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This Hong Kong regulatory update provides a brief overview of the principal Hong Kong regulatory developments in the preceding three months relevant to companies listed or proposed to be listed on The Stock Exchange of Hong Kong Limited (**HKEx**) and their directors, management and advisers. The updates include HKEx announcements and rule or guidance changes, Securities and Futures Commission (**SFC**) decisions and updates, and both HKEx and SFC enforcement-related news. In this update we cover:

- HKEx issues a guidance letter on "shell company" listings
- New listing decision regarding reliance on unrealized fair value gains to meet the profit requirement in a spin-off proposal
- New listing decisions regarding reverse takeovers
- New listing decisions regarding sufficiency of operations or assets after a major disposal as required under Rule 13.24 of the Hong Kong Listing Rules
- New listing decisions explaining the reasons for rejection and return of certain listing applications in 2015
- HKEx issues a guidance letter for issuers subject to market commentaries or rumors
- HKEx issues a guidance letter on bonus issues of shares
- HKEx publishes its latest listing committee report
- HKEx reports on its review of listed issuers' corporate governance practice disclosure in annual reports for the year ended March 2015
- SFC reminds issuers to keep trading suspensions to the minimum
- Guidance on mandatory offer obligation waivers in acquisitions of voting rights by members of a concert group
- SFC issues a corporate regulation newsletter regarding publishing announcements and disclosure of inside information by listed companies
- Recent enforcement actions and penalties

Of particular note are the guidance letters and listing decisions — with respect to shell listings, reverse takeovers and sufficiency of assets — which underscore a heightened push by Hong Kong's regulators to actively monitor the quality of companies listed on the HKEx.

## HKEx Issues a Guidance Letter on "Shell Company" Listings

The HKEx issued guidance letter (GL68-13A), setting out its guidance on the suitability for listing of companies that are, in the HKEx's view, potentially "shell companies." Based on its analysis of recent listings, the HKEx has identified shell companies as possessing one or more of the following characteristics:

- small market capitalization after listing;
- only marginally meeting the listing eligibility requirements;
- fundraising disproportionate to its listing expenses (*i.e.*, a high proportion of the listing proceeds used to pay listing expenses);
- possessing a pure trading business with a high concentration of customers;
- asset-light businesses where a majority of the assets are liquid and/or current assets;
- a superficial delineation of business from the parent whereby the company's business is artificially delineated from the parent by geographical area, product mix or different stages of development; and/or
- little or no external funding at the pre-listing stage.

The HKEx expects companies exhibiting one or more of these characteristics to provide a robust and detailed analysis to substantiate that they are suitable for listing, including with respect to the proposed use of proceeds, future objectives and strategies, profit and revenue growth, and (for companies operating in potential sunset industries) ability to adapt to changing market demands.

The HKEx may impose additional requirements or conditions on companies with the above characteristics or exercise its discretion to reject the applicant's listing on the grounds of suitability. While a company may consult with the HKEx on a confidential basis for an interpretation of the listing rules or specific issues raised in this guidance letter, the HKEx has indicated that it will not give specific guidance on their suitability as a whole for the purpose of this guidance letter until a formal listing application is made.

## New Listing Decision Regarding Reliance on Unrealized Fair Value Gains to Meet the Profit Requirement in a Spin-off Proposal

The HKEx recently published a new listing decision LD93-2016 regarding reliance on unrealized fair value gain to meet the profit requirement in a spin-off proposal. In this listing decision, a listed company (**Company A**) was engaged in a number of businesses, including the manufacture and sale of certain household products (the **Manufacturing Business**) and property investment (the **Property Business**). Company A proposed to inject the existing Manufacturing Business into a new company (**Newco**) and seek a separate listing of the Manufacturing Business on HKEx. After the proposed spin-off of the Property Business, Company A (excluding Newco) (the **Remaining Group**) would continue to carry out the Property Business and the other businesses.

When considering the spin-off proposal, HKEx noted that:

- the Remaining Group's profits during the track record period were mainly attributable to unrealized fair value gains on investment properties retained by the Remaining Group;
- the other businesses retained by the Remaining Group operated at a loss or generated minimal profits;
- the Remaining Group held a number of properties in commercial, industrial and residential buildings in Hong Kong and the PRC for leasing and capital appreciation purpose and did not carry out any property development or construction during the track record period; and
- the Remaining Group generated rental income in the range of about HK$15 million to HK$30 million.

