THE LAW SOCIETY OF HONG KONG 香港律師會

COMMENTS ON THE PROPOSED AMENDMENTS TO THE COMPANIES ORDINANCE TO FACILITATE OFFERS OF SHARES AND DEBENTURES

1. General Comments

1.1 Given the limited time available in which to review and provide comments on the draft forms and guidelines, the committee has limited itself to substantive points only and has not made any drafting suggestions.

1.2 As a general comment, the committee welcomes the proposals put forward and is of the view that the proposals, when implemented, will significantly improve the regulatory framework for offering structures in Hong Kong, removing many of the uncertainties in existing provisions of the Companies Ordinance ("CO") and providing a framework which is more conducive to market practices.

2. Specific Comments

2.1 Exemptions from the Prospectus Regime

2.1.2 ***Professional Investors:*** The committee supports the proposed exclusion of an offer to investors falling within the definition of "professional investors" in Schedule 1 to the SFO as read together with the Securities and Futures (Professional Investor) Rules.

2.1.3 ***Offer to not more than 50 persons:*** Providing a statutory private placement safe harbour which is similar to the existing market practice is helpful.

2.1.4 ***Minimum consideration exemption:*** The committee is of the view that the amount of minimum denomination or consideration for an excluded offer to be set out in Part 2 of the proposed Seventeenth Schedule of the CO is appropriate.

2.1.5 ***Small Offers:*** The committee is of the view that a threshold of HK$1.0 million is rather low (contrast with, for example, the minimum size of a Hong Kong listed IPO of HK$50 million) which may render that exemption of limited use in practice. The figure ultimately adopted should be consistent with experience of market practitioners, who feel the currently proposed threshold to be too low given the local investment appetite.

2.1.6 ***Offer made to persons outside Hong Kong*****:** The amendments clarify that the new prospectus regime will not regulate offers where persons in Hong Kong are not targeted. This is similar to the approach under Part IV of the SFO, which only regulates offers of investments to the public of Hong Kong. However, under the SFO, offers made in Hong Kong to persons outside Hong Kong are also exempted. The committee recommends an amendment to this

exemption to refer to offers made to persons outside Hong Kong (whether the offer is made in or outside Hong Kong).

2.1.7 ***Offer made in connection with a genuine invitation to enter into an underwriting agreement:*** An underwriter should be in a position to obtain all the relevant information from the issuer without relying on a CO-compliant prospectus. The committee notes that a similar exemption is available for forms of application under Part IV of the SFO.

2.1.8 ***Take-over offer exemption:*** The committee is of the view that this amendment will avoid double regulation as the documents complying with the Code are pre-vetted by the SFC. However, the committee suggests that this exemption should also apply to the equivalent of a take-over or merger regulated by legislation or codes of other jurisdictions similar to the Codes, provided they are approved and recognised jurisdictions. In addition, this exemption should also be extended to include an offer to existing policyholders in connection with a demutualisation provided the demutualisation procedure is regulated in the home jurisdiction of the insurer and all information to be circulated to policyholders is approved by a recognised regulatory body in that home jurisdiction.

2.1.9 ***Bonus issue exemption:*** The committee suggests that this exemption should expressly cover: (i) a scrip dividend scheme (i.e. a scheme whereby shareholders are allowed to make an election to give up cash dividends and be issued with new shares in lieu) and (ii) distribution specie made by a company to its shareholders of shares in a second company which in substance is similar to a bonus issue of shares. The committee notes leading counsel has advised before that it technically falls within the requirements of a registrable prospectus under the CO notwithstanding that the market practice in Hong Kong is not to regard it as a registrable prospectus.

2.1.10 ***Offer to "qualifying persons":*** A "qualifying person" is defined to include bona fide current and former directors, employees and consultants and their respective dependants. This exemption allows an offer to employees of the group to fall outside the prospectus regime. The committee notes that a similar "domestic concern" exemption is available under the current CO. It would be helpful if the definition of "qualifying persons" for the purposes of this exemption as set out in paragraph 5(a) of Part 4 of the 17th Schedule is extended to include officers or former officers of the relevant company so as to give flexibility to issuers who may want to award its officers who may not be an employees or directors.

