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SFC Consults on Takeovers Code Changes

Hong Kong's Securities and Futures Commission (**SFC**) published a Consultation Paper[1] (**Consultation Paper**) on proposed changes to the Codes on Takeovers and Mergers and Share Buybacks (**the Codes**) for a 3-month consultation period ending on 19 April 2018.

The key changes proposed are:

- To raise the voting approval threshold for whitewash waivers to 75% of the independent shareholders;
- To allow the Takeovers Panel to require the compensation of shareholders who suffer loss due to a breach of the Codes;
- Amending the definition of "associate"; and
- To provide for delistings to be approved by independent shareholders in jurisdictions which do not provide compulsory acquisition rights.

Other changes proposed would require the timely cooperation, assistance and provision of complete and accurate information by parties dealing with the Takeovers Executive, Takeovers Panel and Takeovers Appeals Committee in transactions subject to the Codes.

The proposed amendments to the Codes are set out in Appendix 1 to the Consultation Paper.

1. Voting threshold for whitewash waivers

Raising the Voting Threshold

Probably the most significant change proposed is to increase the voting approval threshold for whitewash waivers from a simple majority of independent votes to 75%. Independent votes are those of shareholders who are not involved or interested in the transaction in question.[2] The motivation for the proposed change is concern that the grant of shareholders' approval required for a whitewash waiver has come to be seen as a virtual certainty by whitewash applicants and shareholders alike.

The Consultation Paper notes that all whitewash transactions voted on by shareholders between 2015 and 2017 were approved, and the regulator's consequent concern that the current voting threshold prevents the shareholders' approval requirement from performing its intended "gatekeeper" role. If the voting threshold were raised to 75%, 7.4% of the whitewash transactions voted on between 2015 and 2017 would not have been approved. The Consultation Paper also notes that average shareholder turnout rates are typically higher at general meetings where higher voting thresholds apply, e.g. for privatisations and share buy-backs. It is suggested that this may indicate shareholder apathy where more than 50% of independent shareholders will need to vote against a whitewash waiver.

1 http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP1

2 Note 1 to Rule 26 of the Takeovers Code.

Related concerns are that fund raising transactions such as rights issues and open offers that materially dilute voting rights (i.e. large scale new share issues) and value (by setting issue prices at deep discounts to the market price) allow the acquisition or consolidation of control of listed companies at a steep discount. Questions of conflict of interest also arise where the whitewash applicant is a substantial or controlling shareholder. Questions as to directors' exercise of their fiduciary duties (under General Principle 8) and the oppression of minority shareholders (under General Principle 7) raise further concerns. The Executive can of course refuse to grant a whitewash waiver which would trigger a general offer to all shareholders. The regulators are concerned that this does not necessarily deal with potential abuse, since if new shares are heavily discounted, the listed issuer can still proceed with the proposed transaction and make the general offer at such an unattractive price that it is unlikely to be accepted.

Requirement for Separate Resolution for Whitewash Waiver

The Takeovers Code requires both the underlying transaction and the whitewash waiver to be approved by independent shareholders. However, market practice varies as to whether the underlying transaction and the whitewash waiver are put to shareholders in separate resolutions or a combined resolution.

The Consultation Paper is consulting on whether to introduce a specific requirement that separate resolutions are required. This would allow independent shareholders to disapprove the underlying transaction as well as the whitewash waiver and thus provide an additional safeguard for minority shareholders.

The SFC is also consulting on whether the 75% voting approval threshold should apply to both the underlying transaction and the whitewash waiver. Transactions in conjunction with an application for a whitewash waiver would consequently be allowed to proceed only if both the whitewash waiver and the underlying transaction are each approved by 75% of independent shareholders. If the whitewash waiver is not approved, but the whitewash condition is waivable, the applicant would be able to proceed with the underlying transaction, coupled with a general offer, if it obtains separate shareholders' approval by 75% of the independent shareholders of the underlying transaction.

Proposed changes to Note 1 on Dispensations from Rule 26

Note 1 on dispensations from Rule 26 would be revised if the proposed changes are adopted.

The SFC also notes that the current wording of Note 1 could be misinterpreted to imply that in cases involving an underwriting of an issue of shares, the mandatory offer requirement will be automatically waived if there has been an independent vote of shareholders. It is proposed to re-phrase Note 1 to state that the requirement for a mandatory offer will normally be waived in this situation.