The HKEx rejected the proposed spin-off, concluding that the Remaining Group was not suitable for listing by virtue of its reliance on fair value gains on investment properties to meet the minimum profit requirement. In particular, the HKEx noted the following reasons:

- as explained in prior guidance issued by the HKEx, companies relying on unrealized fair value gains must demonstrate that they had a substantive property business during the track record period and that the business is sustainable going forward;
- the Remaining Group's Property Business (which generated annual rental income of about HK$15 million to HK$30 million in the latest three years) was not considered substantive;
- the Remaining Group did not have any property projects under development or significant recurring income to demonstrate the sustainability of the Property Business; and
- the plan to expand the property portfolio submitted by Company A was preliminary and did not demonstrate that the Property Business would generate a significant level of recurring income in the future and that the Remaining Group had a substantive and sustainable property business.

## New Listing Decisions Regarding Reverse Takeovers

The HKEx published three listing decisions regarding reverse takeovers, namely LD94-2016, LD95-2016 and LD96-2016. These decisions highlight the heightened risk of significant acquisitions being viewed as reverse takeovers, together with

the subjective and somewhat unpredictable nature of HKEx decisions in this area. In these listing decisions, the HKEx applied the following criteria from the principle based test outlined in its Guidance Letter GL78-14:

- the size of the transaction relative to the size of the listed company;
- the quality of the business to be acquired — whether it can meet the trading record requirements for listings or whether it is unsuitable for listing (*e.g.*, an early stage exploration company);
- the nature and scale of the listed company's business before the acquisition (*e.g.*, whether it is a listed shell);
- any fundamental change in the listed company's principal business (*e.g.*, the existing business would be discontinued or very immaterial to the enlarged group's operations after the acquisition);
- other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the reverse takeover rules (*e.g.*, a disposal of the listed company's original business simultaneously with a very substantial acquisition); and
- any issue of restricted convertible securities (*i.e.*, highly dilutive convertible securities with a conversion restriction mechanism to avoid triggering a change of control under the Takeovers Code) to the vendor which would provide it with *de facto* control of the issuer.

### LD94-2016

In LD94-2016, the issuer (**Company A**) proposed to subscribe for an interest as a limited partner in a fund (the **Fund**) with commitments of about HK$4.5 billion (which was about 80 percent of the size of the Fund). Company A would have no control over or right to participate in the management of the Fund and the investments to be made by the Fund. The proposed subscription represented about 80 percent of the asset value and over 900 percent of the market capitalization of Company A. Company A intended to finance the subscription using a loan facility granted to it by its controlling shareholder and its internal resources.

#### Decision

HKEx noted that the proposed subscription in the Fund would fall outside the bright line tests for reverse takeovers in Rule 14.06(6). Applying the principle based test with reference to the criteria set out in its Guidance Letter GL78-14, the HKEx considered the proposed subscription in the Fund would be a reverse takeover under Rule 14.06(6) of the Listing Rules because:

- the subscription was of a significant size to Company A based on the asset ratio of 80 percent and the consideration ratio of 900 percent and the investment in the Fund would represent a significant part of Company A's assets;
- the subscription was a means to circumvent the new listing requirements (the Fund was newly set up and did not have any investments or assets and had no track record to meet the profit requirement under Rule 8.05); and
- the fact that Company A would have no control over or right to participate in the management of the Fund or the investments to be made by the Fund raised a concern about suitability for listing.

### LD95-2016

In LD95-2016, the issuer (**Company B**) was principally engaged in the manufacture and sale of household products. Company B proposed to acquire a target (the **Target**), which was newly set up by Mr. X to hold certain inventories, machinery and equipment for the production of beverage products (the **Target Assets**). As the Target had not yet obtained a license for manufacturing beverage machinery and equipment for manufacturing beverage products, it would enter into supply and sales contracts with a PRC Company (the **PRC Company**) pursuant to which the PRC Company would manufacture beverage products for the Target using the Target Assets and the Target would sell the beverage products to the PRC Company.

The asset and consideration ratios for the transaction were about 300 percent and 200 percent, respectively. Company B would satisfy the consideration by issuing new shares and convertible bonds (with a conversion restriction that prevented Mr. X from holding a 30 percent interest or higher) to Mr. X. As a result, Mr. X would become the single largest shareholder (28 percent) of Company B upon completion of the acquisition. Assuming full conversion of the convertible bonds, Mr. X would hold about 78 percent of Company B's issued share capital.