The committee is also of the view that the definition of "consultant" as set out in paragraph 5(b) of Part 4 of the 17th Schedule should be amended such that it means "a person who, pursuant to a contract for services, renders services to a company" and the last part of the proposed definition (i.e. "which are commonly rendered by an employee of the company or a like company") should be deleted. A "contract for services" is a term, which is itself subject to judicial interpretation in case law. The requirement that the services must be commonly rendered by an employee of the company or a like company seems unusual and would render this definition rather restrictive.

2.1.11 ***Others:*** The committee is of the view that the existing exemption for offers which can be regarded as a domestic concern of the issuer and the recipients of the offer should be retained.

2.2 **Points to note on the exemptions**

2.2.1 **A *"mix and match" of exemptions:*** This is possible under the draft Bill. A public offer may be made without a prospectus so long as it falls entirely within any combination of the above exemptions (with the exception, of course, of the "minimum denomination/consideration" and

"small scale offer" exemptions). The Committee is of the view that the logical approach to interpreting the above exemptions is that the conditions set out in the exemptions (except the "offer wholly outside Hong Kong" exemption) need only be satisfied in respect of persons in Hong Kong who are targeted. It would be helpful if this point was clarified in the legislation. Further, the committee notes that there is no corresponding "mix and match" provision in Part IV of the SFO. The committee is of the view that there should be.

2.2.2 ***"Minimum denomination/consideration" and "small scale offer":*** The committee is aware of an anti-avoidance measure to these exemptions. Broadly speaking, where there is more than one public offer done without a prospectus made by the same person within a 12 month period, such offers are to be taken together when determining whether the conditions in the two exemptions are satisfied.

However, such anti-avoidance provisions are only triggered where the different offers are made "by the same person". Therefore, in respect of the "private placement" exemption when read together with the on-selling provisions (see below), it would be possible for a large number of investors to be targeted without a prospectus, e.g. if each of the 50 investors who participated in the original offer each on-sell to a group of 50 investors, and each of the 2,500 investors who participate in the re-sale then on-sell to a even bigger group of investors. The committee is of the view that it is unlikely that such an outcome is intended by the draft Bill.

2.2.3 **Section 103 of the SFO:** The committee is of the view that under this section of the SFO, there is no exemption from the prohibition against the issuance of advertisements or other documents along the lines of the "minimum denomination/consideration", "small scale offer" and other safe harbours under the CO. Therefore, documents in respect of offers falling within such safe harbours may only be issued to the public in Hong Kong where the requirements under the SFO are complied with or where exemptions under the SFO are available. The committee is of the view that the provisions of the SFO should be amended in parallel with the amendments to the CO.

2.3 **New resale restrictions in section 38AA**

Whilst the committee appreciates that the resale restrictions as set out in the new section 38AA are intended to prevent abuse and support that aim, it is of the view that the proposal would impose more restrictions than the existing requirements under the CO. In short, section 41 of the CO does not impose blanket restrictions on resale and it seeks to prevent the abuse only where "any document" is used in a subsequent offer for sale. Further, it only applies if the issuing company allots the shares or debentures "with a view to any of those shares or debentures being offered to the public" and it does not apply following the initial allotment of shares or debentures where there is no such intention.

The draft Bill does not define what constitutes an offer "to the public". Accordingly, an offer falling within any one of the safe harbours described above may still be an offer "to the public" even though the relevant offer document is exempt from the prospectus requirements. In this way, such a document may still fall within the definition of a "prospectus" in the SFO if it nevertheless relates to a "public" offer of shares or debentures. As a result, where a document is issued in respect of an offer falling within one of the safe harbours described above, an exemption from Part IV of the SFO is still available under section 103(3)(a)(i) or (ii) of the SFO in respect of a "prospectus which complies with or is exempt from compliance with the …Companies Ordinance".

The committee is of the view of certain market participants that, public offer of debentures by certain specified categories of issuers, (for example, authorised institutions) should also fall

outside the prospectus regime. In respect of authorised institutions, arguably such institutions are regulated entities, which take deposits from the public in their ordinary course of business, which is akin to (including equity linked deposits) offering debentures to the public. If authorised institutions are allowed to take deposits from the public without any disclosure documents akin to prospectuses, they should be equally allowed to offer debentures to the public outside the prospectus regime.

