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[online version](http://www.charltonslaw.com/sfc-publishes-consultation-paper-on-possible-reforms-to-the-companies-ordinance-prospectus-regime/)

# SFC Publishes Consultation Paper On Possible Reforms To The Companies Ordinance Prospectus Regime

## Introduction

The Securities and Futures Commission (the "SFC") has published a consultation paper setting out its proposals for the final phase of its modernisation of the regime governing the public offering of shares and debentures. The Consultation Paper sets out 21 proposals and stresses that it should be seen as a "concept release" designed to promote discussion and feedback. The full text of the Consultation Paper is available on the [SFC's website](http://www.sfc.hk). The consultation period ends on 30 November 2005.

The purpose of this note is to provide a summary of the Consultation Paper's proposals.

## 1. Transfer CO Prospectus Regime To The SFO (Proposal 1)

It is proposed that the provisions of the Companies Ordinance (the "CO") which deal with the public offering of shares in and debentures of Hong Kong companies and the public offering in Hong Kong of shares in and debentures of non-Hong Kong incorporated companies (the "CO prospectus regime") should be moved to the Securities and Futures Ordinance (the "SFO"). This would consolidate all securities laws in the SFO and allow the removal of inconsistencies between the CO and SFO.

## 2. Shift Of Focus To "Transaction-Based" Approach (Proposal 2)

The CO prospectus regime currently adopts a "document-based" approach focused on the existence of a document containing an offer or invitation to the public. The regime's two central prohibitions provide that:

1. an application form may not be issued without a prospectus (Sections 38(3) and 342(3) CO); and
2. a document containing an offer to the public or calculated to invite offers from the public may not be issued unless it complies with the requirements for prospectuses in the CO (Sections 31(1B) and 342(1) CO).

As the CO prospectus regime is document-based, it does not apply to public offers of shares or debentures made otherwise than with a document. Accordingly some offers are structured with a verbal component in order to take the offer outside the CO prospectus regime. In contrast, the regime under Part IV SFO regulates advertisements and invitations whether in writing or otherwise.

It is proposed that the CO prospectus regime should move instead to a transaction-based approach by providing that no public offer of shares or debentures may be made unless it is contained in a prospectus that complies with the requirements of the CO prospectus regime or falls within a specified exemption. Accordingly, the act of offering would be regulated rather than the document containing the offer.

## 3. Options And Other Rights (Proposal 3)

The CO prospectus regime is silent as to the treatment of offers of options or other rights in or over shares or debentures: it is however generally assumed to extend to them. It is proposed that the CO prospectus regime should expressly provide for such offers. The Consultation Paper invites comments on whether the application of the CO prospectus regime to such offers should be confined to cases where the issuer of the option or other right is in the same group as the issuer of the underlying shares or debentures. Accordingly offers of options or other rights over shares or debentures of an unrelated company would not be regulated by the CO prospectus regime. While many of such offers would be regulated under Part IV SFO, an exemption may permit offers to be made without prior authorisation.

## 4. Scope Of The Regime: Bodies And Place Of Incorporation (Proposal 4)

The CO prospectus regime currently applies only to offers of shares and debentures of a "company" within the meaning of the CO. It also deals separately with Hong Kong companies and companies incorporated outside Hong Kong and imposes different requirements on them in certain respects (e.g. the prospectus signing requirements for the purpose of registration).

It is proposed that the CO prospectus regime should apply to "bodies" (irrespective of their legal form) wherever incorporated. It is suggested that offers by certain types of bodies (for example, sovereign states, supranational organisations and statutory bodies) may fall within an exemption from the CO prospectus regime and comments are invited as to the types of bodies which should be exempted and the rationale for any such proposal.

## 5. Unification Of CO And SFO Regimes

Currently, the CO prospectus regime regulates offers of shares in or debentures of Hong Kong companies and offers in Hong Kong of shares in or debentures of companies incorporated outside Hong Kong. Public offers of securities other than shares and debentures of a Hong Kong company and of securities (including shares or debentures) of overseas companies are outside the scope of the CO prospectus regime but will normally be regulated under Part IV SFO (the "SFO investment advertisement regime").

One particular difficulty under the CO prospectus regime is the broad definition of "debenture", which is defined as including *"debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not"*. The reference to "any other securities" in particular has posed difficulties for market practitioners.

