

Financial Services Acquisitions: A Primer to Buying Securities Firms, Asset Managers, Insurers and Banks

The meltdown in global financial markets has triggered a consolidation of the financial services industry as securities firms, asset managers, insurers and banks alike spin-off assets and restructure their operations to shore up capital. These transactions are often global in nature, involving substantial Hong Kong operations. In this article, we review the basic Hong Kong legal and regulatory framework for these transactions and present some lessons learned.

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Acquisitions of financial services firms are governed in Hong Kong by a patchwork of laws and regulations. Each sector of the industry has its own governing laws and regulators, each with different requirements. The core regulatory framework comprises the following:

- Banking and Deposit Taking. The Hong Kong Monetary Authority (“HKMA”) regulates commercial banks, private banks and other deposit taking institutions under the Banking Ordinance (“BO”).
- Insurance. The Insurance Authority (“IA”) regulates insurance companies under

the Insurance Companies Ordinance (“ICO”).

- Securities and Futures. The Securities and Commission (“SFC”) regulates merchant and investment banks, asset managers, brokers and investment advisers under the Securities and Futures Ordinance (“SFO”). The Hong Kong Exchanges and Clearing, which operates the Stock Exchange of Hong Kong (“SEHK”) and the Hong Kong Futures Exchange (“HKFE”), regulates brokers who are exchange participants.
- Provident and Retirement Schemes. The Mandatory Provident Fund Schemes

Authority (“MPFA”) regulates trustees and intermediaries of mandatory provident fund (“MPF”) schemes under the Mandatory Provident Fund Schemes Ordinance (“MPFSO”).

These laws create challenges specific to acquisitions of financial services firms – challenges which differ from sector to sector not only in respect of requirements arising upon changes in control and ownership but also in respect of ongoing conduct of business. Thus, whilst acquisitions of financial services firms share many characteristics with acquisitions of firms in other industries, an understanding of the legal and regulatory framework applicable to each sector is essential.

At the same time, the laws create overlapping regulatory regimes that may increase the complexity of an acquisition of a financial services firm. For example, it is not uncommon for an insurance company to be regulated by the IA, for its asset management operations and its investment linked policies to be regulated by the SFC and for its retirement scheme operations to be regulated by the MPFA. Equally, for example, it is not uncommon for a bank to be regulated by the HKMA but to be subject ultimately to regulatory oversight by the SFC in respect of its securities and futures activities. In an acquisition, this overlap may necessitate approvals from multiple regulators or due diligence in respect of compliance with multiple regulatory regimes.

Acquisition Structure

As with any other acquisition, a critical initial step is to decide on the form of the transaction and,

more particularly, whether it will proceed through an acquisition of shares or assets. In the context of financial services firms, special considerations in this regard include the need to acquire regulatory licenses, registrations or authorizations, the efficient use of capital and the ease with which obligations to clients may be transferred.

Broadly, an acquirer may prefer a share acquisition where it does not have the requisite regulatory licenses, registrations or authorizations required to carry on the business to be acquired or where the obstacles to transferring obligations owed to clients are too high. However, an acquirer may prefer an asset acquisition where it wishes to integrate the business (and in particular, the client base) to be acquired into its existing operations platform.

Banks

The BO requires the prior consent of the HKMA for any change in the controllers, any change in the directors and any sale of all or any part of the business of an authorized institution (*i.e.* a licensed bank, restricted licensed bank or deposit-taking company authorized by the HKMA) incorporated in Hong Kong. For the purposes of the foregoing, a “controller” includes:

- a person who exercises or controls the exercise of 10 per cent. or more of the voting power of a general meeting of an authorized institution or any company of which the institution is a subsidiary, and
- any person in accordance with whose directions or instructions the board of

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directors of the authorized institution or any company of which the institution is a subsidiary is accustomed to act.

No similar statutory requirements for prior consent apply to authorized institutions incorporated outside of Hong Kong. However, it is advisable to verify whether the institution is subject to any conditions of authorization that may affect any acquisition.

