Hong Kong Institute of
Certified Public Accountants
香港會計師公會

4 January 2006

Our Ref.: C/CFC, M38619

Corporate Finance Division
Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

Attn.: CO Phase 3 Consultation

Dear Sirs,

Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance

The Hong Kong Institute of Certified Public Accountants has considered the consultation paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance, which invites public comments on possible reforms to the law relating to the public offering of shares and debentures contained in Parts II and XII of the Companies Ordinance (Cap. 32).

The Institute's comments on the proposals discussed in the consultation paper, and on related matters that impact upon the proposals, are set out in the Appendix to this letter.

We hope that you find our comments to be helpful. If you have any questions on our submission or wish to discuss it further, please contact me at the Institute on 2287 7084.

Yours faithfully,

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Appendix

Comments from the Hong Kong Institute of Certified Public Accountants in response to the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance

Proposal 1 – Transfer Companies Ordinance (“CO”) prospectus regime to Securities and Futures Ordinance (“SFO”)

Q1 Do you think that the CO prospectus regime should be moved to the SFO?

The Institute does not have any objection, in principle, to the proposal to transfer the legislation relating to the public offering of shares and debentures (“the CO prospectus regime”) to the SFO, for the purpose of consolidating all securities laws into a single piece of legislation. However, we believe that this might not be a simple or straightforward task and have doubts whether, in practice, it will reduce complexity and lower compliance costs, as is suggested in paragraph 1.3 of the consultation paper. In our view, there would not be much value in relocating the CO prospectus regime without also restructuring the SFO.

Furthermore, we are not aware of specific concerns about the current legislation and would suggest that significant changes should not be made unless there are persuasive grounds for doing so, such as anticipated improvements in market efficiency. Therefore, some additional information would be useful, such as the rationale for, and the results of, similar changes made in other comparable jurisdictions.

Proposal 2 – Shift of focus to “transaction-based”

Q2 Do you think that the focus of the CO prospectus regime should change from a “document-based” approach to a “transaction-based” approach, such that all offers of shares and debentures will need to comply with the requirements of the regime unless they fall within an exemption?

We consider that the distinction between “document-based” and “transaction-based” is not sufficiently clearly explained in the consultation paper. Further elaboration and explanation of the situation described in paragraph 3.2 of the paper, i.e., “*offers are structured with a verbal component … and thereby take the offer outside the CO prospectus regime*”, and an indication of the number of transactions that are structured to fall outside the CO prospectus regime, would be helpful. The paper does not state clearly enough the benefits that would accrue from changing the basis of the offer regime and/or the disadvantages of the current regime. Moreover, as the SFO currently adopts a document-based approach and contains many document-based rules, a change to a transaction-based approach would emphasise the need, referred to above (see our response to Q1), for an examination and restructuring of the SFO, if the CO prospectus regime were to be transferred to the SFO.

The Institute is of the view that whatever approach is to be adopted, as a general principle, all information should be available in the prospectus.

Proposal 3 – Scope of the regime: options or other rights

Q3 Do you think the CO prospectus regime should expressly apply to offers of options or other rights, in cases where the issuer of the option or other right is in the same group of companies as the issuer of the underlying shares or debentures?

The Institute is in agreement with the suggestion in the question, as it is considered to be a natural extension to apply the CO prospectus regime to offers of options or other rights in or over shares and debentures.

Proposal 4 – Scope of the regime: bodies

Q4 Do you think that it is appropriate: -

(a) to standardise the requirements of the CO prospectus regime without regard to the place of incorporation of the issuer; and
(b) to provide that the CO prospectus regime should apply to "bodies" rather than companies?

The Institute agrees with (a) standardising the requirements of the CO prospectus regime without regard to the place of incorporation of the issuer; and (b) providing that the CO prospectus regime should apply to "bodies" rather than companies.

Proposal 5 – Unification of regimes: regulatory harmonisation

Q5A Do you think there should be a unified regime for all regulated investment arrangements and instruments currently falling within the CO prospectus regime and the SFO investment advertisement regime?

Please see the response to Proposal 1 above.

Q5B Do you think it is useful to clarify the meaning of "debenture" along the lines suggested in paragraph 9.11 above?

We agree that it would be useful to clarify the meaning of "debenture" as suggested.

Proposal 6 – New safe harbour: takeover and merger offers and schemes of arrangement

Q6 Is it appropriate to create an exemption from the CO prospectus regime in respect of an offer or arrangement of the kind described in paragraph 11.4?

