

Updating Your Study Manual

Instructions for Inserting Version 1.3

The followings serve as the instructions for updating **Topic 1: Overview of the Legal and Regulatory Structure and Code of Conduct** of Study Manual 5 for the Licensing Examination for Securities and Futures Intermediaries. Please be reminded that only the updated sections are provided for downloading. You may replace the relevant sections with this updated version for the study manual you possess.

Instructions:

1. Download and print out the following pages.
 2. **Remove** the original front page and **Insert** the updated front page.
 3. **Remove** pages 1-7 to 1-10 and **Insert** new pages 1-7 to 1-10.
 4. **Remove** pages 1-17 to 1-18 and **Insert** new pages 1-17 to 1-18.
 5. **Remove** pages 1-23 to 1-24 and **Insert** new pages 1-23 to 1-24.
 6. **Remove** pages 1-29 to 1-35 and **Insert** new pages 1-29 to 1-35.
-

[Blank Page]

STUDY MANUAL FOR

PAPER 5

REGULATION OF CORPORATE FINANCE

of

The Licensing Examination
for Securities and Futures Intermediaries

First published June 2003

Current Version 1.3 (March 2005)

Published by:

Hong Kong Securities Institute

© Hong Kong Securities Institute 2003, 2004

© Hong Kong Securities Institute 2005

24/F, Wing On Centre, 111 Connaught Road Central, Hong Kong

Telephone: (852) 3120-6100

Examinations Hotline: (852) 3120-6220

Membership Hotline: (852) 3120-6170

Training Hotline: (852) 3120-6200

Fax: (852) 2899-2611

Email: info@hksi.org

Website: www.hksi.org

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without the prior permission of the copyright owner.

ISBN: 988-97139-4-2

Disclaimer

This is an educational manual only and does not provide legal advice or expert advice in whatsoever form. Every effort has been made to ensure its accuracy, however, no responsibility for loss occasioned to any person acting or refraining from action as a result of any materials in this publication will be accepted by the publisher and/or individual contributors.

- 1.27 The Listing Committee has arranged for most of these powers and functions to be discharged by the Listing Division and the Chief Executive of HKEx. The same arrangements apply to the GEM Board. The listing procedures are described in more detail in topic 2.
- 1.28 The Exchange is responsible for receiving notifications and disseminating information regarding changes in the shareholdings of directors, chief executives and substantial shareholders of listed companies that are discloseable under the SFO.

Role of the Registrar of Companies

- 1.29 The Registrar of Companies administers and enforces certain aspects of:
- the Companies Ordinance;
 - the Limited Partnerships Ordinance;
 - the Trustee Ordinance;
 - the Registered Trustees Incorporated Ordinance; and
 - the Money Lenders Ordinance.
- 1.30 The Companies Registry maintains and makes available for public inspection the financial and other returns made by companies, charges registered by companies, and so on. It will follow up defaults in making the prescribed returns of entities covered by these ordinances and may strike companies from the Register of Companies for failure to make returns and for not carrying on business.
- 1.31 The Registrar of Companies is responsible for the registration of prospectuses under section 38D of the Companies Ordinance for Hong Kong incorporated companies and under section 342C of the Companies Ordinance for companies incorporated overseas.
- 1.32 There are several other regulators that regulate certain industries, which from time to time may be applicable for corporate finance advisers. They include the Insurance Authority and the Telecommunications Authority.

Relationships between legislation, regulations, rules and codes, etc.

- 1.33 The legislation (SFO, Companies Ordinance, etc.) lays down the basic framework in which markets should operate. As markets tend to evolve over time and new products are created on a regular basis, regulations, and especially codes, are best equipped to regulate the market on a day-to-day

basis. In addition, they can be more easily amended to take into account changing circumstances compared to amendments to legislation, which can take years.

