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

1 Outline of this Practice Note

1.1 This Practice Note provides an overview of the exempt system for connected fund managers and principal traders under the Codes[1] and sets out the implications of exempt status and disclosure requirements. The disclosure requirements set out in this Note do not affect the operations of the disclosure requirements under Part XV of the Securities and Futures Ordinance.

1.2 This Note covers the following areas:

- The exempt system
- What exempt status means
- Guidance on Code implications and disclosure requirements for exempt fund managers (**EFM**) and exempt principal traders (**EPT**)
- Guidance on dealing activities by EPTs
- Treatment of Seed Capital
- Timing of disclosure
- How to apply for exempt status
- Dealings by connected non-exempt fund managers and connected non-exempt principal traders

2 The exempt system

2.1 The Codes impose certain prohibitions, restrictions and obligations on dealings by parties involved in an offer and by persons acting in concert with them.

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[1] The definition of "connected fund manager and connected principal trader" provides that *"a fund manager or principal trader will be connected with an offeror or the offeree company if the fund manager or principal trader controls, is controlled by or is under the same control as (i) an offeror (ii) the offeree company (iii) any bank or financial or other professional adviser (including a stockbroker) to an offeror or the offeree company or (iv) an investor in a consortium formed for the purpose of making an offer (e.g. through a special purpose company)".*

2.2 Under class (5) of the definition of acting in concert financial and other professional advisers to corporate clients are presumed to be acting in concert with those clients. Class (5) provides as follows:

"*a financial or other professional adviser (including a stockbroker) is presumed to be acti*

3 What exempt status means

3.1 Once exempt, an EFM or EPT is not normally regarded as acting in concert with the client of the group's corporate finance department that is involved in an offer and hence the implications of concert party status under the Codes do not apply. A similar regime operates in London.

3.2 It is important to note that the benefits of exempt status only apply where the **sole** reason for the connection with an offeror or offeree company is that the EFM or EPT is in the same group as the corporate finance team that is advising the offeror or offeree company (see Note 2 to the definitions of EFM and EPT). In other words an EFM or EPT may not benefit from its exempt status if:

(a) it belongs to the same group as the offeror or offeree company; or

(b) it is a concert party of the offeror or offeree company other than being presumed to be acting in concert under class (5).

3.3 In the case of an EFM, exempt status applies to **all** discretionary dealings in client funds managed by the EFM.

3.4 In the case of an EPT, exempt status is more limited in that it is restricted to the trading activities conducted by the EPT trading as a principal in securities for the purpose of derivative arbitrage or hedging activities such as closing out existing derivatives, delta hedging in respect of existing derivatives, index-related product or tracker fund arbitrage in relation to the relevant securities[2] or other similar activities assented to by the Executive during an offer period (see definition of EPT and paragraphs 6.6 and 6.7 below).

[2] Note 4 to Rule 22 provides that *"relevant securities for the purpose of Rule 22 include (a) securities of the offeree company which are being offered for or which carry voting rights; (b) equity share capital of the offeree company and an offeror; (c) securities of an offeror which carry the same or substantially the same rights as any to be issued as consideration for the offer; (d) securities carrying conversion or subscription rights into any of the foregoing; and (e) options and derivatives in respect of any of the foregoing".*

3.5 For the avoidance of doubt an EFM or an EPT must make full and proper disclosure of its dealings in relevant securities in compliance with Rule 22 (see paragraphs 4 and 6 below).

4 Practical guidance on Code implications and disclosure requirements for EFMs

4.1 Although an EFM who is connected to an offer is not regarded as acting in concert with the corporate finance client of its group it is nevertheless required to make disclosure of its dealings in relevant securities during an offer period.

4.2 *Is an EFM's disclosure public or private?*

The question of whether an EFM's disclosure of its dealings during an offer period are public or private is determined by whether or not the EFM is an "associate" under class (6) of the definition of associate under the Codes as described below:

(a) Normally an EFM (who is not a class (6) associate) must make private disclosure to the Executive under Rule 22.1(b)(ii). This assists the Executive to monitor dealings during an offer period.

(b) If an EFM holds 5% or more of any class of relevant securities, it would be regarded as an "associate" (by virtue of class (6) of the definition of associate in the Codes) and would therefore need to make public disclosure of its dealings in relevant securities (see Rule 22.1(b)(ii)). The reason for such public disclosure is that these dealings are considered to provide relevant information to shareholders and the market during an offer period.