We are of the view that Hong Kong investors, who invest in overseas securities markets and/or hold shares and debentures in entities not listed/traded in Hong Kong, should have the same rights and entitlements as shareholders in other jurisdictions. Hong Kong legislation should not create any obstacle to Hong Kong investors being able to receive such entitlements.

Therefore, we agree that it would be appropriate to create an exemption from the CO prospectus regime in respect of an offer or arrangement of the kind as described in paragraph 11.4 of the consultation paper.

Proposal 7 – Anti-avoidance mechanism

Q7A Do you consider that an anti-avoidance mechanism as described in paragraph 13.4 should be adopted in Hong Kong? If you agree that there should be an anti-avoidance mechanism but do not agree with the wording proposed, please suggest alternative wording.

There would need to be adequate carve-outs from any anti-avoidance mechanism as described in paragraph 13.4 of the consultation paper. However, more explanatory information/statistics should be made available to support the need for such a mechanism to be introduced in the first place.

Q7B Do you agree with the carve-outs from the anti-avoidance mechanism described in paragraph 13.5? If you consider other carve-outs are necessary please justify your suggestions.

Please see the response to question 7A above. If the need for an anti-avoidance mechanism can be shown, we would agree that the carve-outs described in paragraph 13.5 would be sensible.

Proposal 8 – Persons liable for a prospectus

Q8A Do you think that prospectus civil liability should be extended to the issuer and/or offeror of the shares or debentures and the sponsor of an issue (each within the meaning of paragraph 15.7), as well as to persons who accept, and are stated in the prospectus as accepting, responsibility for the prospectus? Are there any other parties involved in the prospectus preparation or public offering process who in your view should also be subject to the civil liability regime?

The Institute has serious reservations about any proposal to extend the civil liability regime without progress having been made on much-needed liability reform in Hong Kong.

We are also of the view that all parties contributing to the prospectus should be responsible for negligence, which is the position under common law. The proposal should be consistent with international practice, and we question whether it would be appropriate to place too much emphasis on the responsibility of any single party, such as sponsors. Sponsors, in any event, are already sufficiently regulated, by the Securities and Futures Commission through licensing and by the Stock Exchange under the listing rules, in terms of their role and responsibilities. This being so, the Institute would suggest that effective enforcement of the existing rules and regulations would be a better direction to follow, rather than relying on more legislation.

It is not clear whether, under the proposal, the civil liability of directors of the issuer/offeror would be retained. We believe that it should be and that this should be stated more clearly.

Q8B Do you think that liability under the prospectus regime of "promoters" and persons who "authorise the issue of" a prospectus should be removed?

In principle, the Institute does not have any strong objection to removing the liability of "promoters" and persons who "authorise the issue of" a prospectus. However, in our view, in order to enable a more considered answer to this question to be given,

further information should be researched and provided, as to the original targets of these terms and whether some or all of these persons should be specified more clearly in any legislative revisions.

Q8C Do you think that the same classes of persons should be subject to both civil and criminal liability for misstatements in prospectuses (with experts liable only in respect of untrue statements in their reports)?

The Institute is of the view that a detailed study and comparison with the regulatory regimes, civil and criminal, of other major financial markets (e.g., UK, US, Australia, etc.) should first be carried out and the information made available to market participants. Hong Kong should not create a liability regime that is out of step with international practice. It appears from the consultation paper (see paragraphs 16.2 and 16.3) that, for example, in overseas markets, criminal liability focuses on specific actions/circumstances, which, in Hong Kong, may already be caught under existing legislative provisions.

Proposal 9 – Misstatements: Persons who may claim compensation

Q9 Do you consider that a secondary market purchaser should be able to bring a claim for compensation for loss resulting from an untrue statement in a prospectus?

It is unclear from the question, whether the secondary market purchaser, referred to in the question, would be limited to the first purchaser from the subscriber, or would include all subsequent purchasers, i.e., is the proposal intended to be restricted to secondary trading or does it extend to tertiary trading?

We believe that it would be critical to establish whether a secondary market purchaser had relied on information in the prospectus, as opposed to, for example, information/news gleaned from other sources, which would be a potentially difficult and complex exercise. Losses suffered by a purchaser would also have to be directly attributable to reasonable reliance on that information. Furthermore, in view of the continually changing market conditions and business environment, there would have to be a maximum time period from the date of issue of the prospectus that a purchaser could, subject to certain conditions, reasonably rely upon the information contained in the prospectus.

On balance, we consider that the proposal would create too much uncertainty and extend potential liabilities in a way that could adversely affect the market overall. This being the case, the Institute does not agree with extending the class of persons who may make a claim for compensation to secondary market purchasers.