- 1.34 Section 3 of the SFO established the SFC, which in turn was given delegated authority to make rules under section 397, SFO and to issue codes or guidelines under section 399, SFO. Subsidiary legislation (rules) issued under the SFO have the force of law, while codes do not. While the former can be enforced through the courts, the latter are normally regulated through industry bodies such as the Takeovers Panel in respect of the Takeovers Code.
- 1.35 The Listing Rules and GEM Listing Rules are not laws and therefore do not have the force of law. This means that the Exchange cannot enforce a breach of its rules through the courts of Hong Kong. However, as discussed above, rules do have advantages over laws in that they can be applied less rigidly to a set of circumstances and can be changed more easily than a law.

2 Corporate governance principles

- 2.1 In recent years, there has been a lot of pressure on listed companies around the world to improve their corporate governance. In the United Kingdom, this initially took the form of the Cadbury Committee report which was then taken up by the then UK Listing Authority in 'The Combined Code-Principles of Good Governance and Code of Best Practice'. International investors will shun those markets that do not adhere to these general international principles. The Enron case in 2002 is a good example of very poor corporate governance.
- 2.2 [Appendix 14 of the Listing Rules contains a 'Code on Corporate Governance Practices' and Appendix 23 of the Listing Rules sets out the rules on the 'Corporate Governance Report'. \(Appendix 15 of the GEM Rules contains a similar Code on Corporate Governance Practices and Appendix 16 of the GEM Rules sets out similar rules on Corporate Governance Report.\)](#)
- 2.3 [The Code on Corporate Governance Practices sets out the Exchange's views on the principles of good corporate governance and two levels of recommendations, namely Code Provisions and Recommended Best Practices. Issuers are expected to comply with, but may choose to deviate from, the Code Provisions. The Recommended Best Practices are for guidance only. Issuers may also devise their own code on corporate governance practices on such terms as they may consider appropriate.](#)

Code Provisions

- 2.4 Issuers must state whether they have complied with the Code Provisions set out in the Code for the relevant accounting period in their interim reports (and summary interim reports, if any) and annual reports (and summary financial reports, if any). Where the issuer deviates from the Code Provisions set out in the Code, the issuer must explain the deviation in the financial reports.

Recommended Best Practices

- 2.5 Issuers are encouraged, but are not required, to state in the interim/annual reports whether they have complied with the Recommended Best Practices and provide explanation of any deviation.

Corporate Governance Report

- 2.6 Issuers are required to include a Corporate Governance Report in their annual reports containing prescribed information on their corporate governance practices.

The Code

- 2.7 The Code has five sections dealing with:
- Directors;
 - Remuneration of directors and senior management;
 - Accountability and audit;
 - Delegation by the Board; and
 - Communication with shareholders.
- 2.8 In each section, the Code sets out the Code Provisions and/or Recommended Best Practices, together with the underlying principles of the relevant provisions to assist listed issuers in developing their own code of board practices.

3 Relevant regulations

Securities and Futures Ordinance

Corporate finance activity

3.1 Under the SFO, ‘advising on corporate finance’ (Type 6 regulated activity) means giving advice:

- about compliance with or rules made under section 23 (rules made by a recognised exchange company) or section 36 (rules made by the SFC) of the SFO which govern the listing of securities and the codes published under the SFO;
- about any offer to dispose of securities to the public or to acquire them from the public, and the acceptance of any offer insofar as the advice is given generally to holders of securities or a class of securities; and
- to a listed corporation or public company (or its subsidiary, officers or shareholders) about corporate restructuring in respect of securities.

Excluded activities

3.2 Some activities are excluded from the definition of ‘advising on corporate finance’:

- where a corporation gives advice solely to any of its wholly owned subsidiaries, its holding company which holds all its issued shares or other wholly owned subsidiaries of that holding company;
- advice given by a person or authorized institution who is licensed for Type 1 regulated activity (dealing in securities) who gives corporate finance advice incidental to dealing in securities;
- advice given by an individual who is registered by the HKMA under section 20 of the Banking Ordinance who is acting as a securities dealer for an authorized institution registered to carry out that regulated activity and who gives advice incidental to carrying out that regulated activity;
- a solicitor, counsel or professional accountant, a trust company registered under the Trustee Ordinance giving advice incidental to their practice or discharge of their duty; and
- advice given by a person in publicly available printed media or radio or television broadcast.

