Chapter Three

Mandatory and Voluntary Offers

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A. INTRODUCTION

The main purpose of the principles and rules of the Takeovers Code is to ensure that shareholders are treated fairly. Underlying the requirement of a mandatory offer is the general principle that if the control of a company changes or is acquired or consolidated, a general offer to all other shareholders is normally required. Unless otherwise stated, a reference to a Rule in this chapter is a reference to the relevant Rule in the Takeovers Code.

'Control' is deemed to mean a holding, or aggregate holdings, of 30% or more of the voting rights of a company, irrespective of whether that holding gives *de facto* control. 'Offer' includes takeover and merger transactions, however effected, including schemes of arrangement that have similar commercial effect to takeovers and mergers, partial offers and privatisations by controlling shareholders.

Most of the rules of the Takeovers Code apply to all offers, but some apply only to mandatory offers. Mandatory offers are offers that are required to be made under Rule 26. All other offers are voluntary offers.

[1] *Angelina Lee and Frank Yuen wish to acknowledge input from Kelvin Tam, previously a partner of Woo, Kwan, Lee & Lo, in updating this chapter since the previous edition was published.*

The Takeovers Code applies to takeovers and mergers affecting public companies in Hong Kong or companies with a primary listing of their equity securities in Hong Kong.

B. MANDATORY OFFER — RULE 26

1. When does a mandatory offer obligation arise?

The trigger

A mandatory offer obligation arises when:

- any person acquires, or
- two or more persons are acting in concert and any one or more of them acquires

voting rights, and the acquisition increases his/their holding to 30% or more of the voting rights of the company.

The creeper

An obligation to make a mandatory offer also arises when:

- a person holding, or
- two or more persons acting in concert collectively holding

between 30% and 50% of the voting rights of the company acquires voting rights, and the acquisition increases his/their holding by more than 2% from the lowest percentage of his/their holding in the preceding 12-month period.

The offer

The person having the obligation to make a mandatory offer is required to make an offer in compliance with Rule 26 to the holders of:

- each class of equity share capital (whether carrying voting rights or not); and
- any class of voting non-equity share capital of the company.

Offers for different classes of equity share capital must be comparable.

2. Lowering of the trigger and the creeper in October 2001

The trigger was introduced into the Takeovers Code at 35% in 1981, together with the creeper, initially at 3% (in any 12 months), but increased to 5% a few months later. It was generally felt that 30% represents a more realistic level at which control passes and that Hong Kong should come in line with the Mainland and the UK.

On 19 October 2001, the trigger was lowered from 35% to 30% and the creeper was reduced from 5% in a 12-month period to 2%. Although the other amendments arising from the consultation in April 2001 became effective only on 1 February 2002, those relating to the trigger and the creeper were announced and became effective immediately on 19 October 2001. The changes were implemented with immediate effect so that persons who were holding less than 30% immediately before the changes could not gain an advantage by having an opportunity to acquire further shares to take their holding above 30%, before the implementation date.

3. Transitional provisions

With the objective of ensuring, as far as possible, that all shareholders were neither advantaged nor disadvantaged as a result of the changes, transitional provisions were introduced in Rules 26.6 and 26.7. Those under Rule 26.6, as set out below, are still relevant.

Transitional provisions relating to the trigger

The transitional provisions relating to the trigger apply to a person who alone, or with concert parties, held 30% or more but less than 35% of the voting rights of a company immediately prior to 19 October 2001. As long as their holdings remain within this range and until 10 years after 19 October 2001, the old trigger of 35% will apply and the new 2% creeper will not apply.

The fixed period of 10 years was considered appropriate by the Securities and Futures Commission (SFC) as this would reduce possible long-term confusion which an indefinite two-tier system might cause; however, if the holding falls below 30% subsequently, then the new trigger of 30% will apply.

A person who alone, or with concert parties, held less than 30% of the voting rights of the company, but held convertible securities, warrants, options or subscription rights immediately prior to 19 October 2001 that could, upon exercise, take their concert parties' holding into the 30% or more but less than 35% range ('30% to 35% range'), will be entitled to enter the '30% to 35% range' upon such exercise. From then on, they will be subject to the transitional provisions for so long as they remain within the '30% to 35% range'. If their holding falls below 30%, they will cease to be able to take advantage of the transitional provisions upon any further exercise.

Where such person or persons continue to hold 30% or more, but less than 35%, of the voting rights of the company at the end of the 10-year period, they will be free to increase their shareholdings without incurring a mandatory obligation subject only to the 2% creeper which will then apply to them, and it would not be necessary for them to sell voting rights to take such holding below 30% in order to avoid a mandatory offer obligation.

