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Destined intermediary: the role of Hong Kong in shaping the regulation of takeover defences in China

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Keywords
China; Comparative law; Co-operation; Financial regulation; Hong Kong; Securities markets; Takeovers

Introduction

In the United Kingdom, Hong Kong and mainland China, takeover defences are prohibited without shareholder approval in advance. This article seeks to answer the question of to what extent the United Kingdom's influence on China's takeover defence regulations has been passed on by Hong Kong, a region with close political and economic ties to both countries.

On one hand, Hong Kong's corporate and securities regulations, including takeover defence regulations, were inherited heavily from the United Kingdom, because of its historical link with the United Kingdom. The major decision-makers in Hong Kong are financial professionals from the United Kingdom in the process of the formation of Hong Kong's securities market and the evolution of Hong Kong's regulatory framework in response to the global and regional stock market crisis. They set the milestones in Hong Kong's legal regime for securities.

On the other hand, Hong Kong has been assisting and co-operating closely with mainland China on the establishment of China's securities market and the development of China's securities regulations. This is evidently demonstrated by the signature of memorandums of regulatory co-operation between these two parties; Hong Kong's assistance in mainland China's establishment of China's H share market; significant personnel exchange between the Securities and Futures Commission of Hong Kong (SFC) and China Securities Regulatory Commission (CSRC); and the granting of easier access to each other's securities markets for legal and financial professionals.

This article argues that Hong Kong played a significant role in the legal transplant of takeover defence regulations from the United Kingdom to mainland China, given its close political and economic ties to both countries. It is structured as follows. The first part studies the takeover defence regulations in the United Kingdom, mainland China and Hong Kong and points out their similarity. The second part reviews how the Hong Kong securities market and its regulatory framework were established and developed under the governance of Britain. The third part demonstrates the co-operation between Hong Kong and mainland China on securities regulation and establishes Hong Kong's role in guiding the shaping of China's securities market and its regulatory framework.

The similarity of takeover defence regulations in the United Kingdom, China and Hong Kong

The UK mergers and acquisitions market had always followed a self-disciplinary tradition until the recent EU Takeover Directive granted statutory status to the Takeover Panel. However, the UK system has preserved most of its shareholder centred self-disciplinary features in its takeover regulations.[1]

General Principle 3, securing the shareholders' "opportunity to decide on the merits of the bid",[2] and General Rule 21, prohibiting conduct which could potentially frustrate takeovers without shareholder approval are two key components of the Takeover Code. Such conduct includes issuing new shares and options, substantial changes of the company's assets and any conduct which may lead the company to enter into contracts other than in the ordinary course of business. These rules demonstrate the Panel's intolerance towards takeover defences. Rule 21 effectively restricts post-bid defensive board actions, such as persuading shareholders to reject the bid, lobbying competition authorities and searching for a more favourable bidder.[3]

In Hong Kong, the Codes on Takeovers and Mergers and Share Repurchases (Hong Kong Codes) states (in r.4) that the shareholders should decide on the merit of a takeover bid and the board of an offeree company should not take actions which may frustrate a bona fide offer, without shareholder approval. These actions include the issuance of new shares, convertible securities, options or warrants; the sale, disposal or acquisition of material amounts of assets; and entry into a contract other than in the ordinary course of business. Rule 4 covers all of the scenarios covered by r.21 of the United Kingdom's Takeover Code. Additionally, r.4 forbids the board of directors of the offeree company from encouraging the offeree company, or its

subsidiaries or associated companies, to purchase or redeem any of its shares of the offeree company.[4]

China's takeover regulation, the Measure for Regulating Takeovers of Public Listed Companies (the Measure for Takeovers), which was enacted in 2002 and amended in 2006, also restricts the adoption of takeover defence.

The Measure for Takeovers 2002 prevented the board of the offeree company from frustrating takeover bids without shareholder approval. The conduct prevented was the issuance of new shares, or convertible company bonds; the modifying of company constitutions; entering into contracts which may have a material impact on the company; entering into contracts which are other than in the ordinary course of business; the disposal or purchase of material assets; and the adjustment of the principal business of the company. The Measure for Takeovers 2002 also includes a rule similar to r.4 of the Hong Kong Codes which prohibits the offeree company from buying back its own shares. The Measure for Takeover 2002 covered almost all of the scenarios listed in the UK Takeover Code and it also had a ban on repurchase of the shares of the offeree company similar to the Hong Kong Codes.