#### Decision

The HKEx noted that the proposed acquisition would fall outside the bright line tests for reverse takeovers in Rule 14.06(6). Applying the principle based test with reference to the criteria set out in its Guidance Letter GL78-14, the HKEx determined that the proposed acquisition would be a reverse takeover under Rule 14.06(6) of the listing rules because:

- the proposed acquisition was a means to circumvent the new listing requirements as:
  - the Target did not meet the new listing requirements and had no trading record to meet the profit requirement under Rule 8.05(1); and
  - the Target would be unsuitable for listing under Rule 8.04 as it would heavily rely on the PRC Company for both the production and sale of its products and would be unable to carry on its business independently;

- the value of the Target Assets was significant to Company B, representing about three times the value of Company B's assets, and would represent a fundamental change to Company B's existing businesses; and
- the proposed acquisition would be a means for Mr. X (who would become the single largest shareholder of Company B) to list the Target by injecting it into Company B.

Subsequent to this decision, Company B submitted a revised proposal as follows:

- Company B will acquire only a 30 percent interest in the Target;
- consideration would be reduced accordingly and satisfied by the issue of the consideration shares and promissory notes to Mr. X; and
- the asset and consideration ratios would be about 80 percent and 90 percent, respectively.

Notwithstanding the fact that the revisions would result in the transaction being a "major" transaction as opposed to a "very substantial acquisition" under the listing rules, the HKEx considered that the revised proposal would still be a reverse takeover under Rule 14.06(6) because:

- as set out in the Guidance Letter GL78-14, HKEx does not prescribe an absolute threshold in determining whether the size of a transaction is extreme;
- when assessing the impact of an acquisition on an issuer, HKEx would take into account the nature and scale of the listed company's existing business after the acquisition, and whether the acquisition would result in a fundamental change to that business;
- the revised proposal would still be significant for Company B and was a means to circumvent the new listing requirements as the Target's business was completely different from Company B's existing business and was not suitable for listing; and
- the revised proposal was an extreme case based on a combination of these criteria.

### LD96-2016

In LD96-2016, the listed company (**Company C**) was principally engaged in trading of food and beverage products. Company C proposed to acquire a target (**Target D**) from another company (**Company D**). Target D was engaged in the production and sale of certain types of organic fertilizers and sold its products to end users through its own sale team and a number of distributors and had recorded profits of between HK$15 million and HK$20 million in the last three years. Company D was the sole supplier of a major raw material (the **Material**) necessary for producing Target D's products and produced the Material using a unique technology developed and owned by it. Target D intended to produce the Material itself and expected to master the technology to do so within three years.

The consideration would be settled by issuing convertible bonds to Company D (with a conversion restriction that prevented Company D from holding a 30 percent interest or higher). Assuming full conversion of the convertible bonds, Company D would hold over 50 percent of issued shares of Company C. The revenue, consideration and equity ratios of the proposed transaction were between 100 percent and 150 percent while the asset ratio was about 90 percent. Company C submitted that Target D would meet the minimum profit requirement under Rule 8.05 and that the size of the acquisition was not extreme.

#### Decision

The HKEx noted that the proposed acquisition would fall outside the bright line tests for reverse takeovers in Rule 14.06(6). In determining that the proposed acquisition would constitute a reverse takeover, the HKEx noted:

- the proposed acquisition was a means to circumvent the new listing requirements because Target D was unsuitable for listing as it relied on Company D's supply of the Material, which was critical to its business operations, and it was uncertain if and when it would be able to manufacture the Material itself;
- Target D's business would be significant to Company C after the acquisition as Company C was operating at a loss in recent years and only operated a trading business that had a low level of activities and generated minimal gross profit, and Target D's business also would represent a fundamental change in Company C's principal business; and
- the acquisition would be a means for Company D (who would acquire *de facto* control of Company C using restricted convertible securities) to list Target D by injecting it into Company C.

## New Listing Decisions Regarding Sufficiency of Operations or Assets After a Major Disposal as Required Under Rule 13.24 of the Hong Kong Listing Rules

The HKEx recently published new listing decisions regarding Rule 13.24 of the Listing Rules, which requires companies to retain sufficient operations or assets to justify their continued listed status after a major disposal.

### LD97-2016

A listed company (**Company A**) and its subsidiaries (the **Group**) were engaged in property construction and related businesses (the **Construction Business**). The Group recently had diversified into property management (the **Property Business**) and the trading of financial products (the **Trading Business**, together with the Property Business, the **Remaining**

**Businesses**). Company A proposed to sell the Construction Business to Mr. A, who was the former controlling shareholder of Company A prior to selling his interest in Company A to the existing controlling shareholder (**Disposal A**). Company A submitted that: (i) the Construction Business had been operating at a loss over the last two years; (ii) Disposal A would allow the Group to diversify into other businesses with growth potential; and (iii) the sale proceeds would be used by the Group as general capital. Disposal A would reduce the Group's revenue and assets by about 70 percent and would constitute a major transaction subject to shareholder's approval.

