SFC 證監會

TAKEOVERS BULLETIN

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A periodic newsletter to help participants in Hong Kong's financial markets
better understand the Codes on Takeovers and Mergers and Share Repurchases

Introduction

1. Revised Practice Note 9 is issued clarifying, amongst other things, the scope of exempt trading activities by exempt principal traders.
2. Rule 22 disclosure forms have been revised.
3. The Executive issues a reminder that the Codes do not apply to all listed companies in Hong Kong.
4. The Executive clarifies the meaning of "completion of subscription" under paragraph 3(b) of the Whitewash Guidance Note.
5. Finally the Executive wishes to remind market practitioners of the importance of compliance with Rule 3.6.

Highlights

- Revised Practice Note 9
- Revised Rule 22 disclosure forms
- Application of the Codes to companies with secondary listings
- Meaning of "completion of subscription" under paragraph 3(b) of Whitewash Guidance Note in Schedule VI of the Codes
- Reminder of importance of compliance with Rule 3.6

Revised Practice Note 9 (PN9) – Exempt fund manager and exempt principal trader status

1. Since PN9 was issued in March 2008 the Executive has noted an increase in the number of enquiries relating to the nature of trading activities that an exempt principal trader (EPT) may carry out under its exempt status. As a result the Executive has reviewed the trading activities commonly carried out by EPTs which may be regarded under the definition of "exempt principal trader" in the Codes as exempt during an offer period. The Executive has consulted a number of financial institutions and market practitioners on an informal basis as part of this review.

2. The Executive has amended PN9 to provide, amongst other things, guidance on the treatment of certain dealing activities carried out by EPTs. The relevant sections (paragraphs 6.6 and 6.7) have been set out in full below.

3. A number of miscellaneous amendments have also been made to PN9 including:

   (a) clarification that where "seed capital" of a connected exempt fund manager (EFM) represents 10% or more (but less than 90%) of the value of the fund, the connected EFM may continue to deal in relevant securities during the offer period as if it were dealing on behalf of discretionary clients subject to the restrictions in Rule 35 (see paragraph 5.1(b)); and

   (b) a description of the provisions relating to dealings by connected fund managers and connected principal traders which do not have exempt status under Rule 21.6 (see paragraph 9).

4. Revised PN9 can be found in the "Prospectuses, Takeovers & Mergers" - "Takeovers & Mergers" – "Practice Notes" section of SFC website. If any person is in doubt on how the Codes apply early consultation with the Executive is strongly encouraged.

5. The Executive wishes to thank those who have participated in the review exercise for their contribution and assistance.

Excerpt from PN9

"6.6 *Dealing activities conducted by an EPT*

(a) **Exempt Principal Trades**

The Codes define an EPT as follows:

"An exempt principal trader is a person who trades as a principal in securities only 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 the relevant securities or other similar activities assented to by the Executive during an offer period, and is recognised by the Executive as an exempt principal trader for the purposes of the Codes. An exempt principal trader who carries out securities borrowing and lending transactions (including the unwinding of such transactions) in the ordinary course of its business is not subject to Rule 21.7."

(b) **Agency Trades**

For the avoidance of doubt the Executive regards dealings in relevant securities for the account of non-discretionary investment clients as agency trades which are permitted and must be disclosed privately under Rule 22.2 of the Takeovers Code. These trades are executed in accordance with the instructions given by non-discretionary clients. The execution process does not involve the trader, who deals in the relevant securities on behalf of its client, taking on a proprietary position.

An EPT's client may sometimes deal in relevant securities via a direct market access platform (**DMA**) whereby the client inputs orders directly through the EPT's trading systems and such orders are executed under the EPT's broker ID. The EPT's traders would not normally have any involvement with the order itself. The Executive regards trades executed by an EPT's clients via DMA as agency trades. They are therefore permitted and must be disclosed privately under Rule 22.2.

6.7 *Guidance on exempt principal trades*

As already stated exempt status for EPTs is limited to the trading activities that are set out in the definition of EPT. The reason for imposing such limitations is that the risk of abuse in the context of an offer is considered to be greater in respect of proprietary dealing activities. Essentially dealings and related hedging referred to in the definition of EPT are permitted in recognition of the fact that an EPT may need to fulfill pre-existing obligations or carry out related hedging or similar activities. In keeping with this approach, the Executive regards certain dealings as exempt for the purpose of EPT status primarily by reference to the restrictions imposed by the definition of EPT (and Rule 35) and provided that the dealings are not conducted for the purpose of assisting the offer. In reaching a decision the Executive may also take into account whether the dealings:

- are wholly unsolicited and client driven and conducted for client facilitation purposes; or
- arise as a result of pre-existing obligations (including market making or liquidity providing obligations).

