TAKEOVERS AND MERGERS PANEL

Panel Decision

In relation to a referral to the Panel by the Executive for a ruling whether a cash alternative should be required under Rule 23.1(b) of the Codes on Takeovers and Mergers and Share Repurchases (the "Code") as a result of the acquisition of shares in CITIC International Financial Holdings Limited ("CIFH") for cash by Lehman Brothers Asia Limited ("Lehman") or persons controlling, controlled by or under the same control as Lehman (the "Lehman group") during the offer period

---

Purpose of the hearing

1. The Panel met on 23rd July, 2008 to consider a referral by the Executive under Section 10 of the Introduction to the Code, which relates to a particularly novel, important or difficult point at issue, for a ruling on whether a cash alternative should be required under Rule 23.1(b) of the Code as a result of the acquisition of shares in CIFH for cash by the Lehman group during the offer period.

Background and facts

2. During late 2007 and 2008 Lehman made a number of proposals to the CITIC group, a state-owned enterprise incorporated in the PRC, in relation to its listed subsidiary, CIFH, and from April 2008 worked specifically on a proposal which, if it were to be implemented, would result in the privatisation of CIFH.

3. On 3rd June, 2008 CIFH announced that it had received a proposal from Gloryshare Investments Limited (the "offeror"), a wholly-owned subsidiary of the CITIC group, regarding a proposed privatisation by a court sanctioned scheme of arrangement. The terms of the privatisation proposal envisaged that Banco Bilbao Vizcaya Argentaria S.A. ("BBVA"), presently a substantial shareholder of CIFH, would increase its shareholding interest in CIFH from approximately 15% to 30%, the balance of the shares in CIFH being held by the offeror or members of its group. At the request of CIFH, the shares in CIFH were suspended from trading on the Hong Kong Stock Exchange with effect from 9:41 a.m. on 3rd June, 2008.

4. In the period before the 3rd June announcement was made and trading in the shares in CIFH was suspended, the proprietary trading operations of the Lehman group had regularly traded in the shares in CIFH and China CITIC Bank Corporation Limited ("CNCB"), the shares of which were to form a portion of the consideration payable to scheme members under the proposed scheme of arrangement. Following the suspension and before the resumption of trading, Lehman sought, apparently at the insistence of the offeror, and received confirmation from the Executive that these trades, which were carried out without any knowledge of the Lehman group's

involvement in the transaction as adviser to the offeror, would not be considered as acquisitions of shares by a person acting in concert with the offeror. As a result of this confirmation any proprietary dealings by the "public" side of the Lehman group, being its sales and trading activities as opposed to its investment banking operations, prior to 11th June, 2008 were not relevant to the matter before the Panel.

5. By 10th June, 2008 Lehman was formally retained by the offeror as its adviser. This is the first time to the knowledge of those present at the hearing that Lehman had been retained in this capacity in a takeover subject to the Code and on that date the offeror and CIFH published a joint announcement setting out the terms of the privatisation proposal in accordance with requirements of Rule 3.5 of the Code. In summary, under the scheme of arrangement, scheme members will receive, in consideration for the cancellation of their shares, one CNCB "H" share and HK$1.46 in cash for every share in CIFH held. In anticipation of the resumption of trading on the following day, the Lehman group instituted a restriction on all proprietary trading, but not agency trading, in the shares in CIFH and CNCB by issuing an R6 notice, its highest level of trading restriction. To the knowledge of those present at the meeting this was the first time a R6 restriction had been initiated by the Lehman group in Hong Kong. Had this restriction been effective it would have stopped all proprietary trading in these shares by the Lehman group, apart from the settlement of contracts entered into before the suspension of the shares in CIFH. Further, the Lehman group arranged training sessions for its traders commencing on the following day so that they would comply fully with the R6 notice.

6. Rule 3.5 required that the announcement of 10th June, 2008 include disclosure of the Lehman group's outstanding derivatives in relation to shares in CIFH, if such information was available. There is no evidence that those at Lehman who advised the offeror knew of the Lehman group's outstanding derivatives at the time the announcement was published and Lehman had been retained as the adviser to the offeror.

7. At 9:30 a.m. on 11th June, 2008 trading in the shares in CIFH was resumed on the Hong Kong Stock Exchange and the Lehman group R6 trading restriction came into effect. On this date also, the Lehman group submitted to the Executive a draft application for "exempt principal trader" status under the Code. This application was subsequently withdrawn but may be renewed.