The HKEx noted that the Rule 13.24 requirement for maintaining sufficient level of operations and assets of sufficiency value is a qualitative test and is assessed on a case-by-case basis. The HKEx concluded that Company A would not have sufficient operations or assets for the following reasons:

- the Construction Business was Company A's main business since its listing and accounted for 70 percent of Company A's revenue and assets, and Disposal A would substantially reduce Company A's scale of operations and assets;
- the scale of the Remaining Businesses was insufficient to justify a listing; and
- the Group would not have sufficient assets to justify a listing after Disposal A as:
  - the assets of the Remaining Businesses were mainly cash and trade receivables, and the operations of these assets could not generate sufficient revenue and profits to justify a listing; and
  - the Property was the only other asset of the Group and it had a value of only HK$20 million.

**LD98-2016**

In LD98-2016, a listed company (**Company B**), through its subsidiary (**Subsidiary B**), was principally engaged in the event operation and entertainment business.

Company B proposed to (i) sell a 25 percent interest in Subsidiary B to a buyer (**Disposal B**); and (ii) grant a call option (the **Call Option**) to the buyer over the remaining 75 percent interest in Subsidiary B exercisable 24 months after Disposal B. Company B intended to diversify into other businesses in the meantime. Disposal B would be a discloseable transaction for Company B and, together with the grant of the Call Option, would be a very substantial disposal with the revenue and assets ratio of nearly 100 percent.

Company B submitted that it would be able to meet Rule 13.24 upon completion of the proposal because:

- until and unless the buyer exercised the Call Option, Company B would continue to control Subsidiary B and therefore its business operations and assets; and
- the Call Option was not exercisable until 24 months after Disposal B. By the time it was exercised, Company B would have had time to expand into other businesses.

In concluding that Disposal B rendered Company B unable to comply with Rule 13.24, the HKEx noted:

- the exercise of the Call Option was entirely at the buyer's discretion. By granting the Call Option, Company B was prepared to lose its ownership and control over its principal business. Whether and when the buyer would exercise the Call Option was irrelevant; and
- Company B stated its intention to carry out other businesses, but could not demonstrate that it would have a new business suitable for listing upon completion of the proposal.

**LD99-2016**

In LD99-2016, the listed company (**Company C**) and its subsidiaries (the **Group**) were engaged in the manufacturing and distribution of multimedia and communication products. One of the Company C's subsidiaries, Subsidiary C, was engaged in manufacturing and distributing communication products of a major brand of the Group and accounted for about 90 percent and 75 percent of Company C's revenue and assets (the **Disposal Business**). Subsidiary C was operating at a loss in the latest financial year and recorded a profit over HK$30 million in each of the past few years. It was proposed that Company C and Mr. X would enter into the following transactions:

Company C would sell Subsidiary C to Mr. X (a controlling shareholder of Company C) for cash (**Disposal C**). Disposal C would constitute a very substantial disposal and connected transaction, subject to independent shareholders' approval; and

- Mr. X would sell his entire shareholding in Company C to a third party, Mr. Y, who would then make an offer to acquire all the remaining shares in Company C from other shareholders, and the transaction was a condition to the completion of Disposal C.

Upon completion of Disposal C, Company C would continue its existing business in manufacturing and distributing multimedia and communication products, excluding the product line owned by Subsidiary C (the **Remaining Business**). Company C submitted that it would be able to meet Rule 13.24 upon completion of the Disposal based on the following:

- the Remaining Business recorded revenue and profit of over HK$200 million and HK$4 million, respectively, for the latest financial year;

- subsequent to the disposal the Group would have total assets of about HK$450 million, including trade and other receivables, cash, inventories, fixed assets and trademark;
- based on Company C's profit forecast, the Remaining Business would continue to record profit and grow steadily;
- the Remaining Business comprised distinct product lines and operated independently from the Disposal Business with its own manufacturing and distribution teams; and
- Disposal C would improve the Group's financial performance by disposing the business that is operating at a loss.