2. Compensation Rulings

It is proposed that the Takeovers Panel should have an explicit power to require a person who has breached certain Code provisions to compensate shareholders who have suffered loss as a result of the breach under a new section 13.13 to the Introduction to the Codes. Shareholders would receive the amount that the Panel thinks they would have been entitled to had the relevant Rule been complied with, plus simple or compound interest as determined by the Panel.

The right to compensation would apply to breaches of the following Rules:

- **Rules 13 and 14** – the appropriate offers and comparable offers requirement which requires offers to be made for other classes of relevant securities;
- **Rule 16** – the entitlement to revised consideration. Rule 16.1 requires that when an offer is revised, all shareholders are entitled to receive the revised offer irrespective of whether they accepted the original offer;
- **Rule 23** – the nature of consideration and the situations in which a cash offer or securities offer is required;
- **Rule 24** – purchases resulting in an obligation to offer a minimum level of consideration. Shareholders of the same class are entitled to no less favourable terms if a certain level of acquisition has been made during specified offer periods;

- **Rule 25** – special deals. Rule 25 prohibits transactions between an offeror, or potential offeror, or parties acting in concert with it and a shareholder of the offeree company which are on favourable terms that are not extended to other shareholders;

- **Rule 26** – the mandatory offer obligation which requires a general offer to be made to all shareholders if certain ownership levels are exceeded;

- **Rule 28** – partial offer requirements;

- **Rule 30** – offer conditions – offers must not normally be made conditional on matters that depend on judgements of the offeror or the fulfilment of which is in its hands; and

- **Rule 31.3** – prohibits the offeror and its concert parties purchasing further securities at above the offer price in the 6 months after the close of the offer.

Disciplinary Proceedings and Remedial/Compliance Rulings

The SFC considers that the wording of Section 12.2 of the Introduction to the Codes unnecessarily restricts disciplinary proceedings as it may be interpreted as precluding the Panel from making rulings that are remedial in nature. It is therefore proposed to amend the section to allow the Panel to impose remedial measures as well as sanctions in all disciplinary matters.

3. Definition and use of the term "associate"

The term "associate" is principally relevant to the disclosure of dealings under Rule 22 of the Takeovers Code. It includes all persons acting in concert with an offeror as well as "*a wider range of persons (who may not be acting in concert) and will cover all persons who directly or indirectly own or deal in the relevant securities of an offeror or the offeree company in an offer and who have (in addition to their normal interests as shareholders) an interest or potential interest, whether commercial, financial or personal, in the outcome of the offer*". The term "associate" is defined to include seven classes of people who are normally regarded as associates of the offeror or the offeree company. A number of these classes overlap with the classes presumed to be acting in concert.

The SFC considers that the definition of "associate" and some of its classes are excessively wide. It therefore proposes to retain the concept of persons acting in concert normally being considered to be associates, but proposes to eliminate the overlap and potential inconsistencies between five of the "associate" classes and their near equivalents under the acting in concert presumption. The following table indicates the key differences between the associate classes and their acting in concert equivalents, and the underlying transactions.

Associate		**Acting in concert**	
class (1)	an offeror's or the offeree company's parent, subsidiaries and fellow subsidiaries, and their associated companies, and companies of which such companies are associated companies	class (1)	a company, its parent, its subsidiaries, its fellow subsidiaries, associated companies of any of the foregoing, and companies of which such companies are associated companies
class (2)	any **bank and** financial and other professional adviser (including a stockbroker) to an offeror, the offeree company **or any company in class (1)**, including persons controlling, controlled by or under the same control as such banks, financial and other professional advisers	class (5)	a financial or other professional adviser (including a stockbroker) with its client in respect of the shareholdings of the adviser and persons controlling, controlled by or under the same control as the adviser (**except in the capacity of an exempt principal trader**)

class (3)	the directors (together with their close relatives, related trusts and companies controlled by any of the directors, their close relatives or related trusts) of an offeror, the offeree company **or any company in class (1)**	class (2)	a company with any directors (together with their close relatives, related trusts and companies controlled by any of the directors, their close relatives or related trusts) of it or of **its parent**
class (4)	the pension funds, provident funds and employee share schemes of an offeror, the offeree company **or any company in class (1)**	class (3)	a company with any of its pension funds, provident funds and employee share schemes
class (5)	any investment company, unit trust or other person whose investments an associate manages on a discretionary basis, in respect of the relevant investment accounts	class (4)	a fund manager (including an exempt fund manager) with any investment company, mutual fund, unit trust or other person, whose investments such fund manager manages on a discretionary basis, in respect of the relevant investment accounts

The following amendments are proposed.