The Measure for Takeovers was amended in 2006, but the principle of inhibiting takeover defences did not change. According to art.8 of the Measure for Takeovers 2006, the board of directors, the supervisory board and the managers of the offeree company owe fiduciary duty and duty of care to the company and must not abuse their power by setting "inappropriate obstacles" in the way of bidders. The article also emphasises the equal treatment of every bidder bidding for the offeree company and prohibits the offeree company from providing any form of finance to its bidders.[5] Also, the amended Measure prevents the offeree company from affecting the company's assets, debts, interests or annual turnover by deploying company assets, making outward investment, changing the company's business strategy, providing warranties for loans or obtaining new loans and signing any contracts other than in the ordinary course of business, without shareholder approval, once the takeover bid has been announced.[6] The 2006 Company Law[7] and the 2006 Securities Law[8] also require shareholder approval to be gained for the disposal of a company's major assets and the issuance of new shares once a bid is announced.

In all three jurisdictions, the United Kingdom, Hong Kong and China, the board of directors and managers are prevented from deploying takeover defences without shareholder approval. The general shareholder meeting is at the heart of any takeover defence decision-making. In China, the general shareholder meetings have more power when compared with those in the United Kingdom and Hong Kong, since it is clearly stated in China's corporate regulations that senior management is subject to fiduciary duty and duty of care in its decision-making in relation to takeover defences.

A brief history of Hong Kong's securities market

The history of trading company shares in Hong Kong can be traced back to the 1860s. The first stock exchange, the Association of Hong Kong Securities Brokers, was established as early as 1891 and was renamed the Hong Kong Stock Exchange in 1914. The Association accepted only British or other foreign residents in Hong Kong as members.

In 1921, the second stock exchange, the Stockbrokers' Association of Hong Kong, was established. It was not until this time that local Chinese people were allowed to be members of a stock exchange. The two stock exchanges merged and were named the Hong Kong Securities Exchanges Ltd, in 1947.[9]

Before the 1960s, the stock exchanges were mostly managed by the British and most of the public companies listed were British companies. The rise of local Chinese companies in Hong Kong in the 1960s increased the need for financing for the new companies. Four local stock exchanges, which were owned and managed by local Chinese people, consequently emerged.[10]

Having four stock exchanges at the same time caused difficulties for administration and supervision. In the late 1960s and early 1970s, the lack of supervision of the stock exchange and the banking sector increased opportunism.[11] The chaos in the securities market, banking section and real estate market, caused by over competition by the mortgage providers, led to a crash of the securities market in December 1973.[12]

The Government responded quickly and tightened market supervision. The Government pressured the aforesaid four stock exchanges to merge into one. The Stock Exchange of Hong Kong Ltd (HKSE) was founded as the successor of the four stock exchanges. It was accepted as a member of the Federation Internationale des Bourses de Valeurs on September 22, 1986, thereby gaining international recognition.[13]

After the 1998 Asian financial crisis, in 1999, Donald Tsang Yam Kuen (the current chief executive of Hong Kong) from the Treasury of Hong Kong launched a reform of Hong Kong's securities and futures market.[14] Because of the reform, on March 6, 2000, Hong Kong Exchanges and Clearing Ltd (HKEC) was established. The HKSE, Hong Kong Futures Exchange Ltd

and the Hong Kong Securities Clearing Company Ltd, were all taken under the wing of the HKEC. The Hong Kong securities and futures markets were reshaped.

TABULAR OR GRAPHIC MATERIAL SET AT THIS POINT IS NOT DISPLAYABLE.

The British influence on the inception of Hong Kong's regulatory regime for securities

The mechanism for issuing and trading securities in Hong Kong originated in the United Kingdom. The close link between these two jurisdictions[15] is reflected in the similarities in their corporate legislation. The British 1929 Companies Act provided a blueprint for the earliest Hong Kong Companies Ordinance, and the British system has also greatly impacted Hong Kong contract law and other financial regulations.[16]

In 1962, before the crash of the Hong Kong securities market, a Hong Kong Company Law Review Group (HKCLRG) was established to deal with the chaos in the market. Its progress was, however, postponed to wait for the latest amendments to the Companies Act 1929 in the United Kingdom, from the Jenkins Committee,[17] in the hope that the corporate regulations in Hong Kong would then be able to comply with the amendments. However, the Jenkins Report was, unfortunately, not fully implemented and the desired result could not be achieved.