General guidance on the treatment of certain types of trading activities commonly carried out by EPTs during an offer period under four broad categories is set out below.

(a) **Client facilitation trades**

At times the client facilitation desk of an EPT might wish to take on a temporary principal position in connection with the fulfilment of a client's order (for example, an order based on the volume weighted average price or relating to basket/program trades or similar transactions). In these circumstances the Executive will take a pragmatic approach and will regard such client facilitation trades as falling within the exempt dealing activities referred to in the definition of EPT during an offer period provided that:

- the client facilitation trades arise from wholly unsolicited client-driven orders. They must not arise as a result of solicitation or indication of interests by the client facilitation desk (by way of e-mails, telephone calls or otherwise) or recommendations provided by the EPT or its related parties during the offer period;
- the client facilitation desk operates independently of the group's proprietary trading desk (this should be supported by appropriate compliance procedures such as the suspension of any proprietary trading by the client facilitation desk); and
- the proprietary positions that arise as a result of client facilitation trades (if any) are flattened no later than the close of the morning trading session the day after the trade is made.

Therefore in assessing whether or not to facilitate a client trade it is important that the client facilitation desk considers whether it is able to close/flatten or unwind the position within the allowable timeframe. EPTs should also maintain proper books and records and audit trails of all client facilitation trades and ensure that they are made readily available for inspection by the Executive upon request.

(i) <u>Delta 1 products and related hedging</u>

A Delta 1 product is a client-driven synthetic financial product that provides clients with the ability to obtain a long or short term exposure to a particular stock without the need for the client to actually buy or sell the underlying shares. When an EPT enters into a synthetic trade with a client, the EPT will hedge against the trade by buying or selling the equivalent number of reference security (the trade is therefore hedged on a one-for-one basis). The economic interests of the trade (i.e. the risks and returns) are passed on to the client as if the client were directly buying or selling the underlying reference shares. The voting rights attached to the underlying shares however rest with the EPT as holder of the shares.

The Executive regards the creation of Delta 1 products and related hedging arising from wholly unsolicited client-driven orders during an offer period as an exempt activity under the definition of EPT provided that the EPT does not take a directional position as a result, for example, by retaining part of the product on its own book.

(ii) Convertible bonds

Convertible bonds (CBs) are debt instruments which provide the holder with the right, under pre-determined terms, to convert into a fixed number of shares of the issuer within a fixed period of time. The CB market is normally illiquid and CB trades are typically conducted on a principal-to-principal basis.

The Executive will regard trading in CBs and related hedging arising from wholly unsolicited client-driven orders during an offer period as exempt under the definition of EPT provided that:

- the CB pre-existed at the commencement of the offer period; and
- the resultant proprietary positions (if any) are flattened no later than the close of the morning trading session the day after the trade is made.

Issuance or participation in the issuance of a new CB during an offer period, albeit at the request of the client, would not be regarded as exempt.

(iii) Issuance of new over-the-counter derivatives and related hedging

Creation of a new derivative and related hedging (albeit as a result of unsolicited client requests) during an offer period is not regarded as an exempt activity under the definition of EPT.

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 (see Note to the definition of derivative). Dealings in such derivatives (and related hedging) would therefore be regarded as exempt under the definition of EPT.

(b) **Market making and liquidity providing activities**

(i) Market maker or liquidity provider activities (and related hedging) in derivative warrants, callable bull/bear contracts and exchange-traded stock or index options involving relevant securities during an offer period are regarded as exempt for the purpose of EPT status provided that:

- the EPT is recognised by The Stock Exchange of Hong Kong Limited (SEHK) as a designated market maker or liquidity provider for the particular derivative or exchange-traded option;
- the derivative or series of exchange-traded options was already in issue before the offer period commenced; and
- the EPT does not apply for market maker or liquidity provider status relating to the relevant underlying securities during an offer period.

(ii) The Executive should be consulted at the earliest opportunity if an EPT wishes to conduct market maker or liquidity provider activities relating to unlisted derivatives or if it wishes to fulfill its obligation as a market maker of a CB during an offer period. In determining whether such trades would be regarded as exempt the Executive would take into account all relevant factors including the number of market makers for the particular unlisted derivative or CB.

(c) **Index-related products and Exchange Traded Funds**

Broad-based index-related product or tracker fund arbitrage in relation to relevant securities during an offer period (including index rebalancing and related hedging) are regarded as exempt activities under the definition of EPT. The Executive should be consulted in advance in respect of sector specific indices and other similar products.