Change in Management

The BO also requires the prior consent of the HKMA for any change in the chief executive of an authorized institution, whether incorporated in Hong Kong or not. In the case of an authorized institution incorporated outside of Hong Kong, the “chief executive” is the chief executive of the institution’s business in Hong Kong.

Mergers

The BO expressly provides for the transfer of authorization from one institution to another with the consent of the HKMA and upon such consent, for the transferee to have the same privileges, and to be subject to the same liabilities and penalties, under the BO as if the authorization had been originally granted to the transferee. However, it appears that these statutory provisions do not provide for the transfer of liabilities otherwise than under the BO and, more broadly, do not establish a statutory scheme for the merger of banks.

In practice, the transfer of authorization provisions may be appropriate for mergers of authorized institutions incorporated outside of Hong Kong where one of the

merged institutions has more limited operations in Hong Kong through a Hong Kong branch and a statutory scheme of merger or amalgamation is available under foreign law.

However, where Hong Kong incorporated authorized institutions merge, in light of the absence of generic statutory provisions for mergers of authorized institutions, it may be easier to effect a statutory merger through specially enacted legislation. Equally, where a merger involves an authorized institution incorporated outside of Hong Kong but with substantial operations in Hong Kong, it may be more appropriate to effect the merger through specially enacted legislation. Where legislation is specifically enacted, the transferee bank will need to ensure separately that it has been authorized to carry on the business which it will assume under the merger.

It is significant to note that where banks merge and the transferor bank is dissolved or wound-up or has its authorization with the HKMA revoked, no person who was the chief executive, a director or a manager of the transferor bank may become an employee of any authorized institution, including the transferee bank, without the consent of the HKMA.

Equally, it is significant to note that where the transferor bank has local branches in Hong Kong which are to be taken over by the transferee bank, the approval of the HKMA is required for the transferee bank to maintain those branches.

Acquisitions by Local Hong Kong Banks

Acquisitions by local Hong Kong banks of overseas financial institutions will generally require prior

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approval of the HKMA. In particular, the BO requires authorized institutions incorporated in Hong Kong which seek to establish or acquire overseas banking corporations or which seek to establish or maintain any overseas branch of overseas representative office to obtain the prior approval of the HKMA.

More generally, an authorized institution incorporated in Hong Kong may not acquire (except as security or as a result of enforcement of security) all or part of the share capital of a company to a value of 5 per cent. or more of its capital base without the prior approval of the HKMA. In the case where such an institution acquires or holds any part of the share capital of any another companies to a value in excess of 25 per cent. of its capital base, the HKMA may not grant approval except in prescribed circumstances, including where the company whose shares are to be acquired carries out nominee, executor or trustee functions or other functions related to banking business, the business of taking deposits, insurance business, investments or other financial services.

Insurance Companies

In a similar way to the BO, under the ICO, no person may become a shareholder controller of an authorized insurer (*i.e.* an insurance company authorized by the IA to carry on a class of insurance business) incorporated in Hong Kong unless the IA confirms that it has no objection to the person becoming a controller or the IA does not, following notice of the proposal for the person to become a controller, object within prescribed statutory period. For this purpose, a

“shareholder controller” means a person who, either alone or with any associate or through a nominee, is entitled to exercise, or control the exercise of, 15 per cent. or more of the voting power at any general meeting of the insurer. As an “associate” includes a subsidiary of a body corporate, a change in a shareholder controller may occur, for example, where there is a change in the shareholding of the ultimate holding company of the authorized insurer.

No similar express statutory requirement applies to changes in shareholder controllers of authorized insurers incorporated outside of Hong Kong. However:

- such insurers may be subject to a condition of authorization requiring consent of the IA for a change in shareholder controller, and
- following a change in shareholder controller, even for an authorized insurer incorporated outside of Hong Kong, the IA takes the view that it may object to the “appointment” of the shareholder controller if the shareholder controller is not, in its view, fit and proper to hold that “position”.

As a result, in practice, it may be prudent to discuss the fitness and properness of the shareholder controller in advance of a change of shareholder controller.

