



Hong Kong

July 2020

DISCIPLINARY ACTIONS FOR TAKEOVERS CODE BREACHES IN JUNE 2020

Two Takeovers Executive disciplinary decisions relating to breaches of the Hong Kong Takeovers Code were published in June 2020. They involved:

- public criticism of members of the China International Capital Corporation Group (the **CICC Group**) for late disclosure under Rule 22 of the Takeovers Code of dealings in relevant securities in hedging activities related to dealings in derivatives by exempt principal traders; and
- public censure of the Chairman of Main Board-listed Macrolink Capital Holdings Limited for acquiring shares in breach of Rule 31.3 of the Takeovers Code.

The following provides a summary of the two disciplinary decisions.

1. SFC Publicly Criticises CICC Group Members for Takeovers Code Breaches

CICC group members, CICC Financial Trading Limited (**CICCF**) and China International Capital Corporation Limited (**CICCL**), have been publicly criticised by the Takeovers Executive for late disclosure of their dealings in relevant securities in two 2019 takeovers in breach of Rule 22 of the Code on Takeovers and Mergers (the **Takeovers Code**). The Takeovers Executive's criticism¹ and related SFC announcement² are available on the SFC website.

1 [https://www.sfc.hk/web/EN/files/CF/pdf/Public_censure/CICC_ES_18%20Jun%202020%20\(Eng\).pdf](https://www.sfc.hk/web/EN/files/CF/pdf/Public_censure/CICC_ES_18%20Jun%202020%20(Eng).pdf)

2 <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR56>

The case concerned two mandatory general offers by: (i) Maanshan Iron and Broadford Global Limited (**Broadford**) for the H Shares of Dalian Port Company Limited (**Dalian Port**) and (ii) Baosteel Hong Kong Investment Company Limited (**Baosteel**) for the H shares of Maanshan Iron & Steel Company Limited (**Maanshan Iron**). The offer periods for the two mandatory offers commenced on 4 June 2019 and 2 June 2019, respectively.

China International Capital Corporation Hong Kong Securities Limited (**CICCHKSL**) acted as the financial adviser to the offeror company on both transactions, Broadford and Baosteel. CICCHKSL and CICCF are both wholly-owned subsidiaries of CICCL and recognised as exempt principal traders for the purposes of the Takeovers Code.

The case concerned hedging activities conducted in relation to derivatives dealings. While the derivative dealings themselves did not need to be disclosed as they were not considered to be connected with the general offers in question under the definition of "exempt principal trader", the hedging activities in the underlying securities (which were A shares listed on the Shanghai and Shenzhen stock exchanges) were required to be disclosed under Rule 22 of the Takeovers Code. The case is a reminder that while dealings in certain derivatives are not considered to have a connection with an offer and need not be disclosed, this does not mean that disclosure is not required for their related hedging activities.

Rule 22 of the Hong Kong Takeovers Code

Rule 22 of the Takeovers Code requires parties to an offer and their respective associates to disclose their dealings in relevant securities (as defined by Note 4 to Rule 22) of the offeree company (and of the offeror in a securities exchange offer) conducted for themselves or on behalf of their clients during an offer period. Where disclosure is required, it must be made by 12.00 noon on the business day following the date of the relevant transaction (Note 5 to Rule 22).

Takeovers Code Definition of Associate

Under paragraph 5 of the Takeovers Code's definition, "associates" include:

"any exempt principal trader or exempt fund manager which is controlling, controlled by or under the same control as the financial and other professional adviser (including a stockbroker) of the [offeree company], its parent, subsidiaries and fellow subsidiaries".

CICCFE and CICCL are exempt principal traders. CICCL controlled CICCHKSL, the financial adviser on both transactions, while CICCFE was controlled by the same company as CICCHKSL. Both companies were thus "associates" for the purposes of the Takeovers Code and were required to disclose their dealings in relevant securities during the offer period before 12 noon on the next business day following the date of the transaction under Rule 22.