Exchange Traded Funds (ETFs) are passively managed open ended investment funds that can be traded like shares on a stock exchange. The Executive notes that all stock-related ETFs currently listed on the SEHK track the performance of an index (index-tracking ETFs). The Executive regards the following activities relating to broad-based index-tracking ETFs as falling within the exempt dealing activities referred to in the definition of EPT:

- dealing in pre-existing index-tracking ETFs and related hedging (where relevant);
- redemption of pre-existing index-tracking ETFs (as a result of unsolicited client requests) and disposal of the underlying shares received from such redemption; and
- creation of new index-tracking ETFs and related hedging so long as the relevant share component is within the limits prescribed in the Note to the definition of derivative under the Codes (see paragraph 6.7(a)(iii) above).

The Executive should be consulted in respect of dealings in, or redemptions of, an ETF that is not a broad-based index-tracking ETF, or in the case of a creation of a new ETF, if the relevant share component exceeds the prescribed limit.

(d) **Securities borrowing and lending**

Securities borrowing and lending transactions (including the unwinding of such transactions) are not regarded as "dealings" under the Codes. Notwithstanding this, if a connected principal trader does not have EPT status, the restrictions in Rule 21.7 would still apply.

The Prime Brokerage desk of an EPT provides custodial and clearing services to clients and, in exchange, the Prime Broker is typically granted the right to rehypothecate the securities held in a client's account. This right entitles the Prime Broker to take beneficial title of a client's securities and to use the securities for its own banking group's funding purposes, for example by on-lending to its own banking group or to third parties or by using the securities as collateral for loans.

The Executive does not regard the act of rehypothecation or the returning of recalled securities as "dealing" under the Codes. However any proprietary dealing in rehypothecated securities (for example disposal of such securities) during an offer period would not be regarded as exempt under the definition of EPT.

The voting rights of rehypothecated shares should be aggregated with an EPT's group's shareholding for the purpose of Rule 26 (see paragraph 6.4 above)."

Revised Rule 22 disclosure forms

The Executive has also made various amendments to the prescribed forms for private and public disclosures under Rule 22 of the Takeovers Code. The revised forms can be found in the "Prospectus, Takeovers & Mergers" – "Takeovers & Mergers" – "Forms" section of the SFC website. Going forward the revised forms should be used for submission of all dealing disclosures under Rule 22.

The Codes do not apply to all listed companies in Hong Kong

Investors may be under the impression that the Codes on Takeovers and Mergers and Share Repurchases (Codes) apply to all companies listed in Hong Kong. They should be aware that this may not be the case where the listing is a secondary listing.

Section 4.1 of the Introduction to the Codes provides that the Codes apply to takeovers, mergers and share repurchases affecting public companies in Hong Kong, companies and real estate investment trusts with a primary listing on The Stock Exchange of Hong Kong Limited (SEHK). It is clear therefore that the Codes apply to every company that obtains a primary listing in Hong Kong irrespective of its country of incorporation, location of management or place of business and assets.

The Codes do not, however, apply to a company with a secondary listing on the SEHK unless it is a "public company in Hong Kong" within the meaning of the Codes. Section 4.2 of the Introduction to the Codes provides guidance as follows:

> *"4.2 In order to determine whether a company is a public company in Hong Kong the Executive will consider all the circumstances and will apply an economic or commercial test, taking into account primarily the number of Hong Kong shareholders and the extent of share trading in Hong Kong and other factors including:-*
>
> *(a) the location of its head office and place of central management;*
> *(b) the location of its business and assets, including such factors as registration under companies legislation and tax status; and*
> *(c) the existence or absence of protection available to Hong Kong shareholders given by any statute or code regulating takeovers, mergers and share repurchases outside Hong Kong."*

The starting point under section 4.2 is to consider the number of public shareholders and the extent of share trading in Hong Kong. These factors need to be considered in the context of the size of the company in question and the relative proportion of its shareholders and share trading activity in Hong Kong. If the proportion is very small, the Executive does not believe that it should assert jurisdiction. If it is not small, then the Executive must turn to the remaining factors set out in section 4.2 to determine whether the Codes should apply.

Factors (a) and (b) are very often referred to as the "centre of gravity" of a company. The "centre of gravity" test considers whether the company has sufficient connection with Hong Kong such that it is appropriate to apply the protection of the Codes to its shareholders. The general principle is that the closer the proximity of the management and the business/assets to Hong Kong, the more likely that protection under the Codes should be afforded.