Part IV of the SFO regulates the issue of advertisements, invitations or documents containing invitations to the public regarding securities, regulated investment agreements and collective investment schemes. The general approach of Part IV is that the issue of such advertisements is prohibited unless authorised by the SFC or within an exemption. The Part IV regime also gives the SFC an express power to authorise collective investment schemes and advertisements containing invitations to the public, subject to any conditions it considers appropriate. In the case of collective investment schemes and certain other investment arrangements, SFC authorisation is conditional upon the product complying with any SFC code applicable to that scheme or arrangement. Examples of such codes include the Code on Unit Trusts and Mutual Funds, the Code on Real Estate Investment Trusts and the Code on Investment-Linked Assurance Schemes. These codes are tailored to take into account the nature of the particular product and prescribe disclosure and other structural safeguards designed to enhance investor protection. The Codes do not however have the force of law and their requirements may be waived by the SFC in appropriate circumstances.

The existing regimes under the CO and SFO are fundamentally quite different. One problem posed by the inconclusive case law as to the definition of "debenture" is that some instruments can be regulated either under the CO or the SFO giving rise to the possibility of regulatory arbitrage. The SFC considers that it is desirable to harmonise the legal and regulatory treatment of investment arrangements and instruments having similar characteristics, regardless of their particular legal form, and invites comments as to how this could best be achieved.

It puts forward the possibility that all investment arrangements and instruments could be regulated under a modified form of the investment advertisement regime in Part IV SFO. The minimum constituents for such a unified regime would be a statutory disclosure standard applying to all regulated investment arrangements and instruments. This would probably be along the lines of paragraph 3 of the Third Schedule to the CO which requires a CO prospectus to contain

*"sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and debentures and financial condition of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered, and the nature of the company, and the nature of the persons likely to consider acquiring them".*

This would then be backed by a statutory liability provision imposing civil and criminal penalties in the event of a failure to meet the required standard. Regulated offers (i.e. those not within an exemption) may require authorisation which would depend on compliance with an SFC product code tailored to take account of the particular characteristics of the relevant investment arrangement or instrument. Objective differences in product characteristics (such as between a managed and unmanaged investment) would justify different levels of regulatory intervention in the product's structure, management, documentation and distribution. SFC guidelines could additionally address issues common to the regime as a whole and deal with borderline cases that do not fit within an existing product code. While compliance with any applicable SFC product code should enable the issuer to obtain SFC authorisation of the offer, it would not provide any assurance that the required disclosure standard has been met. The issuer would still need to be satisfied that the offer contains all information that investors may reasonably require.

The SFC invites views on the introduction of a unified regime and also on whether the definition of "debenture" should be clarified by replacing the reference to *"other securities"* with *"other debt securities"*.

## 6. New Safe Harbour For Takeover And Merger Offers And Schemes Of Arrangement In Compliance With Laws Of A Company's Home Jurisdiction (Proposal 6)

The 17th Schedule to the Companies Ordinance sets out 12 categories of offer, the documentation for which is excluded from the definition of "prospectus" and is therefore outside the scope of the CO prospectus regime. One such exemption relates to an offer made in connection with a takeover or merger that is in compliance with the Hong Kong Codes on Takeovers and Mergers and Share Repurchases (Section 4 of Part 1 of the 17th Schedule). There is however no exemption for an offer made in connection with a takeover or merger which complies with the laws and regulations of another jurisdiction (which will usually be the home jurisdiction of the target company). Likewise, an offer contained in a scheme of arrangement approved by a court in the home jurisdiction of the company concerned will not be exempted under the CO.

To ensure that Hong Kong investors in overseas companies are not disadvantaged in cases where the number of Hong Kong investors does not justify the cost of complying with the CO prospectus requirements, the SFC proposes adding a new exemption for an offer made to holders of shares or debentures of a company in the context of a takeover or merger or under a compromise or arrangement between a company and such holders provided that the offer is in compliance with the laws and regulatory requirements of the company's home jurisdiction and of any principal stock exchange on which the relevant shares or debentures are listed.

## 7. Adjustment Of Anti-Avoidance Mechanism (Proposal 7)

Section 41 CO is intended to catch the possible avoidance of the CO prospectus regime by issuers allotting to one or a small number of people with the intention that the allottees then sell the shares or debentures to third parties in a wider distribution. There are concerns that the scope of the existing provision is too wide, catching transactions to which the SFC has no objection from a regulatory standpoint (e.g. it may catch a disposal in the secondary market of listed shares or debentures taken up by underwriters pursuant to an underwriting commitment in a public offer).