3.3 Corporate finance activity normally involves dealing in securities and advising on securities, both of which are ‘regulated activities’ under the

Hong Kong shareholders and the extent of share trading in Hong Kong and other factors, including:

- the location of its head office and place of central management;
- the location of its business and assets, including such factors as registration under companies legislation and tax status; and
- 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.

3.42 The Takeovers Code is concerned with offers for, and takeovers and mergers of, all relevant companies, however effected. These include partial offers, offers by a parent for share in a subsidiary, etc.

3.43 The Share Repurchase Code is concerned with share repurchases of all relevant companies. Share repurchases by general offer will be considered to be offers and the Rules of the Takeovers Code will also apply.

SFC regulations, codes, guidelines and circulars

3.44 The following is a list of some of the relevant regulations, codes, guidelines and circulars for this topic and are taken from the SFC's website under the site '[Legislation & Regulatory Handbook](#)'. Readers of this topic can refer to the website for a full and up-to-date list.

- Circular to All Securities Dealers — Segregation of Duties;
- Code of Conduct for Persons Licensed by and Registered with the Securities and Futures Commission;
- Presentation Material for Seminar on Prevention of Money Laundering;
- Guidance Note for Short Selling Reporting and Stock Lending Record Keeping Requirements (Addendum);
- Circular to SFC's Registered Intermediaries — Money Laundering — US President's Executive Order;
- Codes on Takeovers and Mergers and Share Repurchases;
- Corporate Finance Adviser Code of Conduct;
- Guidelines on Exempt Principal Trader Status under the Codes on Takeovers and Mergers;
- Update on eIPO — Letter to Securities Dealers and Exempt Dealers;

- Project on the Use of Plain Language — How to Create a Clear Prospectus;
- How to Create Clear Announcements — Guidelines on the Use of Plain Language;
- Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission;
- Guidelines for the Exemption of Listed Companies from the Securities (Disclosure of Interest) Ordinance;
- CIS Internet Guidance Note;
- Guidelines for Electronic Initial Public Offerings; and
- Guidelines on Exempt Principal Trader Status under the Code on Takeovers and Mergers.

Disclosure of interests, Part XV, SFO

- 3.45 Under Part XV, all directors' and chief executives' interests and substantial shareholders' interests in the equity [or debt securities] of the issuer, and any associated corporation, must be recorded in the registers required to be kept under section 336 of the SFO. These requirements cover two situations: first, a listed issuer; and secondly, where a party is planning to take over another listed issuer and may be acquiring shares in the target company.
- 3.46 A person must disclose a shareholding of 5% or more in a listed company, under section 315, SFO. Increases of 1% or more must thereafter be disclosed, under section 315(2), SFO. The SFO requires calculations to be rounded down to the nearest whole number, which will normally result in a disclosure obligation once a whole percentage threshold is crossed.
- 3.47 The de minimus exemption allows for fluctuations within 0.5% from the last notification given under a specific section.
- 3.48 The disclosure notification period under Part XV of the SFO is three business days. Under Part XV, once the initial disclosure threshold has been reached, changes in shareholdings will need to be notified if the change in the aggregate interest crosses any percentage level above the initial threshold (for example, an increase from 5.9% to 6.1%). However, substantial shareholders will not be required to make disclosure if an interest in shares falls by less than 0.5% even if the interest falls below the percentage level last disclosed (for example, a decrease from 6.1% to 5.9%). Notice will also need to be given when a person ceases to be a substantial shareholder of the company.

Securities Review Committee Report, introduced rules to protect the minority shareholders. Chapter 14 and Chapter 14A of the Listing Rules are intended to deal with these issues, especially connected transactions.

