Law Society Response to SFC Consultation Paper on a review of the Codes on Takeovers and Mergers and Share Repurchases

PART A: QUESTIONS FOR CONSULTATION

Class 2 of the definition of "*acting in concert*"

Q1. Do you think that the class (2) presumption should remain unchanged or should it be amended, as set out in Appendix 1 to this paper, to apply only to a company and its directors and the directors of its parent company or parent companies?

A. We agree that the class (2) presumption should be changed as set out in Appendix 1. The current presumption is unnecessarily wide.

Stock borrowing and lending

Q2. Does the reference to a standard form agreement that is recognised by the International Securities Lending Association (marked in bold above [paragraph 11]) encompass the standard agreement(s) used by stock borrowers and lenders in the normal course of business in Hong Kong?

A: The changes proposed in paragraph 11 raise several points:

(1) Clarification is required as to what is meant by "stock lending institution" and "ordinary course of business". This would seem to exclude the common situation on an IPO where a substantial shareholder which is retaining its interest lends stock eg, as part of a price stabilisation arrangement. We believe this type of stock lending should not be treated as acting in concert. In addition, it is common for stock lending in such circumstances not to be effected under standard terms (whether ISLA or other) but rather pursuant to bespoke agreements.

(2) The wording "in such manner" suggests that only when the stock lending arrangement are conducted as mentioned in (1) above, will the transfers not amount to acquisitions of voting rights under Rule 26.1. It goes on to say that the Executive should be consulted where the stock lending is conducted in any other manner. It would be helpful for there to be some guidance on what factors the Executive will take into account in determining whether arrangements falling outside (1) will not amount to acquisitions of voting rights.

(3) From a drafting point of view, it would be useful if the second part of the new Note (starting "Transfers of voting rights….") was reflected in Rule 26.1 itself.

(4) In a recent consultation paper (PCP 2004/3) the UK Takeover Panel has reconsidered its approach to stock lending. It proposes that, for dealings purposes (Rule 8, City Code), stock will be considered to be controlled by the lender, not the borrower. However, for Rule 9 purposes (equivalent of Hong Kong Rule 26) the Panel proposes that a person who either has borrowed or has lent shares should be treated as holding the voting rights attached to those shares (together with other shares held, borrowed or lent by him or persons acting in concert). This approach would appear to have the effect that a controlling shareholder will not trigger the mandatory offer by lending stock, because his deemed voting rights will not change. However, it may be more likely for a non-controlling shareholder to trigger the obligation. This may deal with a possible hole in the proposed Hong Kong provisions whereby a person borrows stock in order to exercise the voting rights, and not for market purposes. Such a person ought to trigger the mandatory offer if they are de facto exercising more than 30% of the voting rights in general meeting.

(5) It is unclear <u>when</u> borrower and lender will be taken to act in concert. If they are already acting in concert, then any stock lending will have no effect for Rule 26 purposes because the concert party as a whole retains the same voting rights (unless stock is on-sold). However, if they act in concert for the first time by virtue of the stock lending, their entire shareholdings will be aggregated and they may trigger a Rule 25 offer unless one of the parties already holds more than 50%. A simple stock lending arrangement which is not intended to obtain or consolidate control should not generally trigger this obligation.

General Principle 9, Rule 4 (no frustrating action) and definition of "*offer*"

Q3. Do you agree that a new note to the definition of "offer" should be added to the Codes as proposed?

A: Yes. In addition to quantification of "substantially below the market price", it would be helpful to have guidance on what sort of evidence will be required to show "a reasonable prospect of success". For example, will the offeror need to have signed irrevocables or will a lesser form of evidence suffice? An example of a lesser form might be a written explanation from the offeror's financial adviser of the factors which indicate that the offer is likely to receive the required level of acceptances.

Q4. Do you think the new Note should contain specific guidance as to the meaning of "substantially below the market price of the offeree company shares" and if so, what is the appropriate threshold to impose (e.g. below 50% of the lesser of the closing price of the relevant shares on the day before the Rule 3.5 announcement and the 5 day average closing price)?

A. *Yes, we do think specific guidance should be included. Although we do not have access to any data on the number of bids that are made at below 50% of market price, our "gut feel" is that this level is rather low. Given that the Executive has discretion over whether to block the offer, a more sensible level would be 70%.*

Rule 7 (resignation of directors of offeree company)

Q5. Do you agree that Rule 7 should not apply to directors of subsidiaries of the offeree company?