Under the existing CO, a debenture is defined to include "debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not". In view of this lack of clarity, a question is often raised as to whether certain and structured derivatives products, such as structured certificates of deposit, derivative warrants and equity linked instruments, constitute debentures for the purposes of prospectus requirements. The committee would highly appreciate clarification on the regulatory treatment of such derivatives and structured products. In addition, the committee questions whether it is appropriate to limit the exemption in 38AA(1)(b) to only shares listed in Hong Kong.

In summary, the committee would propose the following amendments/clarifications to the new section 38AA:

(a) the resale restrictions should only apply where any document is used to make the offer;

(b) the exemption of offers in respect of shares or debentures of the same class listed on the SEHK by a person who has held them for not less than 6 months should be extended to cover shares or debentures of the same class listed on another stock exchange recognised by the SFC; and

(c) the SFC exemption power under section 38A or section 342A as expanded should also be available to the new section 38AA;

(d) clarification of what does, or does not, constitute a debenture.

2.4 **Expanded scope of exemption in amended section 38A and 342A**

In the amended sections 38A and 342A of the CO, the SFC is given the power to issue certificates of exemption, on the request of an applicant, from a range of "relevant provisions" on the basis of the Irrelevance Ground, Undue Burden Ground or No Prejudice Ground (as described above). The committee notes that, as is already the case, the SFC may attach conditions to any such exemptions. The SFC may also grant class exemptions of its own volition by notice in the Gazette on any of the same three grounds. The new legislation will make it clear that the SFC is equally able to attach conditions to class exemptions from the "relevant provisions".

The committee is of the view that such additional flexibility in the implementation of the prospectus regime is extremely positive. However, there are certain provisions, which remain outside this new flexibility where the SFC will have no power to grant exemptions, for example, the requirement as to civil and criminal responsibility for misstatements and omissions attaching to directors of the issuer (as opposed to corporate responsibility).

The committee believes that the requirement for civil and criminal liability to attach to directors personally has proved to be extraordinarily burdensome for large international organisations issuing securities constituting debentures in its ordinary course of business,

where typically there are long chains of delegated authority and the directors are not involved in the day-to-day operations of the debt issuance business of the issuer in Hong Kong. Nevertheless, the committee questions why there is no proposal to give the SFC power to grant exemptions in respect of this requirement on a case-by-case basis.

In addition, the committee suggests that the SFC exemption power should also be available to the following sections of the CO:

(a) section 37 in relation to dating of prospectus. This will bring it in line with the corresponding provisions in section 342(1) applicable to overseas companies;

(b) section 38(1A) in relation to warning statement in English and Chinese. Flexibility for an exemption would be desirable where for example the warning statement has been included in a language other than English or Chinese; and

(c) sections 38D(2)/342C(2) in relation to the appearance of certain statements on the face of a prospectus and sections 38D(3)/342C(3) about endorsement of certain documents to a prospectus.

2.5 **Awareness Advertisements (18 Schedule)**

The committee welcomes the new concept of "awareness advertisements" introduced in the Bill, which aim to provide more user-friendly documents such as fact sheets rather than the prospectus, which is the only marketing document under the current legislation. The awareness advertisements may be in Chinese or English or both. The provisions are similar to those relating to offer awareness materials under the Publicity Guidelines.

However, the committee is aware that unlike the Publicity Guidelines, the Bill does not specify the period during which awareness advertisements may be used. There are also no express provisions relating to summary disclosure materials in the Bill.

2.6 **Programme Structure (New Sections 39A, 39B, 342CA and 342CB and Nineteenth and Twentieth Schedules)**

The committee is aware that there has been some residual doubt as to whether a programme structure is possible under the current prospectus regime. Under a typical debt programme structure, the offer documents consist of (a) a programme document which sets out, among other things, financial and other generic information on the issuer, the terms and conditions of the programme and risk factors and (b) an issue document which sets out offer-specific information (such as pricing) and updates the programme document. Such a structure streamlines the documentation process particularly where offers are to be made on a repeated or continuous basis. The current CO does not expressly provide for such a structure for public offers of shares or debentures. Therefore, the SFC published the "Guidelines on using a "dual prospectus" structure to conduct programme offers of shares or debentures requiring a prospectus under the Companies Ordinance" (**Programme Guidelines**).