Close PRC links

- 4.3 In the lead-up to the resumption of sovereignty by the People's Republic of China of Hong Kong, the Exchange spent a considerable amount of time determining the competitive advantage and the role that the Exchange would play post-1997 in respect of the Mainland. It decided that it should aim to become the 'New York of China', where its large corporations could raise their international capital.
- 4.4 However, the Exchange felt that in order to attract international investors to such PRC corporations, they would have to meet international accounting, legal and disclosure standards. A lot of PRC corporations undergo restructuring prior to listing. The Exchange introduced a special chapter to the Listing Rules, Chapter 19A, which covers PRC companies wishing to list in Hong Kong.
- 4.5 The purpose of Chapter 19A is to clarify that the Listing Rules apply as much to PRC issuers as they do to Hong Kong and overseas issuers, subject to additional requirements. PRC issues in Hong Kong are known as 'H shares' and in London as 'L shares', etc.
- 4.6 Accordingly, as the economies of the PRC and Hong Kong become more integrated, more PRC corporations will seek to raise international capital in Hong Kong.

Companies incorporated in offshore jurisdictions

- 4.7 In the lead-up to 1997 and the resumption of sovereignty by the PRC over Hong Kong, many companies and their controlling shareholders had concerns about this process and about the possibility of nationalization and confiscation of their Hong Kong assets. As a result, a process of re-domiciling of Hong Kong companies (especially listed ones) was undertaken, whereby a new offshore company was established to become the holding company of the Hong Kong company. Presumably, this meant the offshore assets, etc., would be protected from nationalization in Hong Kong, if such a process were to take place.
- 4.8 The Cayman Islands and Bermuda quickly became the popular places of incorporation of the offshore holding company. As a result, the Exchange introduced a new set of requirements in Chapter 19 (Equity Securities – Overseas Issuers) applicable to such foreign jurisdictions. The rules are basically the same as for Hong Kong-incorporated corporations, but there

are some additional requirements such as the appointment of a person authorized to accept service of process (rule 19.05(2)), and some additional requirements in the Listing Rules.

5 Corporate finance adviser Code of Conduct

Underlying principles

- 5.1 [The Code of Conduct for Corporate Finance Advisers \(issued by the SFC\)](#) covers all persons advising on corporate finance matters, as defined in paragraph 1.2, and sets out the requirements and guidelines in respect of the conduct of corporate finance advisers ('advisers').
- 5.2 The SFC will use the Code of Conduct as a benchmark, along with other SFC codes and guidelines, against which an adviser's fitness and properness will be measured.
- 5.3 Advisers engaging in corporate advisory work under the Listing Rules, the Takeovers Code or the Share Repurchase Code are required to observe those rules. In general, any breaches of those codes and rules will cast doubts on the fitness and properness of the adviser concerned.
- 5.4 'Advising on corporate finance', as defined in paragraph 1.2, means giving advice:
- concerning compliance with or in respect of regulations including the Listing Rules, the Takeovers Code and the Share Repurchase Code;
 - concerning any offer to dispose of securities to the public, any offer to acquire securities from the public, or acceptance of any such offers where advice is given generally to holders of securities; and
 - to a listed corporation or public company, or to its subsidiary, or to its officers or shareholders, concerning corporate restructuring involving securities.

'Fit and proper'

- 5.5 An adviser should ensure that it is fit and proper to conduct its business (paragraph 2).
- 5.6 An adviser should ensure that its business is properly established and conducted and that it and its directors and representatives are fit and proper and are appropriately registered.
- 5.7 An adviser should:
- organize and control its business in a prudent and responsible manner;

