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# SFC Publishes Consultation Paper On Proposed Amendments To The Codes On Takeovers And Mergers And Share Repurchases

## Introduction

The Securities and Futures Commission (**SFC**) released a consultation paper (the **Consultation Paper**) on proposed amendments to the Codes on Takeovers and Mergers and Share Repurchases (the **Codes**) on 19 September 2007. The Consultation Paper sets out the SFC's proposals to do the following:

1. Introduce a new Rule 21.7 to the Takeovers Code to deal with securities borrowing and lending activity involving parties connected to an offer.
2. Clarify the treatment of borrowed or lent shares in the context of the mandatory offer obligation and the acceptance condition in voluntary offers.
3. Amend Rule 21.6 of the Takeovers Code to provide more guidance regarding dealings by connected discretionary fund managers and principal traders before and during an offer period.
4. Introduce a new Note to Rule 2 to clarify that the Takeovers Code may apply to transactions involving the disposal by a company of its assets and/or operations and the possibility of delisting.

The SFC has invited interested parties to respond to the Consultation Paper by answering 9 key questions and submitting comments in writing by 9 November 2007. The key consultation questions are reproduced in Annex A to this note. The proposed amendments to the Codes are set out in Appendix 1 to the Consultation Paper.

The purpose of this note is to summarise the new proposals. The [Consultation Paper](https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=07CP2) ([see archive](openFile.pdf)) is available on the SFC website.

## 1. Securities Borrowing And Lending

### 1.1 Proposed restrictions on persons connected to an offer

The Consultation Paper proposes a number of amendments in relation to securities and borrowing lending activity by persons connected to an offer. The proposals recognise that securities and borrowing lending transactions involve an absolute transfer of title in the lent securities in return for an undertaking to return equivalent securities. The right to vote therefore passes along with the shares to the borrower and this currently presents the possibility for abuse. For example, if a shareholder is prohibited from voting on a resolution, he may lend his shares to another person so that the shares can be voted in accordance with the lender's instructions, which may secure a tactical advantage.

The SFC proposes to add a new Rule 21.7 to prohibit parties connected with an offer from entering into or taking action to unwind securities and borrowing lending transactions in relevant securities during the offer period without the consent of the Executive. "Parties connected with an offer" will include offerors, offeree companies and certain of their associates (including their advisers and concert parties). "Relevant securities" for these purposes will mean offeree securities and, in the case of securities exchange offers, offeror securities.

The Executive's main concern in the context of such transactions, is whether the purpose of the transaction is manipulative or abusive. It is therefore likely that the Executive will consent to securities and lending transactions by connected persons during an offer period if it can be satisfied that the activity is not manipulative or otherwise abusive, for example where a person wants to recall his lent securities in order to exercise the voting rights attached to them.

If the Executive agrees to a securities borrowing and lending transaction, the transaction will be required to be disclosed as if it were a dealing in the relevant securities (i.e. a disclosure made in accordance with Rule 22 will be required). Where however a connected lender (but not a connected borrower) wishes to enter into or unwind more than one lending transaction in the course of an offer period, it will be possible for such a lender to obtain a single consent from the Executive and make a single public disclosure.

### Treatment of borrowed or lent shares in the context of a mandatory offer obligation

For the purposes of Rule 26, both the original lender and the end borrower will be regarded as holding the voting rights of the borrowed or lent shares. This will only change if the shares have been on-lent, sold or returned to the lender. A new Note 21 to Rule 26.1 will be added to this effect.

The new Note will also provide that the Executive must be consulted as to whether borrowed or lent shares should be counted towards an acceptance condition and as to what action should be taken if they are not to be counted. If an offer lapses due to insufficient acceptances but would not have lapsed if the borrowed or lent shares had been counted towards the acceptance condition, it may be appropriate for an offeror who has lent the shares not to unwind the transaction for a specified period or, if the lending is unwound and the shares are returned to the offeror, for the offeror to be required to make a new offer or to reduce its shareholding.

### Treatment of borrowed or lent shares in the context of the acceptance condition

Rule 30.2 requires an offeror to hold more than 50% of the voting rights of the offeree company before it can declare an offer unconditional as to acceptances. The Executive considers that an offeror should not be permitted to count borrowed or lent shares towards the satisfaction of an acceptance condition.

A new Note 8 to Rule 30.2 will provide that shares borrowed by the offeror cannot count towards fulfilling an acceptance condition. The Executive does not consider it necessary for the new note to refer to shares lent by the offeror since the borrower would be the registered owner of such shares and not the offeror.

The application of this new note should be fairly limited given that an offeror and its concert parties will be prohibited from carrying out securities and borrowing lending transactions during the offer period under the proposed new Rule 21.7. The issue should therefore only arise in respect of shares that have been borrowed before the commencement of the offer period and not returned before the offer is declared to be unconditional.