The HKCLRG was re-formed in 1969 and published its report in July 1971.[18] It identified the need for legislative supervision for the securities market. The HKCLRG believed that the British self-regulatory model for securities supervision would not work in Hong Kong because Hong Kong did not have the kind of mature securities market infrastructure that London had. But it also noted that the Government should not over-intervene in transactions in securities and that the supervisory power of the Government should only be used when offences occurred or were about to occur. Based on the principles developed by the HKCLRG, a Commissioner for Securities was appointed by the Government to supervise the securities market. No governmental supervisory authority was established. Instead, a Securities Advisory Council of Hong Kong (HKSAC), comprised of securities experts, was set up.

At the end of 1973, oil prices surged owing to the war in the Middle East and caused a global economic bubble. When the bubble burst, the ensuing credit crunch hit the already damaged Hong Kong securities market hard. Brokers closed down and investors withdrew their investments. The securities market collapsed in Hong Kong and the Government intervened, promulgating the Securities Code and the Code of Investor Protection on March 1, 1974.

Shortly after that, the first Commissioner for Securities, a former economist of the BoE, James Selwyn, replaced the HKSAC with the Securities Commission of Hong Kong and increased government intervention. The Commission produced a handbook, the Code on Takeovers and Mergers, which was based on the Takeover Code in the United Kingdom, in August 1975, to provide guidance for mergers and acquisitions.[19]

In October 1987, a crash of the stock market resulted in the closure of both the stock and futures markets of Hong Kong for four days. A Securities Review Committee chaired by Ian Hay Davison was organised to "examine Hong Kong's regulatory structure and regime and how they could be improved, to minimise the chances of a repeat of the disruption and chaos of October 1987".[20] In May 1988, the Committee released the Davison Report, which concluded that the Office of the Commissioner for Securities and Commodities Trading had insufficient resources to properly regulate the rapidly growing and changing Hong Kong securities market. The Committee also found that the Securities Commission was not regulating effectively because of a lack of strong direction.

The recommendation from the Davison Committee was to replace the existing system with a:

"[S]ingle statutory body outside the civil service, headed and staffed by full-time professional regulators and funded primarily by the market, with investigative and disciplinary powers to ensure effective supervision."[21]

What the Davison Committee was suggesting in effect was to establish a Commission similar to the UK Takeover Panel but with statutory status. The Securities and Futures Commission Ordinance was consequently incepted in May 1989.[22] In the Ordinance, takeovers and takeover defences are regulated almost the same way as the UK Takeover Code.

The economic integration of Hong Kong and mainland China

The mainland-Hong Kong border was sealed in the 1950s after the break of the Korean War.[23] Hong Kong lost its hinterland and gradually emerged into a light manufacturing centre. The manufacturing growth had actively impacted on service sectors such as banking and finance, shipping, insurance and tourism.[24] The emergence of the business service sector accelerated the

development of the stock exchange in Hong Kong.

The Chinese open-door policy, which started in 1979, came at a time when Hong Kong was seeking to expand its production to offshore territories. China provided the production advantages for the expansion.[25] The mainland provided natural resources for Hong Kong[26] and the scope for Hong Kong to expand its manufacturing industry. Hong Kong's investment in mainland China therefore surged rapidly during the 1980s and 1990s.[27] The division in the production process between the mainland and Hong Kong was vividly described as "front shop, back factory".[28]

Economic integration has increased the mainland's demand for Hong Kong's business and financial services.[29] After the signing of the Sino-British Declaration which agreed on Hong Kong's reversion in 1997, Hong Kong has benefited substantially from the liberalisation of services in China since the 1990s.[30] What is more, economic integration has also substantially increased the movement of the population and the collaboration of human resources between mainland China and Hong Kong.[31]

The impact of Hong Kong on mainland China's securities market

There are various pieces of evidence suggesting that Hong Kong has had a significant impact on the establishment of the regulatory framework for China's securities market and the drafting of China's takeover regulations. The following pieces of evidence may not seem as direct and obvious as those demonstrating the British influence on Hong Kong's legislation, but do provide strong evidence of the close and "intimate" contact between China and Hong Kong when China's securities regulatory regime first emerged. In the words of Guogang Yu, the founder and first deputy manager of the Shenzhen Stock Exchange, in a financial TV programme:

"When I was preparing for the establishment of Shenzhen Stock Exchange, I translated all securities regulations in Hong Kong into Chinese. These regulations cover areas of the regulation of securities trading, investor protection and the operation of Hong Kong Stock Exchange. Then I transplanted and borrowed from the securities regulations in Hong Kong and wrote our securities rules."[32]