- The SFC has established regulatory committees to which it has delegated some of its functions.
- The main committees are the Market Misconduct Tribunal, the Takeovers and Mergers Panel and the Takeovers Appeals Committee.
- The HKMA is responsible for regulating the banking industry, while many banks may also undertake Types 1 to 7 activities.
- The HKEx is a company listed on the SEHK.
- The Exchange has arranged for all of its powers and functions in respect of listing matters to be discharged by the Listing Committee and the GEM Listing Committee.
- The Listing Committee has arranged for most of these powers to be discharged by the Listing Division and the Chief Executive of the HKEx.
- The Registrar of Companies administers and enforces certain aspects of the CO, the Limited Partnerships Ordinance, the Trustee Ordinance, the Registered Trustees Incorporated Ordinance and the Money Lenders Ordinance.
- The Registrar of Companies is responsible for the registration of prospectuses.
- [Appendix 14 of the Listing Rules](#) contains a 'Code on Corporate Governance Practices' and [Appendix 23 of the Listing Rules](#) sets out the rules on the 'Corporate Governance Report'.
- Under the SFO, 'advising on corporate finance' means giving advice about compliance with or about rules made under the SFO, about offers to dispose of or acquire securities, and to a listed company about corporate restructuring in respect of securities.
- Some activities are excluded from the definition in respect of which no licence for Type 6 activity shall be required.
- All prospectuses must be registered under the CO.
- The principal function of the Exchange is to provide a fair, orderly and efficient market for the trading of securities.
- The primary purpose of the [Codes on Takeovers and Mergers and Share Repurchases](#) is to afford fair treatment for shareholders who are affected by takeovers, mergers and share repurchases.
- The [Codes on Takeovers and Mergers and Share Repurchases](#) do not have the force of law.
- The SFC has issued a number of relevant regulations, codes, guidelines and circulars which corporate finance advisers should be aware of.

- Under the SFO, all directors and chief executives and certain substantial shareholders' interests in the equity or debt securities of the issuer must be recorded.
- A person can now be tried for an offence of insider dealing by either civil proceedings or criminal proceedings.
- There are six types of market misconduct.
- The Code of Conduct for Corporate Finance Advisers contains eight basic principles.
- The SFC will use the Code of Conduct as a benchmark, along with other SFC codes and guidelines, against which an adviser's fitness and properness will be measured.

Revision questions

- Question 1: Name the laws and rules that govern corporate finance activities in Hong Kong.
- Question 2: Explain the roles that the SFC's Corporate Finance Division performs.
- Question 3: Which division of the Exchange is responsible for listing matters?
- Question 4: Which ordinances are administered and enforced by the Registrar of Companies?
- Question 5: [List the 5 main sections in the 'Code on Corporate Governance Practices' in the Listing Rules.](#)
- Question 6: Describe activities excluded from the definition of corporate finance activity.
- Question 7: [Under the SFO, a Type 6 licensed corporation is required to appoint how many responsible officers to supervise its regulated activity?](#)
- Question 8: When a company issues shares to the public, will it also issue a prospectus?
- Question 9: Describe the primary purpose of the [Codes on Takeovers and Mergers and Share Repurchases \(the Codes\)](#).
- Question 10: Do the [Codes](#) have the force of law?
- Question 11: Which companies come within the [Codes](#)?
- Question 12: When does insider dealing take place?
- Question 13: Name the defences to insider dealing.
- Question 14: In order for an adviser to meet the 'fit and proper' test, what actions must he take in respect of his business?
- Question 15: What steps should an adviser take when he has a conflict of interest?

Answers to revision questions

Answer 1: Corporate finance activities in Hong Kong are covered principally by the SFO, the Companies Ordinance, the Listing Rules of the Stock Exchange, the GEM Listing Rules of the Stock Exchange, the Takeovers and Mergers Code, and the Share Repurchase Code.

Answer 2: The Corporate Finance Division of the SFC:

- administers the Takeovers and Mergers Code and Share Repurchase Code;
- promotes fair and equal treatment of public shareholders;
- raises standards of investor protection and corporate governance;
- oversees the Stock Exchange's listing-related functions and responsibilities;
- reviews and recommends changes to the Listing Rules;
- administers securities legislation relating to listed companies;
- facilitates the development of effective and efficient capital markets; and
- assists the development and promotion of Hong Kong as the preferred market for the external listing and trading of Mainland securities.