4.3 *Why should an EFM aggregate its holdings?*

An EFM should aggregate its holdings for various purposes under the Codes including:

(a) To determine whether it would be regarded as a class (6) associate.

(i) If an EFM is not a class (6) associate it should aggregate **its** dealings in relevant securities for private disclosure purposes.

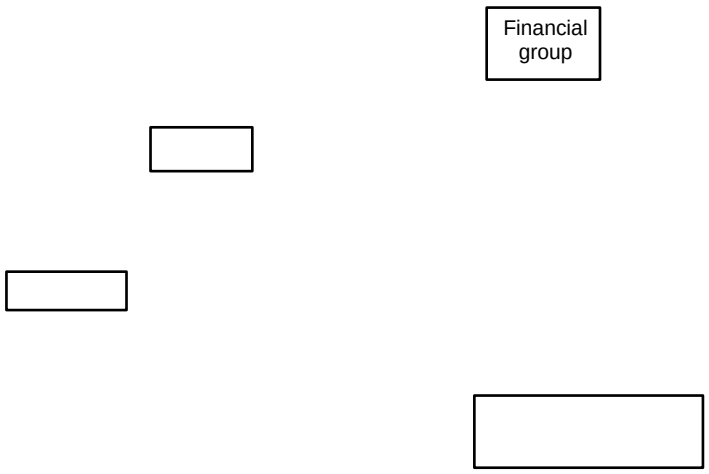
(ii) If an EFM is a class (6) associate or where there are two or more EFMs within the group and one or more of them are class (6) associates, it should aggregate holdings in relevant securities held by **all** discretionary fund managers within the group (irrespective of whether they have exempt status) for public disclosure purposes (see Rule 22.3 and Note 10 to Rule 22).

(b) To determine whether any general offer implication arises under Rule 26.

4.4 In all cases an EFM should count the relevant securities held by the investment accounts it manages on a discretionary basis as controlled by the EFM itself and not by the person on whose behalf the relevant securities are managed (see Rule 22.3 and Note 10 to Rule 22).

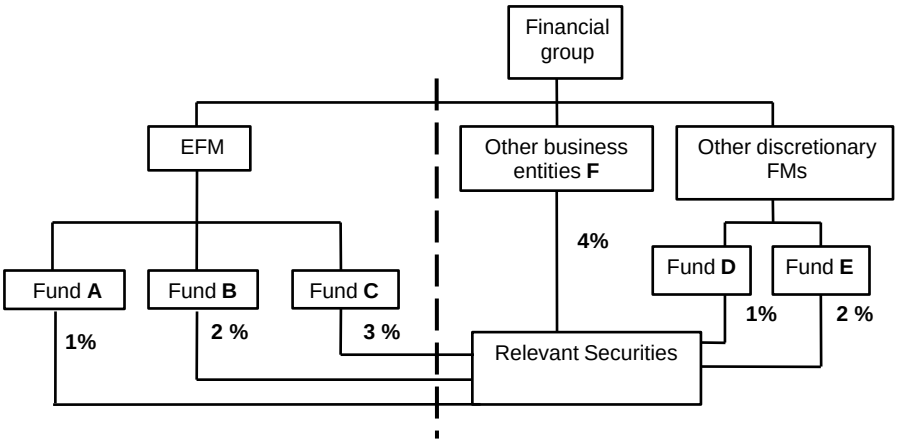
4.5 *How should an EFM aggregate its holdings to determine whether it is a class (6) associate and for the purpose of public disclosure?*

(a) An EFM should count relevant securities held by the investment accounts it manages on a discretionary basis (including **all** relevant securities held in Seed Capital accounts - see paragraph 5 below) but will not normally be required to include any principal (or proprietary) or discretionary client's holdings of relevant securities held elsewhere in the group.



(b) When an EFM makes a public disclosure because it is a class (6) associate, unless the Executive consents otherwise, it is required to disclose the aggregate holdings of relevant securities held by **all** discretionary fund managers within the same group (whether exempt or non-exempt). This is consistent with the view that relevant

circumstances of the particular case. Therefore, to avoid problems under Rule 26, all relevant holdings should be monitored from a central point within the group.