8. On 11th June, 2008 the Lehman group purchased 31,000 shares in CIFH at prices ranging from HK$6.15 to HK$6.17 per share. The purpose of these trades was to rebalance a hedge against existing swaps with a client on the MSCI HK Index. On the same day, Lehman group purchased a further 179,000 shares in CIFH at prices between HK$6.22 and HK$6.23 per share for the purpose of unwinding a short position resulting from over-the-counter sales to clients. Again on the same day, a further 72,000 shares in CIFH were purchased at prices between HK$6.23 and HK$6.24 per share. This trade was generated by a client without reference to any Lehman group employee by executing a "Lehman Performance Swap" through

Lehman's direct market access system.

9. On 13th June, 2008 the Lehman group purchased a further 41,000 shares in CIFH at prices varying from HK$6.23 to HK$6.27 per share. The purpose of these trades was to cover a short position created as a result of a client facilitation trade the previous day under which a Lehman group trader sold to a client the same number of shares. HK$6.27 was the highest price paid by the Lehman group for purchases of shares in CIFH during the offer period.

10. There is no suggestion that either the offeror or BBVA had any knowledge that these purchases were taking place. Indeed, the offeror has stated that it had every expectation that Lehman would not behave in a way which would jeopardise or complicate its proposed privatisation.

11. When the Compliance and Control divisions of the Lehman group were made aware of these purchases, they immediately informed the Executive.

12. As it was apparent that the restriction on proprietary trading was not effective and the Lehman group's systems were having difficulties distinguishing between proprietary and agency trades, the decision was taken to block all trading in CIFH shares with effect from 17th June, 2008 when the stock code of CIFH was removed from all of the Lehman group's trading systems.

13. On 23rd June, 2008, the Lehman group purchased 369,000 CIFH shares at HK$5.446 per share as a result of the automatic delivery of stock by a client in accordance with the terms of a pre-existing derivative contract. Lehman disagreed with the Executive's inclusion of this purchase in the trading which occurred during the offer period because it was in fulfilment of its obligations under a pre-existing contract. The Executive's position was that it should be consulted on all potential trades resulting from derivative contracts in advance of such trades and that this trade should also be included in trades relevant to the application of Rule 23.1(b). However, in the context of the matter before the Panel, it was not necessary for it to determine whether this purchase should have been included. Nothing in its decision turns on whether this purchase is included or not.

14. Following the resumption of trading in the shares in CIFH, the shares traded in considerable volume. To put the trades made by the Lehman group into context, the number of shares in CIFH traded between 11th and 16th June, 2008 amounted to approximately 190 million shares. The lowest daily volume during this period was over 26 million shares.

15. It should be noted that the shares purchased and held by the Lehman group are not permitted to be voted at the scheme meeting to be convened to approve the privatisation proposal. The outcome of the privatisation proposal is unlikely to be affected by these purchases or any other holdings the Lehman group may have in CIFH. Further, without the prior consent of the Executive, Rule 21.2 of the Code

prohibits the sale of shares in an offeree company by the offeror or persons acting in concert with it during the offer period. Accordingly, none of the Lehman group's shareholdings can be sold without the prior approval of the Executive.

The relevant provisions of the Code

16. The first principle of the Code is that in an offer all shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly. For this reason during an offer period an offeror and parties acting in concert with it are constrained from dealing in the offeree company's shares. Normally purchases above the offer price for a cash offer will result in that offer being increased to the highest price paid or, in the case of a securities exchange offer, as in this instance, purchases for cash will result in the offer being accompanied by a full cash alternative, again at the highest price paid. The Code also places strict disciplines on a financial adviser to an offeror in respect of dealing in the shares in the offeree company and this is particularly so of an adviser which is a member of a multi-service financial group, of which fund management and proprietary trading form a significant part. The Code is unambiguous on this and any financial adviser accepting an engagement to advise on a transaction subject to the Code should be fully aware of the disciplines imposed on it and other members of its group.

    The requirement for even-handed and similar treatment is set out in General Principle 1 of the Code, which reads:

    "All shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly."

17. Acting in concert is defined as follows:

    "Persons acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate to obtain or consolidate "control" (as defined below) of a company through the acquisition by any of them of voting rights of the company."