A number of consequential amendments will be made to the Takeovers Code and the Schedules to the Codes to add references to the new Note 8. Of particular note is the proposed requirement for an offeror's receiving agent to have received a confirmation from the offeror of the validity of shares recorded as registered holdings and purchases in the context of the new Note 8 before issuing its certificate (paragraph 9 of Schedule VIII).

### Whitewash transactions

The Executive proposes amending the Codes to provide that the provisions relating to disqualifying transactions should apply to securities borrowing and lending transactions in a new Note 3 to paragraph 3 of Schedule VI.

## 2. Dealings By Connected Discretionary Fund Managers And Principal Traders

More guidance regarding dealings by connected discretionary fund managers and principal traders before and during an offer period is proposed.

### 2.1 Background

By virtue of class (5) of the definition of "acting in concert"; and the definition of "connected fund manager and connected principal trader", a fund manager or principal trader which is part of the same group as any bank or financial or other professional advisers (including stockbrokers) to an offeror or offeree company is presumed to be acting in concert with the offeror or offeree company.

As a result of being presumed to be acting in concert, any shareholdings and dealings in relevant securities by a connected fund manager or principal trader, whether on behalf of discretionary clients or as principal, might have significant consequences for the offeror or offeree with which the person is connected. The class (5) presumption does not however apply to fund managers or principal traders who have been granted exempt status under the Codes.

Rule 21.6 provides that connected non-exempt fund managers who manage accounts on a discretionary basis will not normally be presumed to be acting in concert before the identity of the offeror or offeree company, as the case may be, is publicly known. This is because the fund manager should not be aware that the party with which it is connected is involved in a takeover before the nature of the connection is made public. If however the fund manager is in fact aware of the possible transaction before the relevant public announcement, the relaxation of the presumption of concertedness in Rule 21.6 will not apply. After the public announcement, the presumption of concertedness applies as normal. Rule 21.6 currently makes no specific reference to connected principal traders.

### 2.2 Proposal

The Executive proposes to extend the scope of Rule 26.1 to cover connected principal traders. Amendments to Rule 21.6 are therefore proposed to clarify the following:

* That connected discretionary fund managers or principal traders will only be presumed to be acting in concert with an offeror or potential offeror once the identity of the person with whom it's connected is made public or, if earlier, once the connected party has actual knowledge of the possibility of an offer being made by a person with whom it is connected;
* That connected discretionary fund managers or principal traders will only be presumed to be acting in concert with an offeree company once the offer period has commenced or, if earlier, once the connected party has actual knowledge of the possibility of an offer being made for the offeree company and that it is connected with the offeree company; and
* The treatment and significance of dealings, and securities borrowing and lending transactions, by connected discretionary fund managers and principal traders prior to and after a concert party relationship arises.

## 3. Privatisations And Delisting

A loophole currently arises if a company disposes of substantially all its assets and withdraws its listing from the Stock Exchange under the Listing Rules. The Listing Rules allow the disposal of assets after the approval by a simple majority (50%) of independent votes. If disposal is approved, the company would then be a cash company which may not be regarded as suitable for continued listing and would therefore be suspended for an indefinite period or become delisted. Shareholders then have little choice other than to approve cash distribution and delisting. This allows a company to privatise and delist whilst avoiding the provisions in the Takeovers Code. Rule 2.10 of the Takeovers Code requires that a scheme of arrangement or capital reorganisation to privatise a company be approved by 75% of independent votes cast and that no more than 10% of independent votes be cast against it.

A new Note 7 to Rule 2 is proposed in order to give clarification, stating that, should the above situation occur, the Executive must be consulted at the earliest opportunity and that Rule 2.10 of the Takeovers Code would normally apply.

This note is intended as a summary only of the proposals set out in the SFC's "Consultation Paper on proposed amendments to the Codes on Takeovers and Mergers and Share Repurchases".

## Annex A

Q.1: Do you agree with the introduction of the new Rule 21.7?

Q.2: Do you agree with the consequential amendments as a result of the new Rule 21.7? If not, which of the consequential amendments do you not agree with? Please give reasons.

Q.3: Do you agree with the introduction of the new Note to Rule 26.1?

Q.4: Do you agree with the introduction of new Note 8 to Rule 30.2?

Q.5: Do you agree with the consequential amendments as a result of new Note 8 to Rule 30.2? If not, which of the consequential amendments do you not agree with? Please give reasons.

Q.6: Do you agree with the introduction of the new Note 3 to paragraph 3 of Schedule VI to the Codes?

Q.7: Do you agree with the proposed amendments to Rule 21.6?

Q.8: Do you agree with the consequential amendments as a result of the amended Rule 21.6? If not, which of the consequential amendments do you not agree with? Please give reasons.

Q.9: Do you agree with the introduction of new Note 7 to Rule 2? If not, why not?

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