(c) Given that Rule 22.1 provides that an EFM should disclose (whether privately or publicly) dealings in all relevant securities, Note 9 to Rule 22 is not applicable to EFMs. Therefore an EFM must disclose any dealings in options and derivatives.

(d) Disclosure should also be made to the offeror and the offeree company or their respective financial advisers at the same time (see Note 6 to Rule 22).

(e) The prescribed forms can be found under "Takeovers and Mergers" – "Forms" of the SFC website at http://www.sfc.hk.

5 Treatment of Seed Capital

5.1 An EFM may sometimes invest its own money as start-up money in a new fund at the time the fund is launched (**Seed Capital**). The Executive regards Seed Capital as proprietary funds and therefore any transaction carried out in respect of funds which have Seed Capital would not be covered by EFM status. Notwithstanding the above, in view of the fiduciary duties owed by an EFM to its discretionary clients, the Executive has adopted a pragmatic approach towards Seed Capital as follows:

(a) where Seed Capital represents less than 10% of the value of the fund, the whole of that fund would be covered by EFM status;

(b) where Seed Capital represents 10% or more (but less than 90%) of the value of the fund the connected EFM may continue to deal in relevant securities during the offer period as if it were dealing on behalf of discretionary clients subject to the restrictions in Rule 35. In particular:

(i) the connected EFM must not carry out any dealing with the purpose of assisting the offeror or the offeree company in respect of the **whole** of the fund (see Rule 35.1);

(ii) the connected EFM must not deal with the offeror and its concert parties in relevant securities in respect of the **whole** of the fund during the offer period (see Rule 35.2);

6.2 *Is an EPT's disclosure public or private?*

(a) Rule 22.4 provides that an EPT connected with an offeror or offeree company should make public disclosure of its dealings in all relevant securities. Given this provision Note 9 to Rule 22 is not applicable to EPTs and therefore any dealings in options and derivatives by an EPT must be publicly disclosed.

(b) *Agency trades* - dealings in relevant securities on behalf of non-discretionary investment clients should be privately disclosed (see paragraph 6.6(b) and Rule 22.2).

(c) *Client facilitation trades* - dealings in relevant securities on behalf of non-discretionary investment clients that arise as a result of client facilitation orders (see paragraph 6.7(a)) must be publicly disclosed.

6.3 *Why should an EPT aggregate its holdings?*

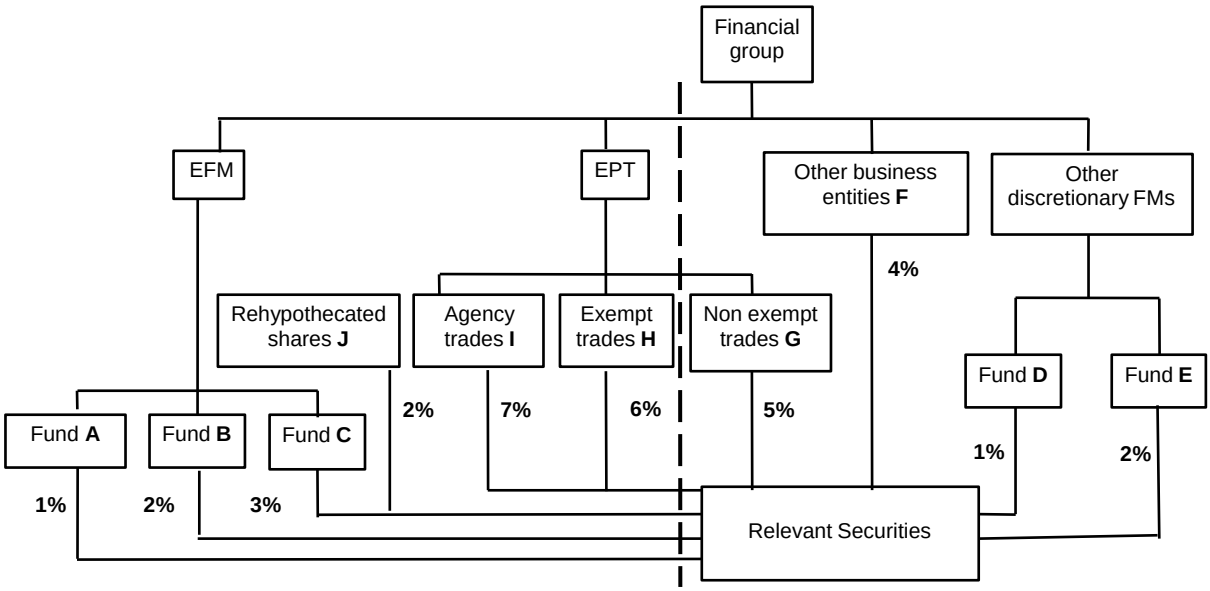
(a) An EPT should aggregate its holdings in relevant securities for public disclosure purposes (see Rule 22.4).