18. The definition of a "acting in concert" includes a number of classes of person who are presumed to be acting in concert with each other including:

    "Without prejudice to the general application of this definition, persons falling within each of the following classes will be presumed to be acting in concert with others in the same class unless the contrary is established:-
    …

    (5) a financial or other professional adviser (including a stockbroker) with its client in respect of the shareholdings of the adviser and persons controlling, controlled by or under the same control as the adviser (except in the capacity of an exempt principal trader)…"

While there is always the possibility of a presumed concert party successfully rebutting the presumption of acting in concert, in practice in the context of a financial adviser and persons under the same group after the commencement of an offer period the presumption is very difficult to rebut as the Code seeks to place the disciplines of the Code not only on the financial adviser but also the financial adviser's group. In this case, even though it is accepted that the trades by the Lehman group were made without the knowledge of the offeror and were initiated by considerations which were unrelated to the offer, Lehman made no attempt to rebut the presumption of acting in concert with the offeror. It is clear it accepted that all the members of its group were considered to be persons acting in concert with the offeror once the offer period commenced. The Panel agrees with this approach.

19. The Code also recognises that for a multi-service financial group the disciplines it seeks to impose on a financial adviser and its group may have an impact upon other activities which are unrelated to the provision of advice to an offeror. In order to alleviate a number of difficulties which may result from this and to exempt certain trades from being considered concert party trades, the Code contains provisions for exemptions for fund managers and principal dealers. Relevant to this matter is the exempt principal trader status available under the Code. During the hearing the Executive confirmed that all the purchases made by the Lehman group on or after 11th June, 2008 would appear to have been exempt had the Lehman group obtained exempt principal trader status, although the Executive had not considered a full submission in this regard. An exempt principal trader is defined as:

"a person who trades as a principal in securities only 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 or other similar activities assented to by the Executive during an offer period, and is recognised by the Executive as an exempt principal trader for the purposes of the Codes.

Notes to the definitions of exempt fund manager and exempt principal trader:

1. Persons who manage investment accounts on a discretionary basis and principal traders may apply to the Executive to seek the relevant exempt status and will have to comply with any requirements imposed by the Executive as a condition of the grant of such status. The Executive will normally require an applicant for exempt principal trader status to describe to the Executive on application the securities and other instruments in which the applicant is or proposes to be trading as principal. This disclosure will be a continuing obligation, in particular at the beginning of and during an offer period. (See Rule 22.)…"

20. It is accepted that the announcement published on 3rd June, 2008 initiated the offer

period which has yet to end. Under the Code, an offer period commences:

"from the time when an announcement is made of a proposed or possible offer (with or without terms)."

21. The announcement of 10th June, 2008 was issued in accordance with the requirements of Rule 3.5. In addition to other information Rule 3.5 envisages that the preliminary announcement will contain details of any outstanding derivatives in respect of the offeree company entered into by the offeror or any person acting in concert with it. The Rule also recognises that this may not be possible immediately because of the requirement for secrecy before an offer is announced but in that event the Executive is to be consulted. Further, the Executive was of the view that as part of its own internal procedures, a potential financial adviser to an offeror should ascertain what derivatives were likely to be outstanding before accepting the engagement. The relevant section of Rule 3.5 and Note 1 to it read as follows:

"When a firm intention to make an offer is announced, the announcement must contain:-

…

(d) details of any outstanding derivative in respect of securities in the offeree company entered into by the offeror or any person acting in concert with it…

Notes to Rule 3.5:

1. Holdings by a group of which an adviser is a member

It is accepted that, for reasons of secrecy, it would not be prudent to make enquiries so as to include in an announcement details of any holdings of offeree company shares or options or derivatives in respect of them held by or entered into by other parts of an adviser's group (see class (5) of definition of acting in concert). In such circumstances, details should be obtained as soon as possible after the announcement has been made and the Executive consulted. If the holdings are significant, a further announcement will be required…"

For a multi-service financial group this imposes an obligation to obtain the information on derivative and other similar arrangements as soon as possible and, in the event that the information cannot be obtained in advance, the Executive is to be consulted. In this matter, the Lehman group was in a position from 3rd June, 2008 onwards to commence collating this information from across its group without concerns over secrecy because trading in the shares in CIFH had been suspended. What initial discussions Lehman may have had with the Executive on this issue appear to have been inconclusive and were subsequently superseded by events. At the time of the hearing there was no evidence given as to whether this information has yet been collated.