1) **Class (1)**

Class (1) of the definition of associate would be deleted since it is identical to class (1) of the acting in concert definition.

2) **Class (2) - banks, financial advisers and other professional advisers**

The scope of class (2) would be limited to the banks, financial advisers and other professional advisers of companies in the same group as an offeror or offeree company (i.e. their parent, subsidiary and fellow subsidiary companies). Advisers to associated companies would no longer be included.

3) **Class (3)**

Class (3) of the definition of associate would be amended to include the directors (together with their close relatives, related trusts and companies controlled by any of the directors, their close relative or related trusts) of either:

a) under Option 1 - any subsidiary or fellow subsidiary of the offeror or offeree company; or

b) under Option 2 - any subsidiary or fellow subsidiary of, or companies controlled by, the offeror or offeree company or its parent.

4) **Class (4) (pension funds etc.)**

The definition of class (4) would be amended to cover pension funds, provident funds and employee share schemes of parents, subsidiaries and fellow subsidiaries of an offeror and the offeree company.

5) **Class (5) (fund managers)**

Class (5) would be replaced with a class including exempt principal traders and exempt fund managers which the SFC considers should continue to be subject to the disclosure obligation and other obligations applicable to associates.

6) **Class (6) (5%+ shareholders etc.)**

Class 6, covering holders or controllers of 5% or more of any class of relevant securities issued by an offeror or offeree (including any person who will own or control 5% or more as a result of a transaction) will be retained.

7) **Class (7) (companies with a material trading arrangement)**

This class is considered to be unnecessarily wide and would be deleted.

4. Dealings with and Powers of the Executive, Panel and Takeovers Appeal Committee

Due to a number of recent cases in which parties dealing with the Executive did not act openly and cooperatively, the Consultation Paper proposes to clarify the obligations of parties dealing with the Executive. A new section 5.2 "Dealings with the Executive" is proposed to be added to the Introduction to the Codes, which would require dealings to be conducted:

a) in an open and co-operative manner;

b) with prompt co-operation and assistance;

c) with disclosure of any information known and relevant to the matter;

d) with provision of true, accurate and complete information;

e) with prompt correction of the position if information provided earlier is not true, accurate or complete; and

f) with prompt notification of any new relevant information.

The Consultation Paper proposes to extend these obligations to dealings with the Panel and the Takeovers Appeal Committee by adding sections 11.8 and 14.9 to the Introduction to the Codes.

5. Executive to be Empowered to Issue Compliance Rulings

On the basis that a pre-emptive action is more effective than warnings in preventing breaches and protecting shareholders, the SFC proposes to add sections 7.2 and 13.12 to the Introduction to the Codes and to amend section 13.10 to clarify the Executive and the Panel's powers to issue compliance rulings. The Executive will be able to give any direction that it considers to be necessary to:

a) Restrain a person from acting in breach of the Codes;

b) Restrain a person from taking a particular action, pending determination as to whether this action would be in breach of the Codes; or

c) Otherwise secure compliance with a relevant requirement under the Codes,

if the Executive is satisfied that there is a reasonable likelihood that a person will contravene the Codes, or if a person has contravened the Codes. The Panel will also be given powers to give directions to effect the above.

6. Approval of Delistings by Independent Shareholders

Rule 2.2 of the Takeovers Code requires that a shareholders' resolution to delist from the Hong Kong Stock Exchange must:

a) be approved by at least 75% of the votes of disinterested shareholders;

b) not be voted against by more than 10% of disinterested shares; and

c) be subject to the offeror being entitled to exercise, and exercising, its rights of compulsory acquisition.

The three-pronged test is designed to prevent an offeror from using a delisting resolution to pressurize minority shareholders into accepting a general offer out of fear that they will be left with illiquid shares. While the laws of Bermuda and the Cayman Islands under which many Hong Kong listed companies are incorporated have compulsory acquisition rights that are broadly in line with those of Hong Kong, other jurisdictions, including Mainland China, have no equivalent compulsory acquisition rights. As a result, the Executive has granted waivers in recent years from the requirement under paragraph (c) above since it is technically impossible to comply under Chinese law.