Changes in Management

Under the ICO, no authorized insurer may appoint a management controller unless the IA confirms that it has no objection to the appointment or the IA does not object to the appointment within the prescribed statutory period. For

[N]o person may become a shareholder controller of an authorized insurer incorporated in Hong Kong unless the IA confirms that it has no objection to the person becoming a controller.

this purpose, a “management controller” means a managing director or the chief executive of the authorized insurer as well as the chief executive of any insurance company that is a holding company of the authorized insurer.

In the case of an authorized insurer incorporated outside of Hong Kong, a managing director includes a managing director in respect of so much of its insurance business as is carried on within Hong Kong and a chief executive includes an employee of the insurer who is responsible for the conduct of the whole of the insurance business carried on by the insurer solely within Hong Kong elsewhere.

Mergers

The IO expressly establishes statutory schemes for the transfer of both long-term and general insurance business from one insurer to another. Under both provisions, a pre-requisite is that the transferee insurer be authorized to carry on the class of insurance business to be transferred.

In the case of long-term insurance business, the transfer is effective upon court sanction. In this regard, the IO requires the court to ensure that the IA has been consulted (and in practice, does not object), policy holders have been notified and an actuary has reached the opinion that the scheme will not have any adverse effect on the reasonable benefit expectations of policy holders of both the transferor and transferee. The court will generally sanction the scheme unless it considers that the scheme as a whole is unfair as between the interests of the different classes of persons who are affected.

As part of the court order sanc-

tioning a scheme of transfer for long-term insurance business, the court may order the transfer of the whole or any part of the undertaking and of the property or liabilities of the transferor company and such incidental, consequential and supplementary matters as are necessary to secure that the scheme shall be fully and effectively carried out.

In the case of general insurance business, the transfer is effective upon the approval of the IA. In this regard, the IO requires public notice of the transfer and allows policy holders to make representations to the IA in respect of the transfer. The approval of the IA operates only to transfer the rights and obligations under the policies to be transferred and may, if the transfer documentation so provides, secure the continuation by or against the transferee of any legal proceedings by or against the transferor which relate to those rights and obligations. It does not operate as a general transfer of all assets and liabilities.

Securities and Futures

The SFO distinguishes between licensed corporations and registered institutions. Registered institutions are authorized institutions regulated by the HKMA but which are registered with the SFC to carry on a business in a regulated activity in the securities or futures markets, including dealing in securities or futures, advising on securities, futures or corporate finance and asset management. Licensed corporations are non-bank securities firms which are licensed by the SFC to carry on a business in a regulated activity in the securities or futures markets.

The SFO requires prior approval

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of the SFC for a person to become a substantial shareholder of a licensed corporation. For this purpose, a “substantial shareholder” includes a person who has an interest in shares in the corporation:

- the nominal value of which shares is equal to more than the nominal value of 10 per cent. of the issued share capital of the corporation, or
- which entitles the person, either alone or with any of his associates and, either directly or indirectly, to exercise or control the exercise of more than 10 per cent. of the voting power at general meetings of the corporation.

A chain principle applies to the definition so that a person who holds shares in a holding company of a licensed corporation which entitles him to exercise or control the exercise of 35 per cent or more of the voting power at general meetings of the holding company may be regarded as a substantial shareholder of the licensed corporation.

The prior approval of the SFC is not required under the SFO in the case of a person becoming a substantial shareholder of a registered institution. However, as set out above, approval of the HKMA may be required.

Change in Management

The SFO also requires the prior approval of the SFC for a person to become a responsible officer of a licensed corporation. A “responsible officer” is a person responsible for supervising a regulated activity of a licensed corporation. Every person who is a member of the board of directors of the licensed corporation and who actively par-

ticipates in or directly supervises any regulated activity of a licensed corporation must be approved by the SFC as a responsible officer.

At the same time, the BO requires the prior consent of the HKMA for a person to become an executive officer of a registered institution. An “executive officer” is a person responsible for directly supervising the conduct of each business conducted by the institution that constitutes a regulated activity under the SFO.