It is therefore proposed that the anti-avoidance mechanism should be adjusted so that an offer for sale of shares or debentures within 12 months of their initial issue will require a prospectus to be issued by the offeror where:

1. the original issue of shares or debentures was made pursuant to a particular exemption;
2. there are reasonable grounds for concluding that the issuer issued the shares or debentures, or the person to whom they were issued acquired them, with the purpose of selling or transferring them; and
3. no exemption would have been available if the issuer had offered the shares or debentures directly to the offerees.

The Consultation Paper also invites comments on a series of exceptions to the proposed anti-avoidance provision. These include:

1. an offer for sale of shares or debentures where:
	1. the issuer offered the relevant shares or debentures on the basis of a prospectus;
	2. the issuer issued the relevant shares or debentures to an underwriter named in that prospectus pursuant to underwriting arrangements; and
	3. the relevant shares or debentures are in a class of shares or debentures which is listed, or to be listed, on the Stock Exchange of Hong Kong (the "SEHK")\*;
2. an offer for sale of shares where:
	1. the issuer issued the relevant shares to existing shareholders pursuant to the bonus issue or scrip dividend exemption provided in the CO prospectus regime; and
* a.the relevant shares are in a class of shares that is listed on the SEHK\*;
1. an offer of shares or debentures where:
	1. the issuer issued the relevant shares or debentures to employees pursuant to the employee scheme exemption provided in the CO prospectus regime; and
	2. the relevant shares or debentures are in a class of shares or debentures that is listed on the SEHK\*;
2. an offer for sale of shares or debentures where the relevant shares were issued pursuant to the exercise of an option or other right which was issued on the basis of a prospectus. This exemption is considered justified because information regarding the rights and liabilities attaching to the underlying shares will have been disclosed in the prospectus containing the offer of the relevant option or other right.
3. an offer for sale of shares or debentures where the relevant shares or debentures were issued as part of a takeover or merger or other compromise or arrangement falling within the proposed exemption referred to in paragraph 6 above (see proposal 6);
4. an offer for sale of shares or debentures where the relevant shares or debentures were issued pursuant to the exemption in the CO prospectus regime relating to an offer regulated by the Hong Kong Codes on Takeovers and Mergers and Share Repurchases; and
5. an offer for sale of shares or debentures where the relevant shares or debentures were issued by a body exempted from the CO prospectus regime (see proposal 4 at paragraph 4 above).

\*Note: For each of the offers referred to at paragraphs (i) to (iii) above, the SFC considers the exemption to be justified on the basis that up-to-date information is available to the market through the continuous disclosure obligations of the issuer under the listing rules.

## 8. Persons Liable For A Prospectus (Proposal 8)

Section 40 CO currently imposes civil liability for any untrue statement in (which includes a material omission from) a prospectus on the following persons:

1. directors of the company at the time of issue of the prospectus and those named in the prospectus as having agreed to become directors;
2. "promoters" being parties promoting the company who are involved in the preparation of the prospectus but not including any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company; and
3. every person "who has authorised the issue of the prospectus".

Section 40A CO imposes criminal liability for untrue statements in a prospectus on "any person who has authorised" its issue.

The SFC proposes to extend civil liability for misstatements in prospectuses to:

1. the issuer and/or offeror/vendor of the shares or debentures;

("Issuer" would need to include a reference to the offeror/vendor of the shares or debentures in an offer for sale because the current Section 41 which imposes civil liability on vendors in an offer for sale would be repealed if the anti-avoidance mechanism described in Proposal 7 is adopted.)
2. the sponsors\* of the issue; and
3. each person who accepts, and is stated in the prospectus as accepting, responsibility for, or for any part of, the prospectus.

\*Note: A "sponsor" for these purposes would mean:

1. in the case of an offering of equity securities to be listed on the SEHK, any person acting as "sponsor" within the meaning of the SEHK Listing Rules;
2. in the case of an offering of equity securities to be listed overseas, any person performing a similar role; and
3. in the case of an offering of debt securities, any manager or arranger appointed for the purposes of the offer.

The SFC also proposes to remove the existing liability of "promoters" and those who "authorise the issue of a prospectus" due to uncertainty as to the range of persons covered by these terms. Experts who consent to the inclusion of their name in the prospectus will continue to be liable only for untrue statements attributed to them in the prospectus. In all cases, the defences to liability in Sections 40(2) and (3) CO will continue to be available where applicable.

The SFC also invites views as to whether the same classes of persons should be criminally liable for misstatements in prospectuses, with experts liable only in respect of statements made in their reports.