22. The consequence of purchasing shares in the offeree company during the offer period is set out in Rule 23.1(b) which states that:

Except with the consent of the Executive….. a cash offer is required where:-

…

(b) …shares of any class under offer in the offeree company are purchased for cash (but see Note 5 to this Rule 23.1) by an offeror or any person acting in concert with it during the offer period, in which case the offer for that class shall be in cash or accompanied by a cash alternative at not less than the highest price paid by the offeror or any person acting in concert with it for shares of that class during the offer period…"

Rule 23.1(b) has the effect on a securities exchange offer, which was the offer being made to the scheme members of CIFH, of introducing a full cash alternative at the highest price paid in the event of purchases by the offeror or persons acting in concert with it during the offer period. There is no concept in the Code of a de minimis trade. The Rule, as with other Rules on the Code relating to the purchase of voting rights attaching to shares, makes no distinction as to the scale of purchases and its provisions apply equally to a purchase of one share as to substantial purchases of shares. If this Rule applies in this matter, the purchases by the Lehman group resulted in the obligation of a full cash alternative being required at HK$6.27 per share in CIFH. This would increase the cash element of the offer from some HK$2.60 billion to between HK$10.92 billion and HK$11.16 billion, depending on whether outstanding options and convertible bonds are fully exercised or converted. This is a very substantial increase in the cash required to fulfil the offer and greatly changes the nature of the proposal to the CIFH scheme members which is presently a share exchange with a modest cash element.

23. While the obligation to make an offer rests with the principal members of a party acting in concert, Rule 36 of the Code envisages that it can be imposed on another party and, in particular, on the party who triggers an increase in the offer price or a full cash alternative under Rule 23, which may be relevant in the matter. Rule 36 states that:

"In addition to the offeror, each of the principal members of a group of persons acting in concert with him may, according to the circumstances of the case, have the obligation to extend an offer.

The prime responsibilities under Rules 23, 24 and 26 normally attach to the person who makes the acquisition which imposes the obligation under the relevant Rule. If such person is not a principal member of the group acting in concert, the relevant obligation may attach to the principal member or members and, in exceptional circumstances, to other members of the group acting in concert…"

24. The Code also gives a general discretion to the Executive and the Panel to modify or relax the application of a Rule if it would operate in an unnecessarily restrictive or unduly burdensome manner. In Section 2.1 of the Introduction to the Code it is stated that:

"the Executive and the Panel may each modify or relax the application of a Rule if it considers that, in the particular circumstances of the case, strict application of a Rule would operate in an unnecessarily restrictive or unduly burdensome, or other inappropriate, manner."

Options for the Panel's consideration

25. In its referral to the Panel, the Executive suggested that there were three alternative responses to the matter. These were:

- the acquisitions should not lead to a cash alternative being required, notwithstanding the applicability of Rule 23.1(b), through the exercise of the discretion to waive the requirements of this Rule given to the Panel under Section 2.1 of the Introduction to the Code;

- a cash alternative be made at HK$6.27 per share in compliance with Rule 23.1(b), failing which disciplinary action may be initiated; or

- in the event that the Panel decided a cash alternative was required in compliance with Rule 23.1(b) to impose the obligation for making it on the Lehman group, rather than the principal member of the concert party group, being the offeror.

Of the three alternatives, the Executive made it clear that it did not favour the third and had included it only for the sake of completeness.

Both Lehman and the offeror argued strenuously for the exercise of its discretion by the Panel to waive the requirement for a cash alternative. No argument was advanced that Rule 23.1(b) was not applicable, simply that its requirements should be waived in this instance. In summary the reasons advanced for this were the insignificance of the purchases relative to the number of shares in CIFH traded; the fact that the trades were unrelated to the offer and counter-productive to it; all the purchases would have qualified for exemption had the Lehman group been granted exempt principal trader status; the fact that public shareholders in CIFH had suffered no discernable harm; the impact such a requirement would have on the offeror's financing requirements and its privatisation proposal in circumstances when it was unaware of the purchases and had every expectation, given the standing of its financial adviser, that actions by it would not prejudice or complicate its privatisation proposal; and a cash alternative would be a disproportionate and draconian response to the failure of the Lehman group to prevent certain small trades from occurring.