By definition, a secondary listing in Hong Kong will also have a primary listing in an overseas jurisdiction. In addition to applying the centre of gravity test, in reaching a decision of whether or not to apply the Codes to a company with a secondary listing in Hong Kong, the Executive also takes into account whether alternative protection is available to Hong Kong investors under factor (c). In this regard the Executive adopts a practical approach to see if the protection available to Hong Kong investors under the overseas jurisdiction regulating takeovers, mergers and share repurchases is broadly comparable to the Codes. The Codes do not set down a qualitative test or a test of equivalence as the application of such tests to takeover regimes of different jurisdictions is in practice problematic and cumbersome.

At present, there are only two secondary listings in Hong Kong, namely, Manulife Financial Corporation and SouthGobi Resources Ltd. The Executive has confirmed in both these cases that the Codes do not apply and this fact was clearly set out in the relevant offering prospectuses.

Before reaching a decision of whether to invest in a company investors should make enquiries to establish whether the protection under the Codes is available. As always, when in doubt, an investor should consult a licensed securities dealer or registered institution in securities, a bank manager, solicitor, professional accountant or other professional adviser.

Meaning of "completion of subscription" under paragraph 3(b) of the Whitewash Guidance Note (Schedule VI of the Codes)

Paragraph 3 of the Whitewash Guidance Note (ie Schedule VI) provides that:

> *"Notwithstanding the fact that the issue of new securities is made conditional upon the prior approval of a majority of the shareholders independent of the transaction at a general meeting of the company:-*
>
> *(a) the Executive will not normally waive an obligation under Rule 26 of the Takeovers Code if the person to whom the new securities are to be issued or any person acting in concert with him has acquired voting rights in the company (save for subscriptions for new shares which have been fully disclosed in the whitewash circular) in the 6 months prior to the announcement of the proposals but subsequent to negotiations, discussions or the reaching of understandings or agreements with the directors of the company (which would include informal discussions) in relation to the proposed issue of new securities; and*
>
> *(b) a waiver will not be granted or if granted will be invalidated if, without the prior consent of the Executive, any acquisitions or disposals of voting rights are made by such persons in the period between the announcement of the proposals and the* ***completion of the subscription****."* (emphasis added)

The Executive has received a number of enquiries about the meaning of "completion of the subscription" in paragraph 3(b) in order to confirm when the disqualifying transaction period ends. The Executive would like to take this opportunity to clarify the position as set out below.

In a transaction which involves the subscription for new shares by a whitewash waiver applicant, "completion of the subscription" means the completion of the issue of the new shares to the whitewash waiver applicant.

In a transaction which involves the issue of convertible securities to a whitewash applicant the position is different. A common feature of these transactions is that the subscriber of the convertible securities seeks approval of a whitewash waiver from both the Executive and independent shareholders before the issue of the convertible securities. In this situation the whitewash waiver relates to the offer obligation that will be triggered when new shares are issued upon the subsequent exercise of the conversion right by the whitewash applicant. This sometimes takes place many months if not years following the issue of the convertible securities. In these circumstances, the Executive interprets "completion of the subscription" to mean the completion of the issue of the convertible securities to the whitewash waiver applicant. Accordingly, the disqualifying transaction period ends at the time when the convertible securities are issued and not when the conversion rights are exercised.

Reminder on the importance of compliance with Rule 3.6

1. The Executive has recently dealt with a disciplinary case relating to a breach of Rule 3.6 of the Takeovers Code which resulted in the issue of a notice of criticism of the parties involved.
2. The Executive would like to take this opportunity to reiterate the importance of Rule 3.6 which provides that "*acquisitions of voting rights of the offeree company by an offeror or by any person acting in concert with the offeror may give rise to an obligation to make a cash offer or securities offer (Rule 23), to increase an offer (Rule 24) or to make a mandatory offer (Rule 26). Immediately after any acquisition giving rise to any such obligation, an announcement must be made, stating the number of voting rights acquired and the price paid, together with the information required by Rule 3.5 (to the extent that it has not previously been announced).*"

3. Where an offer obligation under Rule 26.1 is triggered upon the completion of an agreement to sell and purchase shares, the requirement to announce under Rule 3.6 applies to the completion of the relevant sale and purchase agreement. This is in line with the requirement to make full and prompt disclosure to avoid the creation of a false market under General Principle 6 of the Codes.
4. The Executive Statement can be found under "Takeovers and Mergers" – "Panel and Executive Decisions / Statements" section of the SFC website.

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