Definition of Exempt Principal Trader

The Takeovers Code defines an "exempt principal trader" as a person who trades securities as principal solely for the purpose of derivative arbitrage or hedging activities such as closing out existing derivatives, delta hedging in respect of existing derivatives, index related product or tracker fund arbitrage in relation to relevant securities during an offer period. The note to that definition provides that the Takeovers Code's intention *"is not to restrict dealings in, or require disclosure of, derivatives which have no connection with an offer ... The Executive will not normally regard a derivative which is referenced to a basket or index including relevant securities as connected with an offeror or potential offeror if at the time of dealing the relevant securities in the basket or index represent less than 1% of the class in issue and less than 20% of the value of the securities in the basket or index ..."*

Trades by CICCFE

CICCFE executed swap transactions involving a basket of stocks which included the A shares of Dalian Port and Maanshan Iron (the **Swap Trades**). It also conducted the related delta-one hedging trades of the underlying securities to fully hedge its proprietary positions in the Swap Trades by taking opposite positions in the market through CICCHKSL as its broker (the **Swap Hedging Trades**). Between the 3rd and 26th of June 2019, CICCFE executed 28 Swap Hedging Trades involving the A Shares of Dalian Port and 33 Swap Hedging Trades involving Maanshan Iron's A Shares.

The Swap Trades were not considered to be connected with the mandatory offers and were not required to be publicly disclosed because they were permitted trades under the exempt principal trader definition and represented less than 1% of the respective share classes and less than 20% of the value of the securities in the basket or index.

However, the Swap Hedging Trades involved acquisitions or disposals of relevant securities of Dalian Port and Maanshan Iron and were required to be publicly disclosed in accordance with Rule 22 of the Takeovers Code.

Trades by CICCL as Designated Liquidity Provider of a Shenzhen-listed ETF

CICCL is a designated liquidity provider of an existing A-share index-tracking exchange traded fund (**ETF**) listed on the Shenzhen Stock Exchange. In carrying out its obligations as liquidity provider, it creates and redeems ETF units (**ETF Trades**). When CICCL creates ETF units, it acquires a basket of underlying securities listed on the Shanghai and Shenzhen stock exchanges which it delivers to an ETF provider in exchange for ETF units. When it redeems ETF units on request by a client, CICCL delivers the units to an ETF provider in return for an equivalent basket of the underlying securities which it disposes of in the market.

CICCL also executed index arbitrage activities which involved taking short positions in an A-share index futures product (**Index Futures Trades**) and entering into related hedging transactions (**Index-related Hedging Trades**). The hedging transactions involved acquiring the underlying constituent stocks or related ETF units. Where ETF units were acquired for hedging, when squaring its position, CICCL might make a request for redemption and disposal of the underlying stocks afterwards (**Index-related Disposals**).

The A-shares of Dalian Port and Maanshan Iron were underlying constituent stocks in the ETF and the index futures product.

According to the definition of exempt principal trader, exempt principal traders are permitted to execute the ETF Trades, Index Futures Trades and their respective related hedging transactions during an offer period. The ETF Trades and Index Futures Trades (together the **Derivative Trades**) were not considered to be connected with the Dalian Port and Maanshan Iron offers and therefore did not need to be disclosed because they were trades relating to derivatives which were referenced to a basket or index including the relevant securities that represented less than 1% of their respective class in issue and less than 20% of their respective value of the securities in the basket or index.

However, CICCL's acquisitions and disposals of Dalian Port and Maanshan Iron A-shares, as constituent stocks of the ETF, in its capacity as liquidity provider of the ETF (**ETF-related Hedging Trades**) and the Index-related Hedging Trades, were trades that involved the underlying relevant securities in Dalian Port and Maanshan Iron and not derivatives that were unrelated to the mandatory offers. Therefore, CICCL should have publicly disclosed the relevant trades before 12.00 noon on the business day following the date of each relevant trade in compliance with Rule 22 of the Takeovers Code.

In relation to the A shares in Dalian Port, CICCL executed during the period of 4 June 2019 and 25 June 2019:

- i) 8 ETF-related Hedging Trades; and
- ii) 6 Index-related Hedging Trades.