Answer 3: The Exchange has arranged for all of its powers and functions in respect of listing matters (which includes the Listing Rules and the GEM Listing Rules) to be discharged by the Listing Committee and the GEM Listing Committee and/or their delegates. The Listing Committee has arranged for most of these powers and functions to be discharged by the Listing Division and the Chief Executive of HKEx. The same arrangements apply to the GEM Board.

Answer 4: The Registrar of Companies administers and enforces certain aspects of:

- the Companies Ordinance;
- the Limited Partnerships Ordinance;
- the Trustee Ordinance;
- the Registered Trustees Incorporated Ordinance; and
- the Money Lenders Ordinance.

Answer 5: The five main sections of the Code are as follows:

- Directors;
- Remuneration of Directors and Senior Management;
- Accountability and Audit;
- Delegation by the Board; and
- Communication with Shareholders.

Answer 6: Some activities are excluded from the definition and therefore there is no need to obtain a licence for Type 6 activity:

- where a corporation gives advice solely to any of its wholly owned subsidiaries, its holding company, or other wholly owned subsidiaries of that holding company;
- advice given by a person or authorized institution who is licensed for Type 1 regulated activity (dealing in securities) who gives corporate finance advice incidental to dealing in securities;
- advice given by an individual who is registered by the HKMA under section 20 of the Banking Ordinance who is acting as a securities dealer for an authorized institution registered to carry out that regulated activity and who gives advice incidental to carrying out that regulated activity;
- a solicitor, counsel or professional accountant, or a trust company registered under the Trustee Ordinance, giving advice incidental to their practice or discharge of their duty; and
- advice given by a person in publicly available printed media or radio or television broadcast.

Answer 7: A Type 6 licensed corporation is required to appoint at least two responsible officers to supervise its regulated activity.

Answer 8: When a company offers shares to the public, it will issue a prospectus. All prospectuses must be registered under section 38D, CO for Hong Kong-incorporated companies and section 342, CO for companies incorporated overseas.

Answer 9: The primary purpose of the Codes is to afford fair treatment for shareholders who are affected by takeovers, mergers and share repurchases. The Codes seek to achieve fair treatment by requiring equality of treatment of shareholders, mandating disclosure of timely and adequate information to enable shareholders to make an informed decision as to the merits of an offer, and ensuring that

there is a fair and informed market in the shares of companies affected by takeovers, mergers and share repurchases.

Answer 10: The **Codes** do not have the force of law. They are framed so far as possible in non-technical language and should not be interpreted as if they are statutes.

Answer 11: The **Codes** apply to takeovers, mergers and share repurchases affecting public companies in Hong Kong and companies with a primary listing of their equity securities in Hong Kong.

Answer 12: Insider dealing, under section 270, SFO, in relation to a listed corporation, takes place:

- when a person connected with the corporation and having information which he knows is relevant information in relation to the corporation, deals in the listed securities of the corporation or counsels or procures another person to deal in such listed securities; and
- when a person who is contemplating or has contemplated making a takeover offer for the corporation and knows that the information is relevant information in relation to the corporation either deals or procures as above.

Answer 13: The five defences to insider dealing are:

- shares acquired for being qualified as a director of a corporation;
- shares acquired in performance of an underwriting agreement;
- shares acquired in performance as a liquidator, etc.;
- the persons dealing in the securities did not have the relevant information within the corporation; and
- the purpose of dealing in the securities was not to make a profit or reduce a loss.

Answer 14: To meet the fit and proper test, an adviser should:

- organize and control its business in a prudent and responsible manner;
- maintain satisfactory financial and operational controls;
- maintain satisfactory risk management procedures; and
- ensure it has adequate competence, professional expertise, and human and technical resources for the proper performance of its duties.

Answer 15: An adviser should avoid engaging in work that is likely to involve conflicts of interest. An adviser should withdraw, or decline to accept, a mandate where a material conflict of interest arises with its client.