In order to provide a level playing field for companies that are incorporated in jurisdictions with no compulsory acquisition rights that seek to delist in Hong Kong through a general offer, the Consultation Paper proposes to require such companies to put in place a mechanism to help ensure that passive minority shareholders are afforded an opportunity to exit so that they are not left with illiquid shares.

The SFC proposes adding a note to Rule 2.2 to state that where an offeree company is incorporated in a jurisdiction that does not afford compulsory acquisition rights, the Executive may be prepared to waive the requirement of Rule 2.2(c) and will take into account whether the offeror has put arrangements in place such that:

a) once the offer becomes unconditional in all respects, the offer will remain open for acceptance for a longer period than normally required by Rule 15.3;

b) shareholders who have not accepted the offer will be notified in writing of the extended closing date and the consequences of not accepting the offer;

c) the resolution to approve the delisting is subject to the offeror having received valid acceptances amounting to 90% of the disinterested shares.

7. Disclosure of numbers of, holdings of and dealings in, relevant securities

The Consultation Paper proposes to clarify the scope of disclosure of holdings and dealings in relevant securities, and to relax requirements such as the timing for dealing disclosures.

Rule 3.8: Announcement of number of relevant securities in issue

Rule 3.8 requires the offeree company and the offeror or potential named offeror to announce details of all classes of their respective relevant securities and the numbers of such securities in issue when an offer period begins. Where the offer is likely to be solely in cash, details of the offeror's relevant securities are not required. Offeree and offeror companies are required to include in the announcement a reminder to their associates to disclose their dealings in any securities of the offeree company, and in the case of a securities exchange offer, any securities in the same class as those to be offered as consideration under the offer, as required by Rule 22.

The SFC believes that in securities exchange offers, associates should be required to disclose their dealings in all relevant securities of the offeror, not only dealings in securities of the same class as those offered as consideration under the offer and proposes amendments to Rule 3.8 to reflect this.

Where securities other than those of the offeror will be offered as consideration, the SFC considers that for the purposes of Rule 22, disclosure should only be required of dealings in the relevant securities of the company whose securities are to be offered as consideration for the offer. The definition of "Relevant Securities" in Note 4 to Rule 22 will be amended to include the securities of the company whose securities will be offered as consideration for the offer.

Schedule IX (REIT Guidance Note) – Disclosure of shareholdings and dealings in the offeree board circular

Where the offeree company is a REIT, amendments are proposed so that the disclosure obligations under paragraph 2 of Schedule II and Note 2, namely the disclosure of shareholdings and dealings, would apply to any person who is an associate of the offeree company under class (7) or (8) of the definition of "associate". This will require disclosure of the shareholdings and dealings by the trustee and management company of an offeree company which is a REIT.

Timing of submission of dealing disclosures

It is also proposed to codify the existing practice of allowing an additional business day for disclosure of dealings in the time zones of the United States. It is also proposed that the deadline for disclosure is extended to 12.00 noon, instead of the current 10.00 a.m. on the second business day (Hong Kong time) following the date of the transaction.

Note 6 to Rule 22 – Method of dealing disclosure

The SFC considers the current requirement for parties to make separate disclosures to the offeror, offeree company or their financial advisers unnecessary, and thus proposes to amend Note 6 to Rule 22 to require disclosure to be made in writing to the Executive only, who will in turn arrange the publishing of the disclosure on the SFC's and Stock Exchange's websites.

8. Miscellaneous amendments

Class (5) of the presumption of acting in concert

The Consultation Paper proposes to amend class (5) of the presumption of acting in concert to expressly exclude advisers acting in the capacity of exempt fund managers.

Section 8.3 of the Introduction to the Codes – Certificates of truth, accuracy and completeness

Due to the current overlap between the requirements under section 8.3 of the Introduction to the Codes and the filing form for all applications for rulings under section 8 of the Introduction to the Codes, the Consultation Paper proposes amending section 8.3 to include reference to the filing form.

Notes 2 and 3 to Rule 8.1 - Meetings and materials used in meetings

It is proposed to clarify in Note 3 to Rule 8.1 that the term "meetings" includes conference calls via phone and other electronic means, as well as in-person meetings. The safeguards and disciplines of this note are proposed to be made applicable equally to information released to the media.