A. *Yes, we agree.*

Note 1 to Rule 8 (documents to be on display)

Q6. Do you agree that documents on display should be made available for inspection on the website of the issuer of the document or its financial adviser?

A: *We do not support this proposal. First, although its accessibility is improving rapidly, some investors still do not have easy access to the Web, so an ability to physically inspect documents must, in our view, be retained. Second, publication on the Web gives unfettered access to the public, to documents which may be confidential, commercially sensitive or protected by copyright. While we are aware that these are not often considered sufficient reasons to prevent display for inspection in person, the issues are magnified if the physical barriers (ie, the need to attend in person, the restriction on copying, the need for the inspecting person to identify himself for security reasons) are removed. Third, there will be issues over the location of the documents on the relevant website - their visibility and accessibility. In particular, the website will need to be designed such that documents relating to share offers are not accessible outside Hong Kong. Fourth, financial advisers are likely strongly to resist publication on their own websites as this would raise liability and regulatory issues and would require significant website development and maintenance. Fifth, we are not aware of regulations in any other similar jurisdictions which currently require electronic publication.*

Q7. Do you think that documents on display should be made available on the SFC or Stock Exchange's website rather than or in addition to the website of the issuer of the relevant document?

A. *If documents for display are to be published electronically (which generally, we do not support), we believe this should be on the regulator's website, and should be in addition to the current requirement for physical inspection. The regulator is in a better position to develop, maintain and administer an appropriate site and to ensure easy access and usability. This may also deal with potential sensitivities of foreign regulators regarding the mention of share offers on a company's or financial adviser's international website.*

Rule 10.6 (statements which will be treated as profit forecasts)

Q8. Do you agree with the proposed clarifications regarding working capital statements in proposed new paragraph (f) to Rule 10.6?

A. Yes, we agree in principle. However, we believe the rule should read (in the fourth line) "or contains data sufficient to calculate an approximate figure for future profits…..". "Necessary" data would include (for example) revenue, but this alone would not be sufficient to calculate expected profits. It is only where the reader can determine expected profits from available data that a statement should be considered a profit forecast.

Q9. Do you agree with the proposed obligations of financial advisers in respect of working capital statements?

Yes. We would like to see further clarification of what "properly compiled" means.

Rules 11.1 (disclosure of valuations) and 11.5(d) (valuation certificate to be on display)

Q10. Do you think that the full valuation report, rather than just a summary, should be put into the relevant document given that a full valuation report is a document on display under Rule 8?

A. We do not believe that including the full valuation report in the relevant document will be of any assistance to shareholders. Indeed, including it will considerably add to the length and reduce the readability of the relevant document. If there is a concern about the quality of the summary, Rule 11.1 should be expanded to specify what information should as a minimum, be included in the summary.

Rule 15.5 (final day rule)

Q11. Do you agree with the amendment of the latest time for declaring an offer unconditional as to acceptances from "midnight on the 60th day" to "7pm on the 60th day"? Do you think such changes will pose any practical difficulties on the offeror?

A. We believe that it is appropriate for Rule 15.5 to conform with Rule 19.1. There are likely to be no more practical difficulties for an offeror in making an announcement at 7pm on Day 60, based on a cut-off time for acceptances of 4pm, than there would be on any other closing date.

Note 1 to Rule 16.1 (announcements which may increase the value of an offer) and Rule 21.3 (restrictions on dealings by offeror during non-cash offers)

Q12. Should the activities listed in paragraphs 70 and 75 be restricted throughout the offer period under Rule 21.3 or only after "Day 46" under Note 1 to Rule 16.1?

A. *With regard to paragraph 70, we do not believe the prohibition on announcement of material new information under Note 1 to Rule 16.1 should be extended to the whole offer period. A two month (or longer) black-out period is too restrictive on an offeror. However, the restriction might usefully be brought forward by a few days, in order to allow a competing bidder to assess the offer as revalued following the offeror's announcement and to submit a revised offer before Day 46.*

With regard to paragraph 75, the arguments in paragraph 76 are persuasive. We would argue that on-market share repurchases, off-market share repurchases and share repurchases by general offer comprise dealings in securities and are already restricted during the offer period under Rule 21.3. Nevertheless, we do not believe that the restriction should be a blanket restriction. Ideally there should be some level of materiality (see Q15 below). In addition, there should be a carve-out for share dealings conducted routinely in accordance with existing programmes eg, share repurchases and issues under share option schemes.

Q13. Do you agree that the restrictions in Note 1 to Rule 16.1 should be extended to "any material new information" including any "capital reorganisation" that may have the effect of increasing the value of the offer?