Under the Bill, a programme structure similar to that outlined in the Programme Guidelines will be put on a statutory footing. However, there are differences and certain requirements which are expected to form part of the conditions to an exemption will be set out as a matter of statute. One example of such differences is where an offer is conducted on a continuous basis, for example, where debentures are "warehoused" (i.e. kept on the books of the issuer or an affiliate and only offered to the public over a period of time), all the constituent prospectuses must be made available throughout the offer period. However, the committee

considers it unclear as to what extent the prospectuses need to be kept up-to-date, i.e. whether it is sufficient to make available the constituent prospectuses prepared at launch or the beginning of the offer period. Otherwise, it would be a prohibitive administrative burden to keep the prospectuses up to date in respect of every day during the offer period and for a period of 3 years after the end of such period.

The committee is also aware that in respect of the structure of a programme, it is the view of certain market participants that the typical medium term note programme (**MTN programme**) style documentation does not fit well with retail investors. Under the typical MTN programme documentation, an extensive set of terms and conditions covering a wide range of options is included in the programme offer document. The range of options allow for different bonds to be issued under the programme, for example, the bonds may be zero coupon or interest bearing, and the relevant interest may be determined by reference to a fixed rate or a floating rate. The relevant elections as to which provisions apply and which do not apply to a particular issue of bonds will then be made in the pricing supplement for such issue. The retail investor will then have to read the extensive set of terms and conditions together with the relevant elections in the pricing supplement for a full description of the bonds. It is the view of certain market participants that this may prove to be too confusing for the retail investor. Indeed, the retail market practice in Germany and several other European countries is not to adopt such a documentation structure.

An alternative structure is to set out in the programme offer document distinct sets of terms and conditions for each particular type of product, and the issue offer document will set out the product-specific terms such as the issue size, maturity date and the specified fixed rate of interest. This is indeed the structure adopted for the retail warrant market in Hong Kong, which has been widely accepted. It is proposed that this structure should be adopted for the proposed "dual prospectus" regime.

2.7 **Level Playing Field for Local and Foreign Issuers (Amended Section 44a And 44b)**

The committee agrees with the proposed amendments to remove discrepancies in certain requirements of the CO applicable to companies incorporated in or outside Hong Kong. However, the committee proposes that the discrepancies in the following sections of the CO should also be removed:

(a) section 342 should be amended to the effect that any prospectus making offers for sale (i.e. not only a prospectus offering for subscription) shares in or debentures of a company incorporated outside Hong Kong must be dated and contain the prescribed particulars. The committee is of the opinion that it has been the SFC's view that section 342 also applies to a prospectus offering for sale shares in or debentures of an overseas company;

(b) similarly sections 342B and 342C should be amended to apply not only in connection with prospectuses offering for shares or debentures for subscription, but also to prospectuses offering for sale of shares or debentures issued by an overseas company circulated in Hong Kong;

(c) the discrepancies in the requirements relating to the signing of a prospectus for registration purposes in section 38D(3) applicable to Hong Kong companies (i.e. signing by every director or proposed director of a Hong Kong company or his agent) and those in section 342C(3) applicable to overseas companies (i.e. signing by 2 members of the governing body or their agents certifying the prospectus having been approving by resolution of the governing body) should be removed and standardised; and

(d) the SFC should clarify whether the term “recognised stock market” has the same meaning given to it in the SFO.

2.8 **Prospectus Liability (Amended Sections 40, 40A, 41A and 343)**

The committee welcomes the amendments to the civil and criminal prospectus liability under the CO e.g. that civil and criminal liability will attach to untrue statements as well as material omissions which is consistent with the approach under section 107 and 108 of the SFO.

2.9 **Disclosure on "Guarantor Corporations" (Amended Sections 38(7) and 342)**

Currently the SFC may require disclosure by a guarantor of a debenture issue on the basis of paragraph 3 of the Third Schedule, which provision, briefly speaking, requires a prospectus to contain sufficient information to enable to reasonable person to form an informed investment decision in relation to the debentures.

Under the Bill, disclosure requirements set out in the Third Schedule will also apply to a "guarantor corporation" of a debenture issue in the case of a guaranteed offering of a company.