(b) To determine whether any general offer implication arises under Rule 26.

6.4 *How should an EPT aggregate its holdings to determine whether a general offer obligation arises under Rule 26?*

(a) An EPT must aggregate **all** holdings of relevant securities of the group, irrespective of exempt status, including but not limited to the EPT's own holdings, and any principal (or proprietary), EFM's or discretionary client's holdings held elsewhere in group. Non-discretionary client's holdings need not be included.

(b) An EPT should consult the Executive at the earliest opportunity in any case where an issue under Rule 26 arises so that a ruling may be given in light of all the circumstances of the particular case. Therefore, to avoid problems under Rule 26, all relevant holdings should be monitored from a central point within the group.



Total held by group under Rule 26 = A + B + C + D + E + F + G + H + J = 26 %

Note: Shareholdings held by the group in its capacity as nominee and custodian need not be aggregated.

6.5 *How should an EPT disclose its dealings?*

(a) Dealings in relevant securities by a connected EPT should be disclosed using the prescribed forms for public disclosure and sent to the Executive either by e-mail to cfmailbox@sfc.hk or by fax on 2810 5385. The Executive will arrange for these disclosures to be posted on the SFC website. The disclosure must include the following information (see Rule 22.4):

(i) total purchases and sales (i.e. total number of shares purchased/sold and total amount paid/received);

(ii) the highest and lowest prices paid and received; and

(iii) whether the connection is with an offeror or the offeree company.

(b) Disclosure should also be made to the offeror and the offeree company or their respective financial advisers at the same time (see Note 6 to Rule 22).

(c) The prescribed forms can be found under "Takeovers and Mergers" – "Forms" of the SFC website at http://www.sfc.hk.

6.6 *Dealing activities conducted by an EPT*

(a) **Exempt Principal Trades**

6.7 *Guidance on exempt principal trades*

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

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

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

(a) **Client facilitation trades**

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

- the client facilitation trades arise from wholly unsolicited client-driven orders. They must not arise as a result of solicitation or indication of interests by the client facilitation desk (by way of e-mails, telephone calls or otherwise) or recommendations

provided by the EPT or its related parties during the offer period;

- Á the client facilitation desk operates independently of

provided that the EPT does not take a directional position as a result, for example, by retaining part of the product on its own book.

(ii) Convertible bonds

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

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

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

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

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

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

derivatives (and related hedging) would therefore be regarded as exempt under the definition of EPT.

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

(i) Market maker or liquidity provider activities (and related hedging) in derivative warrants, callable bull/bear contracts and exchange-traded stock or

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

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

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

(d) **Securities borrowing and lending**

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

The Prime Brokerage desk of an EPT provides custodial and clearing services to clients and, in exchange, the Prime Broker is typically granted the right to rehypothecate the securities held in a client’s account. This right entitles the Prime Broker to take beneficial title of a client’s securities and to use the securities fi

using the securities as collateral for loans.

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

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

6.8 *Restrictions on an EPT*

Rule 35 imposes certain restrictions on connected EPTs to prevent a principal trader from abusing its exempt status. The overriding principle is that a connected EPT must not carry out any dealings or securities borrowing or lending transactions with the purpose of assisting the offeror or the offeree (see Rule 35.1). Failure to comply may lead to revocation of exempt status. In ensuring compliance with Rule 35.1:

(a) if the EPT is connected with an offeror it must not deal in relevant securities of the offeree company with the offeror or its concert parties during the offer period (see Rule 35.2);

(b) if the EPT is connected with an offeror securities owned by it must not be assented to the offer until the offer becomes or is declared unconditional as to acceptances (see Rule 35.3); and

(c) securities owned by an EPT connected with an offeror or offeree must not be voted in the context of an offer (see Rule 35.4).