In relation to the A shares of Maanshan Iron, CICCL executed during the period of 3 June 2019 and 25 June 2019:

- i) 11 ETF-related Hedging Trades; and
- ii) 6 Index-related Hedging Trades.

CICC Group Consultation with the SFC Executive

CICCHKSL's compliance team consulted the SFC Executive regarding the disclosure requirements under Rule 22 of the Takeovers Code on 27 June 2019. It became clear that CICCFT and CICCL should have disclosed the ETF-related Hedging Trades, the Index-related Hedging Trades and the

Swap Hedging Trades. CICCFT and CICCL then immediately self-reported non-compliance with the Takeovers Code and submitted all relevant disclosures on 28 June 2019.

The CICC Group recognised and apologised for the breaches of Rule 22 and has adopted enhanced compliance measures to address the shortcomings in its disclosure compliance system. Enhancements include the enhancement of internal reporting control, engaging external counsel and putting in place additional reminders for traders and operations teams.

SFC Comments on the Rule 22 Disclosure Obligations

The SFC noted in the disciplinary statement that the disclosure obligations are intentionally onerous in view of the high degree of transparency necessary for the efficient functioning of the market and that timely and accurate disclosure plays a fundamental role in ensuring that takeovers are conducted within an orderly framework and that market integrity is maintained.

The SFC also emphasised that while disclosures are not required for dealings in certain derivatives which are not considered as having a connection with an offer or potential offer, this does not mean that disclosures for their related hedging activities are not necessary. Holdings by parties related to an offer are material information in the context of an offer.

As to the sanction imposed, the SFC took into account that CICC Group acted promptly to rectify the non-disclosure, the relatively short period of breach and the group's full co-operation and implementation of additional controls and measures to ensure future compliance with the Takeovers Code.

2. SFC Publicly Censures Listed Company Chairman for Breach of the Hong Kong Takeovers Code

The SFC has publicly censured Mr. Fu Kwan, Chairman of HKEx-listed Macrolink Capital Holdings Limited (the **Company**) for breaching Rule 31.3 of the Hong Kong Takeovers Code in acquiring the company's shares within six months of the close of a previous takeover offer at prices above the original offer price.

Rule 31.3 of the Takeovers Code

Rule 31.3 provides that, except with the consent of the Executive, a person holding 50% of a company's voting rights and persons acting in concert with him are prohibited from making a second offer to acquire, or acquiring, shares from any shareholder in that company at above the offer price of a previous offer made by him to the shareholders of that company in the six months after the end of the offer period of the previous offer.

Breach of Rule 31.3 of the Takeovers Code

On 1 August 2018, Macrolink Group Limited (the **Offeror**) made an unconditional mandatory general offer in cash for the Company's shares at \$0.6217 per share which closed on 22 August 2018. The Offeror is beneficially owned as to approximately 42.06% by Truly Industry Investment Company Limited, which is 70% owned by Mr. Fu. Upon the close of the offer, the Offeror and its concert parties (which included Mr. Fu) held 67.85% of the Company's shares.

Mr. Fu made a series of on-market acquisitions on 8 and 9 November 2018 acquiring a total of 3,990,000 shares in the Company at prices higher than the offer price in breach of Rule 31.3.

Mr. Fu alleged that the breach was inadvertent and unintentional and that he had not been alerted to the requirement under Rule 31.3. Memoranda relating to the restriction under Rule 31.3 were however circulated to the Offeror's representatives by its legal counsel prior to the offer and by the financial adviser after the offer closed.

Mr. Fu has since admitted the breach was due to his oversight and apologised and undertaken to take all necessary steps to ensure future compliance with the Takeovers Code and all other rules and regulations.

SFC Comments on Rule 31.3 of the Takeovers Code

The SFC emphasised the importance of Rule 31.3 in ensuring that shareholders are treated equally in accordance with General Principle 1 of the Takeovers Code. It also creates certainty for shareholders that an offeror will not pay a price higher than the offer price for the shares in the offeree company in the six-month period after the close of an offer.

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