A. *Yes, we agree in principle with the revision to Note 1 to Rule 16.1. However, while the wording used in the question above suggests that the restriction is only on the announcement of material new information "that may have the effect of increasing the value of the offer", this is not reflected in the drafting in paragraph 71. We can see considerable benefits for an offeror in allowing flexibility in the application of this rule, particularly if it is to apply to proposals for capital reorganisation.*

Q14. If capital reorganisations are to be restricted under Note 1 to Rule 16.1 as proposed, what should be the scope of restricted activities (see paragraph 72 for further discussion)?

A. *It is not clear from the consultation paper whether a definition of "capital reorganisation" is to be included in the Code, along the lines of paragraph 72. Paragraph 72 attempts to divide all the possible forms of capital reorganisations into two classes: (1) those which are likely to affect the value of the offeror's consideration securities and (2) those which are not likely to affect their value. While the division appears to be generally well thought through, we can see a benefit in having more flexible drafting which merely restricts capital reorganisations "that may have the effect of increasing the value of the offer" without specifying the various types. This follows on from our comments on Q13.*

Q15. If the activities referred to in paragraphs 70 and 75 should be restricted as proposed, should there be a materiality test: if the size of an offer is less than a small percentage of the offeror's total issued share capital, the Executive may grant a waiver from the restrictions imposed on such transactions?

A. We believe that it is appropriate to apply a materiality test to the restriction in Rule 21.3. Depending on the level of materiality chosen, it may also be necessary in addition to introduce a carve-out for dealings made in accordance with existing programmes (see Q12 above).

Q16. Do you think that Rule 21.3, in its current form is wide enough to deal properly with competing offerors? If so, should there be a more general restriction on all offerors from dealing in each other's relevant securities (as defined in Rule 22) during an offer period?

A. We do not fully understand the justification for restricting dealings by a competing offeror. An offeror may be capable of influencing the value of a competing offeror's shares in the same way as it can influence its own, but it seems sufficient to rely on the SFO prohibitions on insider dealing and market manipulation.

Rule 28 (partial offers)

Q17. Do you agree with Option 1 and Option 2? Please give reasons for your response.

A. We agree with Option 2. We do not see the justification for banning partial offers which will result in a holding of between 30% and 50% (Rule 28.4). Since independent shareholder approval must be given under Rule 28.5, it is no different to a whitewashed new issue (which is permitted even if it results in a holding of 30% to 50%).

We do not believe there is any need to specify the number of shares in respect of which the offer is approved under Rule 28.5. This is not provided for in Rule 36.4 of the UK's City Code.

Rule 32.1 of the Takeovers Code and Rule 6 of the Share Repurchase Code (Takeovers Code implications of share repurchases)

Q18. Should the Codes be amended to provide for whitewash waivers of general offer obligations triggered as a result of on-market share repurchases and if so, do the provisions set out in paragraphs 125 to 137 provide sufficient safeguards for shareholders?

A. Generally we support amending the Codes to provide for whitewash waivers of general offer obligations triggered by on-market share repurchases, subject to the establishment

of proper safeguards to protect the interests of shareholders. However, we believe that the market would benefit from a further consultation paper on on-market repurchases that attaches a draft of the proposed changes to the Code. This would clarify the exact nature of the proposals. For example, the Consultation Paper does not make it clear that in respect of on-market share repurchases, an unconnected shareholder would not be regarded as having triggered a mandatory bid obligation under Rule 26 and whitewash waiver would only be required for directors or parties acting in concert with directors.

While we have responded to the specific questions raised in Appendix 4 to the Consultation Paper below, we are not persuaded that the procedures applicable to on-market repurchases should be substantially different to those for off-market repurchases or for repurchases by way of general offer. We would prefer to see a simple arrangement whereby Rule 32 is extended to on-market repurchases (as in the UK). In addition, we do see any particular benefit in duplicating in the Code rules which are already contained in the Listing Rules.

Q19. Do you agree that Rule 3.5 should be amended as proposed? Is there any additional information that should be included in the Rule 3.5 announcement?

A. The information listed in paragraph 125 largely duplicates that required to be included in the Explanatory Statement made under Rule 10.06(1)(b), Listing Rules. We do not support unnecessary duplication. We would however, suggest adding information such as price range (assuming that would be fixed by the date of announcement - further discussion below) and time period during which repurchases would be made. We are of the view that should an announcement be considered necessary, it should not be overly detailed and duplication of information between the announcement and the circular to shareholders should be avoided.