The decision and reasons of it

26. In the absence of a successful rebuttal of the presumption, all members of the Lehman group are persons presumed to be acting in concert with the offeror. The definition of the persons presumed to be acting in concert under paragraph 5 of the definition makes this abundantly clear. Once the details of the offer were published and the offer period commenced all purchases of shares in CIFH by the Lehman group, unless specifically exempted by the Executive in advance, were relevant to the application of Rule 23.1(b), irrespective of whether the purchases were made with the offer in mind or not or whether other members of the presumed concert party were aware of such purchases. The scale of purchases was also irrelevant to the application of this Rule. Accordingly, in the absence of the waiver of the Rule 23.1(b), the Code requires that a cash alternative be made at the highest price paid during the offer period: that is at a price of HK$6.27 per share in CIFH.

27. The Panel then had to decide whether it was appropriate to consider the exercise of its discretion under Section 2.1 of the Introduction of the Code to waive the requirements of Rule 23.1(b). In this case, relatively small purchases by members of the financial adviser's group made for purposes which did not relate to the offer had through the application of Rule 23.1(b) potentially calamitous consequences for the offeror, which would alter and possibly undermine its privatisation proposal. These circumstances should require the Panel to consider the exercise of its discretion to waive the application of Rule 23.1(b) in this instance.

28. Having considered the representations made to it by Lehman and the Executive, the Panel decided that it should exercise its discretion to waive the requirement for a cash alternative in this case for the following reasons. These are that:

- the size of the purchases, which were unconnected with the offer, were very small relative to the size of the offer and the total volume of the shares in CIFH traded;

- given the negligible impact that these purchases had on traded prices or volume, they also had a negligible impact on public shareholders so that the even-handedness and equality of their treatment under the offer had not been compromised to any significant degree;

- the imposition of the requirement for a cash alternative would have a substantial and adverse impact on the offeror, greatly increasing the cash component of its proposal and changing the terms and possible outcome of that proposal, in circumstances where it had not purchased shares itself and had no knowledge of the purchases made by the Lehman group on and after 11th June, 2008 at the time they were made; and

- were the decision be made under Rule 36 that the primary obligation for the

offer fall on the Lehman group, the remedy would be disproportionate to the scale of the purchases.

Further observations and recommendations

29. The hearing before the Panel was not a disciplinary proceeding but a referral to it under Section 10 of the Introduction to the Code. By referring a matter to the Panel, it is expected that the Panel's decision will be made public and that this will assist the market in understanding better the requirements and operation of the Code. It is in this spirit that the Panel wishes to make some observations on this matter which may have more general application than the matter before it. By its own admission and to its regret, Lehman's performance in this matter fell short of the standards expected by its clients, its regulators and also itself. It appears that the Lehman group was simply unprepared. It had never in its recall acted in this capacity in Hong Kong, it did not appear to be in a position to collate the relevant information on derivative and other outstanding commitments within a reasonable time frame, restricted dealing procedures were untried, systems were inadequate and traders were not properly trained in advance of the imposition of dealing restrictions. Had Lehman applied for and received exempt principal trader status, this embarrassment is likely to have been avoided. Early consultation with the Executive on the basis that it was fully informed of its derivative and other similar positions would have mitigated and possibly avoided some of the difficulties that were experienced. In the light of what has happened in this instance and in the hope it does not happen again, the Panel reminds practitioners and parties to a takeover transaction of the clear impositions in the Code for early consultation with the Executive and for the need for full disclosure in circumstances that might bear upon a proper consideration of the matter. In addition, the Panel wishes to advise multi-service financial groups with active fund management and proprietary trading businesses who are, or intend to be, involved in corporate finance activities and transactions which are subject to the Code of the benefits of exempt status and the importance of timely application for such status.

29th July, 2008

Parties present at the hearing:

The Executive
Lehman Brothers Asia Limited (advisers to the offeror), advised by Herbert Smith
Gloryshare Investments Limited (the offeror), advised by Richards Butler
Jones Day, advisers to CITIC International Financial Holdings Limited (the offeree company)
Linklaters, advisers to Banco Bilbao Vizcaya Argentaria S. A. (a person acting in concert with the offeror)