Memorandums of regulatory co-operation between Hong Kong and China

The securities supervision authorities in China and Hong Kong worked closely with each other during the establishment of China's securities market. They signed two memorandums of regulatory co-operation, and China's economic authorities at the time consulted securities experts from Hong Kong on how to choose the right supervisory model for the securities and futures market.[33] According to Mr Yongwu Fan, the director of the Department of Supervision on Public Offerings of the China Securities Regulatory Committee (CSRC):

"We communicate frequently with the Securities and Futures Commission of Hong Kong (hereafter SFC) on securities regulation. It may not always be formal correspondence but often by fax or a quick phone call."[34]

The CSRC, Shanghai Stock Exchange (SHSE), Shenzhen Stock Exchange (SZSE), SFC and Hong Kong Stock Exchange (HKSE) signed a memorandum of regulatory co-operation on June 19, 1993, not long after the establishment of the SHSE and SZSE. They then signed a second memorandum of regulatory co-operation concerning futures on July 4, 1995.[35] The memorandums established a co-operation mechanism between the CSRC and SFC. The 1993 memorandum stated that the principle underlining the co-operation was to protect investors, maintain an open, efficient and harmonised securities market and, most importantly, to keep each other's laws and regulations.[36]

Hong Kong and China's co-operation on H shares

The issuance of Chinese H shares on the HKSE brought the co-operation between the CSRC and the SFC to the next level. H shares are shares in Chinese registered companies listed in Hong Kong but traded in RMB. In 1993, during China's corporatisation reform, a group of SOEs were selected to be transformed into corporations and to be listed on the Hong Kong Stock Exchange. To fulfil this aim, the CSRC and SFC put together a pilot programme of H shares.[37]

In line with this new programme, the HKSE specifies the requirements that the Chinese SOEs need to meet in order to be listed in the H shares market. For example, the SOEs need to have articles of association specifying the shareholders' rights, the duties of the directors, the disclosure of financial statements, articles for arbitration and, most importantly, the right of every individual shareholder to take legal action against any directors breaching the directors' duties. Because mainland China was using the Chinese Accounting Standards for Enterprises, which were different from Hong Kong's accounting standards, the HKSE required the Chinese SOEs to prepare a set of financial statements according to the International

Accounting Standard as well as the Chinese standard financial statements.[38]

The issuance of H shares is a milestone for the co-operation of the regulation of securities market between mainland China and Hong Kong because it provides an opportunity for the policy-makers in mainland China and Hong Kong to work together and develop better understanding of each other. It enables mainland China to study and learn from the more mature and advanced securities regulations at the time in Hong Kong. The efforts made to meet the international accounting standard increased the transparency and improved the corporate governance of the first Chinese SOEs listed in the H share market. This contributed to the birth and growth of China's first large corporations which later become listed companies on China's stock exchanges.

The appointment of individual officials

Mrs Laura M. Cha, the former vice-chairwoman of the SFC, was appointed vice-chairwoman of the CSRC from March 2001 to July 2004. Mrs Cha was the Chinese Central Government's first non-mainland China-born employee to work at the ministry level. She contributed greatly to the enactment of the current takeover regulations and the public listing mechanism reform in China's securities market. The appointment of Mrs Cha was a crucial aspect of the co-operation between the CSRC and SFC in relation to takeover regulations.

Mrs Cha joined the SFC in January 1991 not long after the 1987 stock exchange crisis, as one of the few Chinese staff in the SFC. She said in an interview:

"At the time, the SFC was facing a lot of criticism. I learned that although we had to respect the reality of the market in implementation, rules should not be bent and principles had to be followed."[39]

Mrs Cha was promoted to vice-chairwoman of the SFC in 1998 in charge of policy-making and compliance of takeover regulations.

Meanwhile, Mrs Cha had experience in working with the Chinese Government. From 1992 onwards, before the CSRC was established, Mrs Cha worked closely with the State Commission for Restructuring the Economy of China, on the establishment of the H share market. She worked on ensuring the H share SOEs' standard of disclosure and corporate governance.

In February 2001, Mrs Cha was appointed vice-chairwoman of the CSRC, in charge of merger and acquisition supervision, public offering supervision and the financing of publicly listed companies.[40] In 2002, one year after Mrs Cha's appointment, the Measure for Takeovers 2002 was published by CSRC. The department of the CSRC which deals with takeover matters is the department of public offering, which was headed by Mrs Cha. Therefore it would be hard to deny that Mrs Cha would have had a significant impact on the preparation of the Measure for Takeovers 2002. Given Mrs Cha's SFC background and the similarity between the Measure for Takeovers 2002 and the Hong Kong Codes, it would be fair to say that the Hong Kong influence on the Measure for Takeover 2002 is evident.