Q20. Do you agree that the relevant whitewash should be subject to independent shareholders' approval and the Executive's consent as described in paragraph 126?

A. We agree that whitewash waiver should be subject to independent shareholders' approval. As far as the Executive's consent is concerned, the provision should be the same as whitewashes for new issues ie. reflect the first paragraph of Note 1 on the dispensations from Rule 2.6, which provides "the Executive will normally waive the obligation if there is an independent vote at a shareholders meeting".

Q21. Do you agree with the additional disclosure requirements set out in paragraph 127? Is there any additional information that should be included in the circular?

A. We are concerned that the information to be included in the circular may be overly detailed. Generally, when on-market share repurchases are to be made, they are to be effected quickly in response to prevailing market prices. Given that on-market share

repurchase is one of the exemptions under the Repurchase Code and therefore is not subject to any of the detailed contents requirements of the Repurchase Code, we do not agree that an application for a whitewash waiver of the general offer obligation arising from this type of exempted share repurchase program should be subject to overly detailed disclosure requirements. In particular, given the proposed restrictions on the period and maximum number of shares that can be repurchased in any whitewash period, we consider that, if there should be any difference at all, the disclosure obligations should be less onerous than in the case of a share repurchase by general offer.

However, we are of the view that the circular should state, as a minimum, the price range restrictions and the maximum period for the waiver as discussed in paragraphs 128 and 129.

Q22. Do you agree with the proposals set out in paragraph 128 concerning shareholders meetings and announcements of the results?

A. We do not understand why this proposal is restricted only to meetings to approve on-market repurchases? The issue would seem equally relevant to off-market repurchases and repurchases by way of general offer. In any event, we do not agree with separating the annual general meeting from the meeting to approve on-market share repurchases by at least a day. This is impractical. It should be possible to have separate votes at the same meeting or to have two meetings with one following the other on the same day.

We agree with voting by poll.

Q23. What is the appropriate threshold for shareholder approval? (i) 50% (ii) 75% or (iii) 75% but not voted against by more than 10% of all independent shareholders?

A. We agree with a 50% threshold. There is no general 75% threshold applied on whitewash waivers (although an off-market share repurchase requires 75% independent shareholders' approval).

Q24. What should be the appropriate maximum period for a waiver of the obligation triggered by on-market share repurchases? 1 month? 3 months? or 6 months?

A. We agree with a maximum period of 3 months. We also agree that a period of 12 months would be too long and would lead to uncertainty to shareholders.

Q25. What do you consider to be an appropriate level of restriction? 3%? 5%? or 10%?

A. We are of the view that a level of around 5% would be most appropriate, taking into account the 10% share repurchase mandate that is available for 12 months under the Listing Rules.

Q26. What do you consider to be the appropriate price restrictions for repurchases under a whitewash waiver?

A. *The proposed restriction is not consistent with Listing Rule 10.06(2)(a) as the dealing restriction under that rule is made by reference to the 5 days before any day on which shares may be purchased instead of a fixed announcement date. In addition, the wording in paragraph 131; "not higher than 5% or more than the average closing price…" is confusing. In any case, we believe no specific provision is needed in the Code as the company must comply with Rule 10.06(2), Listing Rules in respect of its on-market repurchases.*

Q27. Do you agree that the consideration should only be in cash?

A. *The Listing Rules already provide that an issuer shall not purchase its shares on the Stock Exchange for a consideration other than cash. We have no particular objection to keeping this requirement, although we do not believe it is necessary to duplicate the Listing Rule requirement in the Code.*

Q28. Do you agree with any of the options set out in paragraph 133? Please give reasons for your response.

A. *The consultation paper did not go into the reasons for each of the options. As a result, we find it difficult to address the concerns that the options seek to deal with. Share repurchases should only be made by the company to benefit the company and the shareholders, for example, by enhancing the net asset value and/or earnings per share. It is unclear why repurchases by the company during the periods suggested should be deemed "disqualifying transactions" or there should be restrictions on share repurchases during certain periods. A further point to note is that there may be a significant time gap between the date of announcement and the shareholders meeting, taking into account the time it takes to prepare and clear the whitewash circular and notice period for shareholders meetings. A prohibition from dealing in the securities by the company for an extended period of time because of a whitewash application may not necessarily be in the interests of the shareholders.*

The consultation paper also did not deal with the impact on dealing restrictions if for some reason, the whitewash application did not proceed after the announcement.