Proposal 10 – Misstatements: reliance on the prospectus

Q10 Do you consider that the requirement for claimants to prove that they have actually read and relied on the prospectus when making a claim for compensation under section 40 of the CO should be repealed?

The Institute does not agree that the requirement should be repealed. It is considered that claimants should have to demonstrate that they have read and relied on the prospectus and that they have suffered loss as a result of having done so.

Proposal 11 – Defence for those liable: due diligence

Q11 Do you believe that the reasonable belief defence contained in sections 40(2)(d)(i), 40(3)(c) and 40A(1) of the CO should be subject to the requirement that such belief must be founded on all inquiries which were reasonable in the circumstances having been made?

We question the need to make any change in the first place.

If there is clear and sufficient justification for a change, the Institute would emphasise that the "reasonable belief" defence contained in sections 40(2)(d)(i), 40(3)(c) and 40A(1) of the CO should be subject to a requirement that that belief be founded on "all inquiries that were reasonable at the time" having been made. "All inquiries", which is the wording currently contained in the question, would be too onerous a standard.

Proposal 12 – Disclosure standard and contents of prospectus

Q12A Do you consider that an overall disclosure standard along the lines proposed in paragraph 23.3 should be given prominence and tied specifically to the liability provisions?

The Institute does not have any strong view as to the relocation of "the overall disclosure standard" from the Third Schedule to the body of the CO prospectus regime, which would not appear to make any difference to its legal status. However, the intention of the proposal is not entirely clear to us as, on the one hand, question 12A refers to tying the overall disclosure standard "specifically to the liability provisions", whereas paragraph 23.3 of the consultation paper merely suggests moving the standard "adjacent to section 40 and 40A of the CO", which, on the face of it, is not the same thing. This needs to be clarified before we can comment further.

Q12B Do you think that the overall disclosure standard should be supplemented by prescribed content requirements in subsidiary legislation differentiating between equity and debt offerings?

Given that the market has been working quite well so far, and we are not aware of any complaints or demands from the market in this regard, we would question the need to supplement the overall disclosure standard by prescribed content requirements in subsidiary legislation, differentiating between equity and debt offerings.

Q12C Do you think that the International Disclosure Standards for Cross Border Offerings and Initial Listings of Equity Securities by Foreign Issuers issued by IOSCO serve as a useful model on which to base Hong Kong's prospectus disclosure standards?

In general, Hong Kong should endeavour to adopt international good practice. However, it is important to know how successfully specific practices, which may already exist in other markets, are operating in those markets, before deciding on the suitability of introducing them into Hong Kong. In this regard, it would be useful to know to what extent, and how, the "*International Disclosure Standards for Cross Border Offerings and Initial Listings of Equity Securities by Foreign Issuers*", issued by IOSCO, have been adopted in other markets, and the response in those markets to the practical implementation of the standards.

Proposal 13 – Disclosure for Rights Issues

Q13 Do you consider that rights issues and issues of shares or debentures, which are uniform in all respects with listed shares or debentures, should not be entirely exempt from the content requirements of the prospectus regime?

We do not have sufficient information to enable us to form a considered view on the need for such a change.

Proposal 14 – Incorporation by reference

Q14 Do you agree that a provision should be introduced in the CO prospectus regime to enable incorporation by reference (subject to certain conditions) upon the establishment of a central on-line document repository?

The Institute believes that the proposal to permit incorporation of information in prospectuses by reference makes sense, in principle. Nevertheless, it would appear that other jurisdictions have proceeded down this road, if at all, only with caution. Hong Kong needs to take an equally cautious approach in introducing any changes to the legislation in this regard and in establishing a central on-line document repository. Furthermore, the overriding aim of such a proposal should be to reduce the size of prospectuses. Incorporation by reference, therefore, should be restricted basically to items of information that are standardised (e.g., how to apply). There should be safeguards to ensure that facilitating incorporation by reference would not, ultimately, result in expanding the contents of prospectuses.

Proposal 15 – Pre-deal research

Q15A What are your views on (i) a requirement to publish leaked pre-IPO research by connected analysts coupled with commentary by the company in the prospectus on information that does not already appear in the prospectus; and (ii) a prohibition on the issue of written pre-IPO research reports by connected analysts? If you think there is an alternative way to address the concerns in paragraph 29.8, please describe it.

(i) We would have reservations about a requirement for publication of leaked pre-IPO research by connected analysts, as the information would not be of the same standard as a prospectus.