It is significant to note that under the SFO, every licensed corporation is required to have not less than 2 responsible officers for each of its regulated activities and under the BO, every registered institution is required to have not less than 2 executive officer for each of its regulated activities. As the regulations governing the exercise of discretion for approval of responsible officers and executive officers requires that such persons have minimum industry experience and regulatory knowledge, an acquirer must be careful to ensure that changes in management personnel, whether arising from resignations of directors at completion, insufficient retention incentives or otherwise, do not result in a shortage of responsible and executive officers and hence, unnecessary disruption of the acquired business.

Mergers

The SFO neither provides for the transfer of licenses and registrations nor for the transfer of assets from a licensed corporation or registered institution to another. Indeed, regulations under the SFO governing custody of client assets may create difficulties for an acquirer who wishes to migrate cli-

The SFO requires prior approval of the SFC for a person to become a substantial shareholder of a licensed corporation.

ent portfolios from the acquired business onto its existing operations platform.

To the extent that operations of a licensed corporation are to change as a result of a merger, it is necessary to ensure that the licensed corporation is licensed for the regulated activities which it will carry on following the merger. At the same time, it is notable that any significant changes in the business plan or nature of business of the licensed corporation must be notified to the SFC. An asset purchase, which substantially changes the scope or nature of the business of the acquirer, may therefore oblige the acquirer to notify the SFC of the purchase following completion of the purchase. Whilst this does not amount to a pre-approval requirement, if the SFC is not satisfied that the acquirer remains fit and proper following the completion of the purchase, it may take action to suspend the activities of the acquirer. As a result, it may be desirable to discuss the merger with the SFC in advance of completion.

It is advisable, as usual, to check any conditions of licensing or registration to ascertain whether such conditions may affect any merger.

Hong Kong Exchanges

In the case of a transferor licensed corporation which is a holder of a trading right on the SEHK or the HKFE, the rules of the SEHK or the HKFE may apply to the acquisition.

In the case of the acquisition of the shares of a licensed corporation which holds a trading right but which is not a participant of the SEHK or HKFE, a transfer of a trading right will be deemed to occur if there is a change in control

of the licensed corporation (or of any holding company of such corporation). If a transfer of a trading right on the SEHK will be deemed to occur, the licensed corporation will need to apply to the SEHK (i) to become an exchange participant, or (ii) to relinquish the trading right. Similarly, if a transfer of a trading right on the HKFE will be deemed to occur, the licensed corporation will need to apply to the HKFE for approval of the transfer or relinquishment of the trading right.

Trading rights themselves are transferable only once up to March, 2010. As above, a trading right on the SEHK may only be transferred if the transferee applies successfully to the SEHK to become an exchange participant and a trading right on the HKFE may only be transferred if the transferee applies successfully to the HKFE for approval of the transfer. In either case, it is possible for an acquirer to apply directly to the SEHK or the HKFE for a trading right.

Retirement Schemes

Under the MPFSO, a person may not become a substantial shareholder of an approved trustee of an MPF scheme without the prior consent of the MPFA. For this purpose, a “substantial shareholder” includes a person who, together with any associate, controls at least 15 per cent of the voting shares of the approved trustee. In light of the definition of an “associate” under the MPFSO, a change in the shareholding of a holding company of an approved trustee may require consent of the MPFA on the basis that the holding company may control, directly or indirectly, the exercise of that voting power of the approved trustee or

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influence substantially the exercise of that voting power.

Approvals of trustees may be subject to conditions and, consequently, it is advisable to ascertain whether there are any conditions applicable to a trustee to be acquired which may affect any acquisition.

Management

An approved trustee of an MPF scheme must not appoint a person to be its chief executive officer or as one of its directors without the prior consent of the MPFA. At the same time, (i) an approved trustee must have at least 5 directors, all of whom are natural persons, (ii) a majority of its directors must have the skill, knowledge, experience and qualifications that are, in the opinion of the MPFA, necessary for the successful administration of provident fund schemes, and (iii) the approved trustee must have sufficient expertise and management resources in Hong Kong.