The International Advisory Council (IAC) of the CSRC

The impact from Hong Kong on China's securities regulations is also demonstrated by the establishment of the International Advisory Council (IAC) in June 2004. The IAC is a consulting body within the CSRC. The role of the IAC is to keep the CSRC up to date with the latest regulatory developments and trends in the foreign securities markets and advise the CSRC on how to further open up China's securities market and bolster its development. The IAC has 14 members and is chaired by the CSRC chairman. Because most members of the IAC are foreign professionals, analysing the nationality and background of the IAC members indirectly indicates which countries or regions have the largest influence on the opinions offered to the CSRC when it consults for external advice (see Table 1).

Table 1: Background of the members of the IAC	
Chairman	
Mr Fulin Shang	Chairman, C
Vice-chairwoman	
Mrs Laura M. Cha	Former vice-

	Former vice-
Members	
Mr Thaddeus T. Beczak	Chairman, La
	Member, Ho
Mr Alan Cameron	Former chair
Mr Howard Davies	Director, Lo
	Former chair
Mr Linin Day	Former chair
Mr Peter J. Dey	Former chair
	Former chair
Mr Hasung Jang	Dean and pro
Mr Anthony F. Neoh	Former chief
	Former chair
Mr Luigi Spaventa	Former chair
Mr John L. Thornton	Professor, Ts
	Former presi
Mr John S. Wadsworth	Honorary cha
Mr Georg Wittich	Former presi
	Chairman, F
Mr Weiguo Zhang	Full-time me
	Former chief

As shown in Table 1, four of the IAC members, Mrs Laura M. Cha (SFC), Mr Thaddeus T. Beczak (SFC), Mr Howard Davis (FSA) and Mr Anthony F. Neoh (SFC), have experience of the supervision of securities markets, either in the United Kingdom or Hong Kong. Therefore, apart from the chairman, Mr Fulin Shang, and the IAC full-time member Mr Weiguo Zhang, who are current CSRC members of staff, one-third of the IAC members have British or Hong Kong backgrounds. Excluding Mr Howard David from the FSA, three members (one-quarter of the IAC) have a Hong Kong background. How much actual influence the IAC has in forming the securities regulation is yet to be seen. Nevertheless, this demonstrates how much weight the CSRC puts on different jurisdictions. The UK-Hong Kong model has obviously gained much more attention than any other jurisdictions, judging by the number of representatives from those two countries.[41]

Easier market access between Hong Kong and mainland China

The Central Government of China has special arrangements with the Hong Kong Special Administrative Regions regarding

the opening-up of its securities service sector. The Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), set up on June 29, 2003, has accelerated the convergence of the securities market in Hong Kong and mainland China.[42] For example, there is easier access for licensed professionals, fewer requirements for qualified service providers[43] in Hong Kong wishing to enter China's securities market and easier access for qualified Chinese securities companies, futures companies and fund management companies to enter into Hong Kong's securities market.[44] Easier market access between Hong Kong and mainland China enhances the freedom of movement of legal and financial professional work force between them. This increases the interaction and integration of the securities regulations of these two places.

Conclusion

By demonstrating direct and indirect connections of securities regulations between the United Kingdom, Hong Kong and China, this article concludes that Hong Kong has played a crucial role in "broadcasting" the United Kingdom's takeover and takeover defence regulations to China.

Takeover and takeover defence regulations in Hong Kong are inherited heavily from the United Kingdom owing to the pre-1997 British governance. It provided a good model for China to look up to. The Securities Supervisory body in China took the initiative to sign memorandums of co-operation with Hong Kong and learned (and, in a way, mimicked) the securities regulations and regulatory framework from Hong Kong during the establishment of the H share market. The appointment of individuals also contributes greatly to the legal transplant of securities regulations, especially the takeover and takeover defence regulations from Hong Kong to mainland China. The composition of the IAC suggests that the influence from Hong Kong and the United Kingdom to the CSRC is greater than any other countries or regions in the world. This also indirectly points out the significant intermediary role of Hong Kong in the legal transplantation.

Given the similarities between the takeover defence regulations in the United Kingdom, Hong Kong and China, and the linkage between Hong and both China and United Kingdom, it is fair to argue that Hong Kong, to a great extent, influenced the legal transplant of takeover regulations from the United Kingdom to China.

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