The HKEx considered that Company C would not have sufficient operations or assets to meet Rule 13.24 upon completion of Disposal C for the following reasons:

- Disposal C would reduce substantially Company C's scale of operations and assets;
- the Remaining Business recorded only minimal profit for the latest financial year and was loss making in the past few years and did not have a proven track record. Company C's profit forecast also failed to show substantial improvement after Disposal C;
- the assets of the Remaining Business would be insufficient to meet Rule 13.24 because they could not generate sufficient revenue and profits to justify a listing. The other asset of the Group would be the cash proceeds from Disposal C, but Company C could not demonstrate how the cash retained would enable it to substantially improve its operations; and
- Disposal C formed part of the arrangements between Mr. X and Mr. Y and was made to facilitate the sale of a controlling interest in Company C. The Disposal Business accounted for the bulk of Company C's existing businesses and had been profitable in the past except in the latest financial year. Company C failed to support its case that Disposal C would improve its financial performance or demonstrate that the Remaining Business was viable and sustainable.

## New Listing Decisions Explaining the Reasons for Rejection and Return of Certain Listing Applications in 2015

In April 2016, the HKEx published two listings setting out the reasons for rejection and return of certain listing applications in 2015, a summary of which is set out below:

### Rejected Cases

| Company | Reasons for Rejection |
|---|---|
| **A mining company whose principal operations and assets were in a high risk jurisdiction** | - being located in a jurisdiction with legal and political uncertainties and high Corruption Perceptions Index gave rise to the questions whether the company would be able to carry out its business in a viable manner or retain ownership of its assets;<br>- repeated delays in the trial production schedule for a major project during and after the track record period; and<br>- its other mining projects had ceased operation after the track record period pending renewal of the company's exploration license, which had been outstanding since submission of listing application. |
| **A company in a gambling-related business that received income from casino operators for introducing VIP players to designated VIP rooms at the casino operators' venues** | - deteriorating financial performance during the track record period was unlikely to be short term;<br>- questionable payments of service fees to a connected person who represented a material portion of the selling, general and administrative expenses; and<br>- track record results were not representative of its future performance due to material changes in its revenue model since the third quarter of the second year of the track record period. |
| **A company providing services in the construction industry** | - material noncompliances for undertaking projects that exceeded the permitted scope of its qualification and failing to comply with the work safety licence requirement during the track record period;<br>- failing to demonstrate satisfaction of the profit requirement under Rule 8.05(1)(a) after exclusion of the profit contributed by the material impact noncompliant business during the track record; and<br>- failing to satisfy HKEx rules that the directors had the integrity, competence and required level of skill, care and diligence as they had been aware of the noncompliances and the company continued to carry on its business during the track record period. |

## Rejected Cases *(continued)*

| Company | Reasons for Rejection |
|---|---|
| **A mining company, which commenced commercial production in 2014, recorded immaterial revenue in 2014 and the first half of 2015 and applied for a waiver from strict compliance with the profit requirement of Rule 8.05 under Rule 18.04** | The company failed to demonstrate that the mine had a clear path to commercial production and a demonstrable path to profitability based on the following factors:<br>- insufficient justification for the breakdown analysis to substantiate the mine's profitability;<br>- failing to demonstrate that it was able to generate sufficient funding for a planned increase of its annual designed mining capacity where approximately half of the required funding had to be derived from the company's operating activities and/or future fund raisings; and<br>- uncertainties as to whether the company would be able to renew its mining permit for insufficient funds to design and construct the relevant facilities and measures and pay relevant fees and taxes. |
| **A property investment company** | - no track record of current business structure (originally operated by the controlling shareholder who was assisted by one staff member and 11 staff were employed in preparation for listing);<br>- extreme reliance on fair value gains from investment properties to meet the minimum profit requirement as the fair value gains accounted for more than 80 percent of its net profit during the track record period; and<br>- deteriorating financial performance due to poor market outlook and failing to demonstrate the sustainability of the business. |
| **An exhibition organizer** | One of the directors was not considered suitable for the following reasons:<br>- failing to fulfill his fiduciary duties and act in good faith in the interests of company in respect of (i) two advances to third parties, which were significant but were unsecured, interest-free and with no fixed repayment terms, and (ii) receipt and deposit of partial repayments into his personal account;<br>- the advances and the receipt of partial repayments by the director resulted in material misstatements in the company's group-audited accounts;<br>- systemic noncompliances for six instances of noncompliances related to its core business during the track record period; and<br>- not enhancing its internal controls to prevent the reoccurrence of the systemic noncompliances. |
| **A company providing printing services** | Taking into account the following factors, there were concerns on the sustainability of the business:<br>- deteriorating financial performance showing a significant decline in net profit during the track record period (the largest customer shifted its orders to the company's competitor);<br>- profit forecast could not be substantiated;<br>- intense competition — the company was believed to have lost its largest customer due to price competition; and<br>- use of more than 90 percent of its net IPO proceeds to purchase new machines despite the fact that the utilization rates of the existing major machines were only between 46 and 55 percent during the track record period — the resulting additional depreciation charges arising from any new machines and the related additional fixed costs would negatively impact the company's future profitability. |