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Register of shareholdings of 30% or more, but less than 35%

Posted on the SFC's website is a register of shareholders who, immediately prior to 19 October 2001, alone or acting in concert, either:

- owned voting rights in the '30% to 35% range' of a company; or
- owned convertible securities, warrants, options or subscription rights that could, upon exercise, take them or their concert parties into the '30% to 35% range'.

The register does give an indication of which tier of the two-tier system a company falls into. If the holdings of such shareholders fall below 30%, they should notify the Executive Director of the Corporate Finance Division of the SFC or his delegate (the Executive) and their holdings will be removed from the register.

4. Persons acting in concert

Definition

Since mandatory offer obligations may arise if a controlling group acquires or consolidates control, the Takeovers Code introduced the concept of persons acting in concert in order to identify the controlling group, so that the voting rights acquired or held by persons acting in concert with each other are aggregated when determining whether the relevant threshold is reached.

The Takeovers Code defines 'acting in concert' as comprising persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate to obtain or consolidate 'control' of a company through the acquisition, by any of them, of voting rights of the company.

The definition further provides for nine classes of persons who will be presumed to be acting in concert with others in the same class, unless the contrary is established. The words 'in the same class' are significant, so that persons are not presumed to act in concert with others (except those appearing in the same class or as specifically provided in Note 1 to the definition).

The definition of 'acting in concert' is drawn in deliberately wide terms. It covers both an agreement and an understanding, and whether the arrangement is a formal or an informal one. In particular, the definition in the Takeovers Code of 'associated companies' is wider than the typical accounting definition, and captures a company that owns or controls the voting rights of the associated company, fellow associated companies.

Interpretation of the definition of 'acting in concert'

The 10 notes to the definition of 'acting in concert' provide useful guidance as to how it is interpreted by the Executive, including:

Classes (1) and (8) — Note (1)
An individual who owns or controls the voting rights of 20% or more of the voting rights of a company in class (1) will (together with the persons falling within class (8)) be presumed to be acting in concert with the persons in class (1).

Break-up of concert parties — Note (3)
When a ruling or admission of concert parties has been made, clear evidence is required before it can be accepted that such parties are no longer acting in concert.

Irrevocable undertakings and warranties — Note (5)
Giving an irrevocable undertaking to accept an offer (or to vote in favour of a resolution in a scheme of arrangement) or provision of warranties by a shareholder to an offeror will not, by itself in the absence of other factors, lead to a presumption that the shareholder is acting in concert with the offeror.

This is an important guidance in practice (when an offeror and their advisers formulate the structure of a proposed offer) and is relevant in determining whether the offer could be structured as a mandatory offer, which is subject to more stringent rules under the Takeovers Code, or a voluntary offer.

Standstill agreements — Note (6)
Standstill agreements restricting the increase or reduction of shareholdings or making or accepting an offer may be relevant for the purpose of the definition of 'acting in concert'.

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Close relatives — Note (8)
'Close relatives' mean a person's spouse, *de facto* spouse, children, parents and siblings.

Underwriting arrangements — Note (9)
This Note clarifies the position of underwriters of a cash alternative offer.

5. Interpretation of Rule 26.1 and further interpretation of the definition of 'acting in concert'

Many of the issues in takeover transactions involve determining:

- whether certain persons are acting in concert; or
- whether a mandatory offer obligation has arisen from the holdings and dealings of such persons.

The 21 Notes to Rule 26.1 provide useful guidance as to how that Rule is interpreted, and how the definition of 'acting in concert' is further interpreted by the Executive. The more significant Notes follow.

Chapter Five

Disclosure Obligations and Dealing Restrictions Before, During and After a Takeover Offer

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A. INTRODUCTION

This chapter considers the disclosure obligations and dealing restrictions that should be kept in mind before, during and after a takeover offer. These obligations arise under the Securities and Futures Ordinance (SFO), the Takeovers Code and the Listing Rules. Unless otherwise stated, a reference to a Rule in this chapter is a reference to the relevant Rule in the Takeovers Code.

B. DISCLOSURE OBLIGATIONS

1. Position under the SFO

The SFO requires any person who acquires, or ceases to have, an 'interest' in 5% or more of the 'relevant share capital' of a listed company to give written notice of this interest to the The Stock Exchange of Hong Kong Limited (SEHK) and the company within three business days of achieving that level.[1] The 'relevant share capital' includes a listed company's issued voting share capital and unissued shares which, if issued, would have voting rights.