6.9 *Other obligations of an EPT*

In addition to its own disclosure obligations an EPT who deals in relevant securities on behalf of clients should ensure that its clients are aware of, and comply with, the disclosure obligations under Rule 22 if they are associates of the offeror or offeree company (see Note 11 to Rule 22).

7 *Timing of disclosure*

7.1 All disclosure must be made no later than 10.00 a.m. on the business day following the date of the transaction (see Note 5 to Rule 22).

7.2 Where dealings have taken place on stock exchanges in the time zones of the United States and there may be difficulty in disclosing dealings by 10.00 a.m. the Executive should be consulted. In such cases, the Executive may allow disclosure to be made no later than 10.00 a.m. on the second business day following the date of the transaction.

7.3 Where a client of a group's corporate finance department is involved in an offer or a whitewash transaction, the Executive requires the group to submit details of the group's aggregate holdings of relevant securities of the offeree company and, in the case of a securities exchange offer, the offeror, as at the close of business on the day the offer period commences or the whitewash transaction is announced. In this regard long and short positions should not be netted off and details should include all program trades involv

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involved in corporate finance activities may apply for exempt status under the "fast-track" procedures.

(b) Under this method the Executive is normally prepared to grant exempt status (without first conducting a comprehensive review of the information as required under the Guidelines) if the applicant provides a signed confirmation from the group senior compliance officer, confirming among others, that:

(i) the applicant entity and the fund managers/principal traders employed by it are independent of the group's Hong Kong corporate finance operation;

(ii) there are sufficient Chinese Walls and compliance procedures in place to maintain the independence of the relevant business operations; and

(iii) the individual fund managers or principal traders of the applicant are properly trained in the relevant rules of the Takeovers Code and in particular that they understand the meaning and significance of "acting in concert" and the situations in which the EFM/EPT status will fall away.

8.3 In order to maintain its exempt status the EFM/EPT must provide an updated signed confirmation to the Executive on an annual basis. Failure to do so may result in the revocation of its exempt status. It will then have to make a fresh application in order to reinstate its exempt status.

8.4 *Applications under the Guidelines*

Applications from firms that are not considered to be large multi-service organisations would be dealt with in accordance with the Guidelines on Exempt Fund Managers and Exempt Principal Traders (April 2001) which set out the information that should be provided by an applicant to satisfy the Executive as to its suitability for EFM/EPT status.

8.5 The guidelines for applications under both methods can be found under "Takeovers and Mergers" – "Exempt status" section of the SFC website at http://www.sfc.hk.

9 *Dealings by connected non-exempt fund managers and principal traders*

9.1 The Executive recognises that not all relevant fund managers or principal traders have exempt status and, in any event, exempt status may not be relevant by virtue of the operation of Note 2 to the definitions of EFM and EPT or may fall away in certain circumstances. Furthermore only certain dealing activities by an EPT are covered by exempt status.

9.2 In this regard Rule 21.6 provides as follows:

(a) Discretionary fund managers and principal traders who, in either case, are connected with an offeror or potential offeror, will not normally be presumed to be acting in concert with that person until its identity as an offeror or potential offeror is publicly announced or, if prior to that, the time at which the connected party had actual knowledge of the possibility of an offer being made by a person with whom it is connected. Rules 23, 24, 25, 26 and 28 will then be relevant to purchases of offeree company securities and Rule 21.2 to sales of offeree company securities by such persons. Rule 21.7 will be relevant to securities borrowing and lending transactions.

(b) Similarly, discretionary fund managers and principal traders who, in either case, are connected with the offeree company, will not normally be presumed to be acting in concert with the offeree company until the commencement of the offer period or, if prior to that, the time at which the connected party had actual knowledge of the possibility of an offer being made for the offeree company and that it was connected with the offeree company. Rules 21.5 and 26 may then be relevant to purchases of offeree company securities. Rule 21.7 will be relevant to securities borrowing and lending transactions.

(c) An EFM or EPT which is connected for the sole reason that it controls, is controlled by or is under the same control as a financial or other professional adviser (including a stockbroker) to the offeror or the offeree company will not be presumed to be acting in concert even after the commencement of the offer period or the

identity of the offeror being publicly announced (as the case may be).

30 September 2010