We also suggest amending the wording of paragraphs 3(a) and 3(b) of Schedule VI so that it is more directly applicable to whitewash waivers in the context of share repurchases.

Q29. Do you agree with extending the restrictions on dealings to directors and persons acting in concert with them?

A. Connected person under the Listing Rules already includes directors so the question is whether the restriction should be extended to persons acting in concert with directors generally. We agree with such extension but would prefer the Listing Rules and the Codes to be consistent for ease of application.

Q30. Do you agree that the restriction on new share issues should apply from the date of the Rule 3.5 announcement to the end of the mandate period?

A. We do not agree. From the date of the announcement to the end of the mandate period, share repurchases may or may not be made. We consider that the restriction should only apply if share repurchases are actually made, as is the position under the Listing Rules.

Q31. Do you agree with the proposed contents of an announcement at the end of the whitewash period or when the maximum number of shares have been repurchased?

A. We agree with the proposed content.

New Rule 37 - The Telecommunications Authority

Q32. Should the Takeovers Code be amended as proposed in Option 1?

A. We agree that Option 1 (to delay timetable for maximum of 3 months) is preferable for the reasons given in the consultation paper. However, in the case of an ex post investigation, it does not seem particularly fair to keep a bidder committed for 3 months, to an offer which has been unexpectedly referred to the TA. We believe that in these circumstances, subject to certain requirements (eg, that the offeror can show that it had good reason to believe that there would be no "change" under section 7P), the Code should allow the bidder to withdraw the offer or the offer to lapse, with the consent of the Executive.

Q33. Should the Takeovers Code be amended as proposed in Option 2?

A. See answer to Q32.

Requisitioning shareholders meetings after an offer

Q34. Do you agree with Option 1 or Option 2? Please give reasons for your response.

A. Option 1 is not appropriate. Unless the offeror has obtained 100% control, the offeree board is bound to act (and should be free to do so) in the interests of all shareholders, not just of the offeror. The requirement to extend the "fullest cooperation to the successful offeror" suggests that the board of the offeree should become a puppet to the

offeror, which is neither appropriate nor desirable. In addition, the expression "fullest cooperation" is rather vague and difficult to police.

We distinctly prefer Option 2. The restrictions in Rule 4 are familiar, well defined and are appropriate to offers with an acceptance level set below 90% (as well as those which will result in 100% control). We believe these actions should require shareholder approval, not merely "the offeror's consent".

PART B: OTHER COMMENTS

Paragraph 16

With reference to paragraph 16, we are unclear how the proposals for the alteration of the definition of offer will work in practice. Will a public announcement of a standing instruction therefore trigger an offer period - if so, what will the timetable requirements be? It seems that the offer period could potentially be indefinite, and impose onerous ongoing restrictions on the "target". If such an announcement is to constitute a voluntary offer, how will the requirement as to the 50% acceptance condition be treated? What will be the implications in terms of restrictions on dealings (and disclosures) for the offeror and persons acting in concert, such as the broker? Would the "target" be required to get independent advice and make a response? Could the offeror withdraw the standing instruction? What would be the requirements on the offeror in terms of announcements and documentation? Will a mandatory offer be triggered on the announcement of a standing instruction (if below 50%) to acquire more than 2%? We can see the rationale in treating a standing instruction as a voluntary offer where the offeror holds less than 50%, but the way such an offer will be handled is unclear. Furthermore, where an offeror already holds more than 50%, we do not think that a standing instruction should be treated as a voluntary offer.

Paragraph 28

The Consultation Paper proposes a requirement that the independent committee of the board comprises "all independent non-executive directors of the company". We believe the requirement should be for at least three INEDs (or if there are less than three on the board, then all those on the board). This is more practical for a company which has a large number of INEDs appointed to the board.

Paragraph 89

As the Consultation Paper recognises, there have been involved discussions in London about the applicability of Note 6 to Rule 8 of the UK Takeover Code (which is almost identical to the current Note 8 to Rule 22). Extending this note to "rights over shares" may lead to

unexpected results (eg, custody arrangements, security for loans etc.). Given that there have been no proposals to change the UK Code, we believe it is best to leave the provision as it is and draw on the UK Takeover Panel's decisions when interpreting the note.

Paragraphs 102 and 103

We do not agree that the solution to the situation described in paragraph 103 is the removal of the words "with the directors of the company". There will always be "discussions", even if simply internally, before putting forward a whitewash proposal. Those discussions should be with the company or any of its representatives before the restriction applies.

The Law Society of Hong Kong
The Securities Law Committee
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