Once the 5% level is attained, further notice must be given for subsequent changes in the size of a shareholder's interest that cross over a whole percentage number[2] (for example, an acquisition of shares that increases a shareholding from 7.7% to 8.1%). An exemption for *de minimis* changes to shareholdings applies where: (i) the whole number percentage level of interest (rounded-down) immediately after a relevant event is the same as, or less than, the level in the last notification[3]; and (ii) the difference between the actual (non-rounded) percentage figure at all times since the last notification is less than 0.5%.

For example, if the last notified percentage was 8.1% (making a rounded-down percentage level of 8%) and 0.4% was sold which reduced the actual percentage level to 7.7% (making a rounded-down percentage level of 7%), the *de minimis* exception applies and no new notice is required. Subsequently, if 0.8% is purchased, bringing the actual percentage level to 8.5% (making a rounded-down percentage level of 8%), the *de minimis* exception still applies, as the current percentage holding is within 0.5% of the last notified percentage holding of 8.1%.

The *de minimis* exception does not apply where the level of an interest falls below the 5% notification threshold; in this case, the shareholder would need to file a notice disclosing that it no longer holds 5% or more of the listed company's shares.

A disclosure obligation will also arise when the nature of a person's interest in the shares has changed.[4] This provision is very broad and can encompass a wide range of events and transactions. In general, a change in the nature of an entity's interest in a listed company's shares includes changes to its title to the shares, its legal or equitable interest in those shares, and its interests in underlying shares of equity derivatives upon the exercise by, or against, it of rights under the equity derivatives. For example, depositing shares into a Central Clearing and Settlement System (CCASS) account will constitute a change in the nature of a shareholder's interest, as legal title to the shares will transfer to CCASS, even though the shareholder will retain the beneficial interest in the shares. Similarly, if a person declares a trust over his shares in favour of a third party, such that he has transferred his beneficial interest to the third party, there is a change in the nature of interests.

Where a person has authorised an agent to acquire or dispose of shares on his/her behalf, he/she must ensure that the agent notifies him/her immediately of acquisitions and disposals which he/she is obliged to disclose. Directors and chief executives of listed companies are required to disclose all of their interests in any shares of the listed company.

What interests are caught?

An 'interest' includes interests of any kind in the shares, notwithstanding any restraints or restrictions on the exercise of rights attached to the shares.[5] It includes any interest in the shares arising under an uncompleted or conditional contract, or

by virtue of an option to acquire (whether for cash or other consideration) issued or 'unissued' share capital (eg, subscription warrants or convertible bonds), or where a person is entitled to control the exercise of rights attached to the share (eg, a person entitled to vote under a voting trust). Ownership of cash-settled or physically settled derivatives over the shares (eg, listed derivative warrants) will also need to be disclosed.

A person (including a director or chief executive) is deemed to be 'interested' in shares in which his/her spouse or child under the age of 18 has an interest, and in shares in which a corporation has an interest, where the corporation or the directors of that corporation act on the first person's instructions, or the first person is entitled to exercise or control the exercise of one-third or more of the voting rights of the corporation in a general meeting. Thus, an individual with *de facto* control of any company is interested in shares owned by it, and a parent company is interested in shares in which its subsidiaries are interested.

Interests held as a nominee, however, are disregarded. Where shares are registered in the name of a bare trustee or nominee, the disclosure obligation falls on the beneficial owner, not the nominee.

Interests that are 'exempt security interests' or 'exempt custodian interests' are also disregarded and, therefore, are not discloseable. 'Exempt security interests' are interests by way of security held by authorised financial institutions, stockbrokers, exempt dealers and certain other persons, where the security interest is created for the purposes of a transaction entered into in the ordinary course of business of the relevant person. 'Exempt custodian interests' are interests held by a corporation which carries on a business of holding securities in custody for another person, and which has no authority to exercise discretion in dealing in the interests or in exercising rights attached to the interests. These exemptions apply to long positions but not to short positions.