Mergers

The MPFSO does not expressly address mergers involving an approved trustee. However, approved trustees are required to comply with prescribed qualifications and capital adequacy requirements and if they do not, the MPFA may revoke their approval.

Consequential Matters

Where a financial institution is the subject of a merger or acquisition and that institution is an insurer, investment manager, custodian of an MPF scheme, the eligibility of that institution to continue in that role must be assessed in accordance with the MPFSO.

Human Resources

As with many acquisitions, a key concern for an acquirer may be to retain key personnel of the firm to be acquired. This concern is particularly critical for many sub-sectors of the financial services industry, including for example, private banking, which are sometimes heavily relationship based.

News of an acquisition inevitably raises uncertainty in the minds of personnel of the firm to be acquired. Such individuals may fear for job security, may be wary of incompatibilities with new management or may consider that the platform offered by the acquirer is undesirable. These concerns in turn raise the real possibility that such individuals may seek employment or engagement elsewhere or that competitors may seek to exploit their fears and entice them away.

Responses

Experience suggests that it is critical for an acquirer:

- to put in place retention arrangements for key personnel of the target firm as soon as possible so that these important assets do not walk out the door, and
- to communicate with clients of the target firm so as to mitigate the impact of any loss of key salespersons.

An acquirer may counter the possible loss of personnel at the target firm by offering retention packages under which employees may receive economic incentives to remain at the target firm. In this regard, an acquirer should aim to put retention packages in place as soon as possible and ideally, at the

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time of the disclosure of the acquisition to pre-empt the loss of key personnel. However, a vendor is likely to be reluctant to allow an acquirer the freedom to communicate and contract with personnel of the target firm and thus, an acquirer should work with legal counsel to ensure that the transaction documentation can accommodate this.

As an adjunct to a retention package, an acquirer may consider a communications program to counter the loss of personnel and clients ahead of the completion of the acquisition. For personnel, timely and regular communications may counter fears for the worst and for clients, they may provide a more balanced perspective on the purchase, a perspective that clients may not get from nervous salespersons ready to jump to a competitor. However, again, a vendor is likely to be reluctant to allow an acquirer the freedom to communicate with personnel and clients and thus, an acquirer should work with its legal counsel to ensure that a communications program can be accommodated within the transaction documentation.

Due Diligence

Due diligence is a natural and essential part of any acquisition, not only to understand the business of the target firm but also to avoid the unknowing assumption of li-

abilities. Acquisitions of financial services firms may raise some special due diligence issues.

The SFO, for example, imposes statutory obligations of non-disclosure as regards any ongoing regulatory investigation. A target firm could be subject to an ongoing investigation but, although the details of the investigation may be material to the acquirer, the statutory secrecy obligations would limit the extent of disclosure available to the acquirer. Similarly, the acquirer will naturally be interested in having access not only to the target firm client list but also to each client's business history with the target firm. This information may be subject to personal data privacy laws.

Furthermore, given the complex regulatory framework governing each sub-sector of the financial services industry, due diligence will generally be required to assess compliance and in this regard, the potential for major regulatory enforcement action against any acquired firm.

Post-merger integration

The post-merger integration process should be carefully planned. A compliance audit should be performed to ensure that there are no unknown material violations of applicable laws and regulations

and that appropriate notifications in respect of the completion of the acquisition are sent to the regulators. Capital efficiency scenarios should also be considered to maximize the benefits of the consolidation. The merger of front office or back office operations is not an easy task and should not be underestimated. The merger of different IT systems may be particularly complicated given regulatory requirements including record keeping and client reporting requirements. The potential need for clients to re-sign documentation may be a cumbersome process. ■

TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to financial institutions. The firm has advised on acquisitions, mergers and corporate re-organizations of insurance companies, banks and securities firms. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200. It is ranked by the International Financial Law Review 1000 as a leading practice in Hong Kong banking law and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.

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