A "guarantor corporation" is defined to be a corporation that has guaranteed or has agreed to guarantee:

(a) the repayment of any money received or to be received by the company in response to an offer or invitation to the public to subscribe for or purchase debentures of the company (this definition already exists in the current Third Schedule); or

(b) any other obligations of the company to the holders of debentures of the company; or

(c) the company in relation to any amount to be obtained by the company in relation to the debentures of the company.

The committee submits that the definition is arguably too broad for the following reasons:

(d) the general reference in the definition as currently drafted to "debentures" is not limited to the debentures as the subject of the public offer in question. It is possible to interpret the definition such that the prospectus in respect of a particular public offer of debentures need to include disclosure on all the corporations which have ever guaranteed any payment or other obligations of any debentures. The committee is of the view that the current wording should be tightened to avoid the possibility of this anomalous interpretation;

(e) in addition, the reference to "any amount to be obtained by the company in relation to the debentures of the company" is also too wide. According to the consultation paper in respect of the Bill, presumably this is relevant to a situation where the debentures the subject of a public offer (**primary debentures**) are secured on some underlying debentures of a different company (**underlying debentures**) and where a corporation guarantees the repayment of such underlying debentures, then disclosure on that guarantor is required.

The committee submits that if this interpretation is adopted, the following uncertainties may in turn arise:

(a) it would be anomalous to require disclosure by the underlying guarantor but not the underlying issuer. If the primary debentures were not so secured, disclosure on the issuer and the guarantor of the primary debentures are typically required (unless an exemption is granted);

(b) it will be unduly harsh for the issuer of the primary debentures to be subject to civil and criminal liability, which may attach to misstatements and material omissions relating to information on the guarantor of the underlying debentures.

In any event, it is not clear what amounts to a sufficient link between amounts obtained by the company (for example, trade receivables) and the debentures of the company. It is very possible that the company relies heavily on its trade receivables to service the repayment of the debentures, but it will be absurd to require disclosure by any guarantors of such trade receivables.

2.10 Other Amendments

2.10.1 Material Contracts (amended sections 38D and 342C)

Under the existing CO, paragraph 17 of the Third Schedule requires disclosure of details of every material contract, not being a contract entered into in the ordinary course of business carried on or intended to be carried on by the company or a contract entered into more than 2 years before the date of issue of the prospectus. Sections 38D and 342C require that certified copies of such contracts be delivered for registration together with the prospectus. Paragraph 17 also requires a statement confirmation delivery for registration.

Under the Bill, it is proposed that registration of material contracts should no longer be required. Instead, certified copies of such contracts shall be made available for inspection by the public for not less than 14 days at one or more specified locations in Hong Kong. The committee notes that to the extent any part of such material contracts are wholly or partially in a language other than English or Chinese, translation into English or Chinese is still required. There are also new requirements as to certification of documents (see below). The committee considers that the requirement of a statement confirming delivery for registration in paragraph 17 should also be removed.

2.10.2 Certification of Documents (new sections 39C and 342CC)

Where a document is required to be delivered for registration, it is sufficient if a certified copy of such document is delivered. Certification must be made as to authenticity and legibility and by officers of the company (at least 2 directors or at least 1 director and the secretary), a solicitor, a professional accountant or a notary public.

These new provisions follow the approach set out in the "guidelines on applying for a relaxation from procedural formalities to be fulfilled upon registration of a prospectus under the Companies Ordinance" as part of the First Phase of the company law reform referred to above. The committee is of the view that they allow flexibility as to registration of, for example, bulk print proof of prospectuses and faxed copies of written consents of experts.

2.10.3 **Amendments to the Third Schedule**

The Bill proposes an amendment to paragraph 3 of the Third Schedule, which sets out various contents requirements in respect of prospectuses.

The new paragraph will require the inclusion of sufficient information to enable a reasonable person to form a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the company, and the nature of the persons likely to consider acquiring them (words in italics being the amendments).

The committee welcomes this amendment which allows additional flexibility. For example, in respect of debentures, the investors may be less concerned with the profitability of the issuer than the financial condition - the key is that the issuer can repay the debt, not that it is profitable.

3. General Comments

The provisions in the CO and SFO clearly demonstrate the need for company directors to receive appropriate training and education in order to enhance corporate governance.

The Law Society of Hong Kong
Securities Law Committee/
Companies and Financial Law Committee
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