'Interests' include concert party arrangements

The SFO requires disclosure of interests arising under 'concert party arrangements' (this term is not defined in the SFO and is commonly referred to as a section 317 arrangement or agreement).[6]

A section 317 agreement or arrangement is one that includes provisions for the acquisition by any one (or more) of the parties of interests in the shares of a listed company and provisions that: (i) impose obligations or restrictions with respect to 'the use, retention or disposal' of such interests; or (ii) provide for the making of a loan (or providing security for a loan) by a controlling person or a director of the listed company to anyone with the understanding or knowledge that the loan would be used for the acquisition of interests in the listed company's shares. References to an 'agreement' include agreements that are legally binding and agreements which are not legally binding, but involve some mutuality in the undertakings, expectations or understandings of the parties to them. References to 'provisions'

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in an agreement include undertakings, expectations and understandings operative under any arrangement. Section 317 agreements may arise out of the operation of one or more documents. For example, the disposal of shares by one party to another may constitute a concert party agreement if there are special provisions (either in the share sale agreement or a separate shareholder agreement) affecting the use of the shares (eg, in relation to voting at a particular meeting or generally). Pure underwriting agreements are excluded from the definition of section 317.

The particular disclosure obligations in relation to section 317 agreements arise only when interests in shares have been acquired in pursuance of the section 317 agreements. The significance of such agreements is that each of the parties to the agreement is deemed to be interested in all the shares in which each of the other parties is interested 'apart from' the section 317 agreements, that is, to the extent they have an interest in the shares in their own right and not as a result of attribution from the section 317 agreement.[7] There are also obligations on each party to keep the others informed of details relating to its interests. Once an interest in shares has been acquired pursuant to a section 317 agreement, and irrespective of any further acquisitions of interests in shares, changes to the parties or variations in the agreement, the agreement will continue to be considered a section 317 agreement, as long as it has the required provisions described above.

Thus, if parties to a section 317 agreement have an aggregate interest equal to or over the 5% disclosure threshold, each party has a duty to disclose, despite each party's individual holding falling below 5%. This means that it is not possible to secretly build up a significant stake in a listed company by means of splitting holdings between numerous linked concert parties.

Power of listed companies to make enquiries as to interests in their shares

A listed company may issue a notice requiring any person whom the listed company 'knows or has reasonable cause to believe' to have, or at any time during the three immediately preceding years to have had, an interest in any of its shares or derivatives over its shares (whether or not the number of shares, or shares underlying the derivatives, exceeds the 5% level):

- to confirm or deny that fact;
- to give particulars of his/her present or past interests;
- if any other person is, or has been, interested in the same shares or derivatives within that three-year period, to give, 'so far as he is aware', particulars with respect to that other person's interest; and
- if he/she is no longer interested in shares in the listed company, to give 'so far as he is aware', particulars of the identity of the person who acquired his/her interest.[8]

This procedure may be used, in particular, by companies as a means of keeping an eye on those dealing in its shares whom they suspect would like to build up a controlling stake in them or to make a full bid.

A reply must be given to any such notice within any 'reasonable time specified in the notice'. Depending on the circumstances, a 'reasonable time' may be as short as 24 hours. An 'interest' in shares has the same meaning for the purposes of section 329 as for the disclosure provisions discussed above, and so includes interests arising through membership in a concert party arrangement. Hence, a listed company can inquire into long positions as well as short positions in its shares and interests in its shares arising by virtue of an interest in a derivative over its shares.

What are the sanctions for breaches?

Failure to notify the SEHK and the listed company as required by the SFO or to respond to an inquiry notice from the listed company is a criminal offence, which may be punished by imprisonment or a fine, or both.[9] In addition, the Financial Secretary may impose restrictions on the transfer, issue, cancellation or removal from the Hong Kong register of the shares or derivatives in question.

Public register of notified interests to be maintained

Listed companies are required to maintain registers of interests and short positions notified to them and of inquiry notices given and replies received. These registers must be made available for inspection by any person and, obviously, they may contain information of particular use to any person contemplating a bid for the company concerned.

2. Position under the Listing Rules

Chapter 10 of the Listing Rules restricts the ability of controlling shareholders to dispose of shares for a period of six months after a new listing. In the second six-month period after a new listing, a controlling shareholder may not dispose of any shares if, immediately following such disposal, that person would cease to be a controlling shareholder.[10]

In addition, Appendix 10 of the Listing Rules (the Model Code)[11] states that a director should not deal in any security of his/her own company without first notifying the chairman (or other director(s) appointed for that specific purpose) and receiving a dated written acknowledgment. For the purposes of the Model Code, the grant to a director of an option to subscribe or purchase his/her company's securities shall be regarded as dealing by him/her if the price at which such option may be exercised is fixed at the time of such grant. If, however, an option is granted to a director on terms whereby the price at which such option may be exercised is to be fixed at the time of exercise, the dealing is to be regarded as taking place at the time of the exercise.

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