## 9. Misstatements: Secondary Market Purchasers Eligible For Compensation (Proposal 9)

Under Section 40(1) CO civil liability for untrue statements is currently owed to persons "who *subscribe* for any shares or debentures on the faith of a prospectus". Section 40(7), when read with the 22nd Schedule to the CO clarifies and extends the class of persons who can make a claim for compensation to:

1. persons who subscribe for or purchase shares or debentures pursuant to an offer in a prospectus;
2. persons who pursuant to an offer in a prospectus acquire shares or debentures through an agent; and
3. persons who acquire shares or debentures pursuant to arrangements made between the issuer or vendor of the shares or debentures and intermediaries appointed for the purposes of the offer.

These provisions clarify that investors purchasing from placing agents and underwriters are entitled to compensation in the same way as investors subscribing or purchasing direct from the issuer or vendor.

However, the classes of persons entitled to claim compensation for loss sustained by reason of an untrue statement in a prospectus is limited to persons who acquire in the primary market. It is proposed that the class of persons who may claim compensation in respect of a misstatement in a prospectus should be extended to include subsequent purchasers who purchase in the secondary market.

## 10. Misstatements: Removal Of Requirement For Proof Of Reliance On Prospectus (Proposal 10)

Section 40 CO entitles any person who subscribes for shares or debentures "on the faith of a prospectus" (such persons are deemed by Section 40(7) to include any person specified in the 22nd Schedule) to bring a claim for compensation for loss resulting from an untrue statement in a prospectus. The investor must prove both that his loss resulted from the untrue statement and that he relied on the prospectus, which may require proof that he actually read it.

It is proposed that provided that it can be established that the loss was caused by an untrue statement in the prospectus, it will not be necessary for a claimant to prove he has actually read and relied on the prospectus.

## 11. Amendment Of "Reasonable Belief" Defence (Proposal 11)

Section 40(2)(d)(i) CO provides a defence in respect of civil liability for an untrue statement in a prospectus (not purporting to be made on the authority of an expert) if the person reasonably believed that the statement was true. A similar defence is available to experts under Section 40(3)(c) CO in respect of statements that they were competent to make and reasonably believed to be true. A defendant also has a defence to criminal liability in respect of an untrue statement in a prospectus if he reasonably believed the statement to be true (Section 40A(1) CO).

It is proposed to make the reasonable belief defence contained in the sections referred to above subject to a requirement that the belief must be founded on all inquiries which were reasonable in the circumstances having been made.

## 12. Overall Disclosure Standard And Prospectus Contents (Proposal 12)

Paragraph 3 of the 3rd Schedule to the Companies Ordinance contains what may be considered as the "overall disclosure standard" in that it requires that a CO prospectus contain *"sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and debentures and financial condition of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered, and the nature of the company, and the nature of the persons likely to consider acquiring them".*

It is proposed to move the overall disclosure standard into the body of the CO prospectus regime adjacent to the sections imposing liability for misstatements in prospectuses (Sections 40 and 40A). The relevant provision would require a prospectus to contain all information that investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of:

1. the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the shares or debentures: and
2. the rights attaching to the shares or debentures,

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

The Consultation Paper further proposes to supplement this overall disclosure standard with prescribed content requirements which would differentiate between debt and equity and be set out in subsidiary legislation. Comments are also invited on whether the international disclosure standards issued by the International Organisation of Securities Commissions could be a useful model on which to base Hong Kong's prospectus disclosure requirements.

## 13. Disclosure For Rights Issues (Proposal 13)

Prospectuses for rights issues and issues of shares or debentures that are uniform with listed shares or debentures are not required to comply with the CO prospectus content requirements including the requirements of the Third Schedule (Sections 38(5) and 342(5) CO).

The SFC considers that it is not appropriate for these transactions to be totally exempt from disclosure regulation. On the other hand, less information will be required than for an IPO given that, in the case of a rights issue, the offer is to existing members or debenture holders of the company who already possess a certain amount of knowledge about the affairs of the company and, in the case of offers of shares or debentures of a class already listed, material information about such securities is available under the continuous disclosure requirements of the Listing Rules.

It is therefore proposed that prospectuses for rights issues and issues of shares or debentures that are uniform with listed shares or debentures should comply with reduced (rather than negligible) disclosure standards which would be prescribed in subsidiary legislation. They would additionally be subject to the overall disclosure standard discussed in relation to Proposal 12 above.

## 14. Incorporation By Reference (Proposal 14)

It is proposed to allow information lodged with a central online document repository (which could be similar to EDGAR in the United States) to be incorporated into a prospectus by reference provided that the prospectus contains sufficient information about the contents of the information (including a statement as to whether it is of a type primarily of interest to professional advisers) or a summary of the incorporated information, to enable investors to decide whether they wish to obtain a copy. The prospectus would also have to include a statement that the issuer will provide a copy of the incorporated information free of charge on request. Civil and criminal liability for misstatements in such information would apply in the same way as to information contained in the prospectus.