With regards to Rule 12.1, it is proposed that the term "documents" will not include materials distributed at meetings with shareholders, analysts, brokers or other persons interested in the offer, or with the media, and hence these materials would not need to be provided to the SFC for comment before release. The relevant financial adviser will however be required to confirm that these materials do not contain any material new information or significant new opinions, and that the information is fairly presented.

Rule 12 – Confirmation as to publication, no material change and translation

The Consultation Paper proposes to add Notes 4 and 5 to Rule 12 to codify the existing practice[3] of requiring the issuer of a Code document to provide the Executive with the directors' confirmation of the accuracy of the translation and the veracity of the Chinese version to its English version, or vice versa, no later than 5:00p.m. on the day after the publication of the document. Written confirmation of the time and date of the publication of the document and of the absence of material change to the version of the document in respect of which the Executive has confirmed that it has no further comment, will need to be provided by the party issuing the document, or its advisers.

Note 3 to Rule 15.5 and Note 4 to Rule 26.2 – References to the Telecommunications Ordinance

The definition of "CA" (Communications Authority) is proposed to be deleted from the Definitions section of the Codes, and consequently Note 3 to Rule 15.5 and Note 4 to Rule 26.2 are proposed to be amended to reflect this.

Rule 18 – Setting aside "no extension" and "no increase" statements

Competitive situations (Note 2 to Rule 18)

The Consultation Paper proposes to amend Note 2 to Rule 18 to clarify that in a competitive situation, the offeror is free to not only extend its offer, but also to amend or increase its offer as contemplated in Rule 18.3.

Circumstances in which statements may be set aside (Note 4 to Rule 18)

The Consultation Paper also proposes to allow an offeror's reservation of the right to set aside a no extension or no increase statement to be made in any situation which cannot be determined or controlled by the offeror, provided that the reservation does not depend solely on subjective judgements by the offeror or its directors.

Rule 19.1 – Results announcements

Amendments to Rule 2.9 and a new Note to Rule 19.1 are proposed to exempt schemes which are not subject to the Headcount Test from the requirement to disclose the number of shareholders who voted for and against, and to impose additional disclosure requirements on schemes subject to the Headcount Test.

Rule 30.1 – conditions should not be subjective

The heading of Rule 30.1 "Subjective conditions" is proposed to be amended to remove the reference to "Subjective", since the natural meaning of the Rule includes all conditions, whether subjective or objective. It is proposed to add an explicit reference to the non-permissibility of offer conditions which are dependent on judgements of the offeree company, as well as the offeror.

3 as per Practice Note 20

Rule 31.3 – Six-month delay before acquisition above offer price

Rule 31.3 prohibits an offeror from paying a price that is higher than the offer price for shares in the offeree company for six months after the closing of an offer. It is proposed that this be amended to reflect that it applies equally to offers that are unconditional at the time of publication of the offer document, or which become or are declared unconditional subsequently.

Paragraph 1 of Schedule II – Views of offeree board

The offeree board circular is required to include a statement of whether the board of the offeree recommends shareholders to accept or reject the offer and a copy of the financial advisers' written advice. In practice this requires the inclusion in the offeree board circular of (a) the advice of the offeree company board's independent committee and (b) the advice of the appointed independent financial adviser. Paragraph 1 of Schedule II and Note 4 are proposed to be amended to require the inclusion in the offeree board circular of:

a) The names of the directors of the offeree company and of the directors comprising the independent committee of the board;

b) The recommendation of the independent committee of the board or a statement that the independent committee is unable to make a recommendation (with reasons); and

c) A copy of the written advice in the independent financial adviser.

Paragraph 12(a) of Schedule I, Paragraph 6(a) of Schedule II and Paragraph 16(a) of Schedule III – Financial information

To avoid duplication of the Historical Financial information, Schedule II is proposed to be amended to allow offeree companies to make reference in the offeree board circular, or a composite document, to published documents which contain the Historical Financial Statements. The same disclosure requirements are proposed to be applied to the information required to be disclosed in the offer document. Where the offeror is a company listed on the Stock Exchange, the offeror could similarly make reference in the offer document to published documents which contain the Historical Financial Statements.

Alignment with latest terminology commonly used in accounting standards and certain provisions of the Listing Rules.

Relevant accounting terminology used in the Schedules to the Codes is proposed to be brought into line with the latest accounting standards and to be conformed to certain amended requirements of the Listing Rules.

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