out from the Bill clauses 4 and 17 (i.e. proposed new sections 38AA and 342AB), as well as provisions relating to punishment of offences under sections 38AA(4) and 342AB(4) in clause 26 as Committee Stage Amendments. Subject to Members' comments, we shall move an amendment to this effect during the Committee Stage.

Financial Services and the Treasury Bureau
Securities and Futures Commission
6 November 2003