(ii) The Institute agrees that the current market practice in respect of pre-IPO research should be codified in some form. We do not have any strong objection to prohibiting the issue of written pre-IPO research reports by connected analysts, as this could help to create a more level-playing field. However, it needs to be clarified whether it is intended that any such prohibition would apply only to information published for public consumption.

Nevertheless, if publication of written pre-IPO research were to be prohibited, there should continue to be some facility to allow the marketing of IPOs privately to institutional investors, investment professionals, etc., by, for example, allowing registration of final proof of a prospectus, or allowing an issuer to produce an executive summary of the prospectus (without any projections) and provide some sector commentary, etc.

Q15B Do you consider that pre-deal research in the case of a follow-on offering gives rise to the concerns described in paragraph 29.8 such that it should be treated in the same way?

It is difficult to generalise. The position would depend very much on the circumstances of the offering.

Proposal 16 – Supplemental prospectus and right of withdrawal

Q16A Do you consider that there should be a statutory obligation on issuers of prospectuses to publish a supplemental or replacement prospectus if they become aware of a significant change affecting any of the prospectus disclosures?

The Institute agrees that there should be a statutory obligation on issuers to publish a supplemental or replacement prospectus if they become aware of a significant change affecting any of the prospectus disclosures.

Q16B Do you think that this obligation should apply until the close of the offer period or the actual allotment and issue of the applicable shares or debentures?

We consider that, in principle, the obligation (set out in Q16A above) should apply until the allotment and issue of the applicable shares.

Q16C Do you think that issuers should:

- ***extend the offer period upon publication of a supplemental or replacement prospectus in order to allow applicants sufficient opportunity to evaluate the supplemental or amended information. If yes, by how many days do you think the offer period should be extended?***
- ***notify applicants of the publication and availability of the supplemental or replacement prospectus or give applicants a copy of the supplemental or replacement prospectus; and***
- ***give applicants a right to withdraw their applications and be repaid?***

The Institute considers that issuers should take all the actions set out in Q16C.

Proposal 17 – The 3-day rule

Q17A Do you consider that the 3-day waiting period in the prospectus regime for allotments should be extended in the case of initial public offers of shares or debentures (whether to be listed or unlisted)?

Q17B Do you think that the 3-day waiting period in the prospectus regime for allotments should not apply to public offers of shares or debentures in the same class as those already listed?

The Institute has no strong view on this proposal.

<u>Proposal 18</u> – Application forms and procedures

Q18 Do you consider that the distribution of application forms or implementation of application procedures for shares or debentures by parties other than the issuer of the prospectus should be regulated along the lines suggested in paragraph 35.3 above?

We agree that the distribution of application forms or implementation of application procedures for shares or debentures by parties other than the issuer should be regulated. However, we believe that prospective investors, who take the application forms, should be able, and be encouraged, to also take a printed copy of the prospectus. We therefore have doubts about the proposal regarding the use of hyperlinks on the internet, referred to in paragraph 35.3 of the consultation paper, which, in practice, would be unlikely to encourage people to access and read prospectuses.

<u>Proposal 19</u> – Statements in lieu of prospectus

Q19 Do you agree that section 43 of the CO relating to statements in lieu of prospectus should be repealed?

The Institute has no strong view on this proposal.

<u>Proposal 20</u> – Employee offers

Q20 Do you think that: -

(a) there should be a separate regulatory regime to regulate offers to employees and their dependants?

The Institute notes that no separate regime exists in the other jurisdictions examined and considers that, in the absence of any clear evidence of abuse of the current arrangements, there is no need to introduce a separate regulatory regime in Hong Kong to regulate offers to employees and their dependants.

(b) we should introduce a requirement for the provision of a declaration of solvency and going concern by the directors and auditors of a company whose shares or debentures are being offered to employees or dependants?

The Institute does not have any objection to require a declaration of solvency and going concern by the directors of a company whose shares or debentures are being offered to employees or dependants, but considers that it would be wholly inappropriate to seek to extend the requirement to the auditors of the company. This is not part of the scope of a company audit and it could have adverse implications for auditors’ professional independence if they were expected to make a declaration of solvency on behalf of a client company.

<u>Proposal 21</u> – Void or voidable transactions

Q21 Do you consider that an issue or sale of securities in contravention of the law should be rendered void or voidable transactions?

Prima facie, it would appear that the existing powers to apply to the court for a range of possible orders might be adequate. However, it would be useful for further information to be provided in relation to the consequences of rendering an issue or sale of securities void or a voidable transaction, and the remedies that would subsequently be available to the affected parties.