## 15. Pre-Deal Research (Proposal 15)

As regards pre-deal research published by "connected analysts" (i.e. analysts who are employed by a sponsor, manager or underwriter to the offer (or by a related company)) the Consultation Paper puts forward two possibilities. The first would require that where any information emanating from pre-IPO research reports appears in the media, all pre-IPO reports by connected analysts dealing with the relevant matter would be required to be published immediately to the market at large accompanied by appropriate disclosure as to the independent nature of the material, the procedures undertaken to ensure its accuracy and reliability, and the identity of the person or persons legally responsible for its contents. In addition, irrespective of the source of the information, the company would be required to record and address, in a section of the prospectus or (if the prospectus has already been issued) in a supplemental prospectus, all information in the media that does not appear in the company's prospectus.

The alternative would be a ban on all written pre-IPO research by connected analysts. Verbal communications with institutional clients over the telephone or in meetings and use of visual media in a non-printable format such as flip-charts would not be affected and would be exempted in a "transaction-based" regime as contemplated by Proposal 2. Consideration might also be given to formalising the use of "red-herring" prospectuses and permitting their distribution to institutional investors earlier than is currently the norm to alleviate the consequences of a ban on pre-deal research by connected analysts.

## 16. Supplemental Prospectus And Right Of Withdrawal (Proposal 16)

It is proposed that an issuer of a prospectus should be obliged to publish an addendum or replacement prospectus if, before the close of the offer period (or, alternatively, before the shares or debentures are allotted of issued), it becomes aware of a significant change affecting any of the prospectus disclosures, or a significant new matter arises which would have been required to be disclosed in the prospectus.

It is further proposed that upon the publication of the addendum or replacement prospectus, the issuer will be required to extend the offer by a specified minimum period during which applicants will be notified of the publication and given either the addendum or replacement prospectus or details of its availability. Applicants will have the right to withdraw their applications and be repaid in full.

## 17. The 3-Day Rule (Proposal 17)

Allotments of shares or debentures may not be made until the third day after the issue of the prospectus (Section 44A(1) CO). It is proposed that this 3-day waiting period before allotment should be removed in the case of offers of shares or debentures of a class already listed.

In the case of other offers, the SFC seeks views on whether the 3-day period should be extended to allow investors longer to read the prospectus.

## 18. Application Forms And Procedures (Proposal 18)

The CO currently prohibits the issue of any form of application for shares or debentures unless the form is issued with a prospectus complying with the CO's prospectus requirements.

It is proposed to extend the scope of regulation so that the distribution of any type of application form for shares or debentures or the implementation of any application procedure for shares or debentures by any person (including an intermediary) will be prohibited unless accompanied by a prospectus which either complies with, or is exempt from, the prospectus requirements.

## 19. Statements In Lieu Of Prospectus (Proposal 19)

It is proposed to repeal Section 43 of the CO which requires that a company that has not issued a prospectus on its formation, or has issued a prospectus but has not allotted any of the shares offered to the public for subscription upon it, is prohibited from allotting any of its shares or debentures until it registers a statement in lieu of prospectus containing specified information. The section is redundant as the anti-avoidance it was intended to addressed is covered by Section 41 CO.

## 20. Employee Offers (Proposal 20)

Offers to employees and their dependants are generally treated as a matter of "domestic concern" for the purposes of Section 48A of the CO. Such offers would not therefore be an offer to the public and are not regulated under the CO prospectus regime.

Offers of shares or debentures in a company to the employees of such company or another group company (and their dependants) are also one of the categories of offer listed in the new 17th Schedule to the CO as being excluded from the definition of "prospectus" and therefore outside the CO prospectus regime.

The Consultation Paper seeks views on the establishment of a separate regulatory regime to govern offers to employees and their dependants which would include a requirement that the directors and auditors of the company provide a declaration of solvency or going concern.

## 21. Void Or Voidable Transactions (Proposal 21)

It is proposed that an issue or sale of securities in contravention of the law should be void or voidable.

## 22. Consultation

Comments on the Consultation Paper should be submitted by 30 November 2005. Written comments may be sent:

By mail to:

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

By fax to: (852) 2810 5385

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

By e-mail to: cfdconsult@sfc.hk

*This note is intended as a summary only of the proposals set out in the SFC's Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance. Specific advice should be sought in relation to any particular situation.*

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