## Returned Cases

| Company | Reasons for Return |
|---|---|
| **A company providing conferencing services** | - failing to disclose in the application that connected persons had provided guarantees for loans to independent customers, which accounted for 3.5 to 11.1 percent of the total amount of loans granted during the track record period;<br>- HKEx considered transactions involving connected persons should be subject to a higher level of scrutiny and the amount involved does not need to be large for it to constitute material information; and<br>- there were associated concerns on the effectiveness of the company's corporate governance measures as there was no guarantee agreement between the company and the connected persons while the company entered into guarantee agreements with non-connected persons. No information was provided as to (i) the terms and conditions of the guarantees from the connected persons/how they could be enforced in the absence of agreements; and (ii) whether the guaranteed loans would continue and whether they would constitute connected transactions upon listing. |
| **A company providing conferencing services** | Omission of the following material information in the application relating to a director, who was also the company's chairman and controlling shareholder (Director I), that the HKEx considered material:<br>- a compulsory winding order granted by the court against a company in which Director I was an executive director and a minority shareholder; and<br>- certain noncompliances of the listing rules by two Hong Kong-listed companies during the period when Director I was a director of these companies. |
| **A company in the catering business** | Failing to provide, at the time of filing its Form 5A, a profit forecast memorandum covering the period up to the year ending [year T+1] as required under GEM Rule 12.22(14b) based on its proposed listing timetable as stated in its Form 5A (which is required where an application proof does not contain a profit forecast). |

## HKEx Issues a Guidance Letter for Issuers Subject to Market Commentaries or Rumors

In April 2016, the HKEx issued a guidance letter (GL87-16) to provide guidance to listed companies subject to market commentaries or rumors. The main principles set out in this guidance letter are summarized below:

### Address False or Disorderly Market Concerns

- the HKEx may inquire if it is concerned that certain allegations regarding a company may disrupt orderly share trading.
- If the allegations have, or are likely to have, an effect on the issuer's share price such that, in the view of the HKEx, there is or there is likely to be a false or disorderly market in the company's securities, the company must make a clarification announcement promptly, and this obligation exists whether or not HKEx makes an inquiry.
- If the company cannot promptly publish the clarification announcement, it must apply for a trading halt to prevent the possible development of a false or disorderly market.
- If trading is halted, the duration should be for the shortest possible period, and the company must ensure trading resume as soon as practicable following publication of a clarification announcement.
- The clarification announcement should (i) make reference to the allegations; (ii) inform the market about the company's position regarding each allegation; (iii) contain particulars to address, or to refute, the allegation; and (iv) disclose any inside information required to be disclosed under Part XIVA of the Securities and Futures Ordinance (or an appropriate negative statement).
- The HKEx may require the company to provide further information and halt trading pending further clarification if it believes that the clarification announcement would not address the concerns on false or disorderly market.

### Continuing Reviews or Investigation

- After publication of the clarification announcement, the HKEx may follow up with the company as it considers necessary on matters that have arisen out of the allegations and may even require the company to provide further information to support its denials of allegations, to review or investigate the claims and documents used to support the allegations.
- The company is expected to identify and correct any weaknesses in its internal controls and adopt good corporate governance practices.

- Where any follow up action reveals that an announcement or document was materially inaccurate or misleading, or that there are serious concerns about the company's compliance with Listing Rules, the HKEx may (i) suspend share trading pending further clarification, or (ii) make a referral to an appropriate law enforcement agency (*e.g.*, the SFC) for further action.

## HKEx Issues a Guidance Letter on Bonus Issues of Shares

The HKEx issued a guidance letter (GL88-16) in April 2016 regarding bonus issues of shares. A bonus issue of shares generally refers to an allotment of new shares by a listed company to its existing shareholders, credited as fully paid out of its reserves or profits, in proportion to their shareholdings. The main guiding principles in the guidance letters are summarized as follows:

### Size of Bonus Issues

- It is the responsibility of listed companies to ensure that their issues of bonus shares are conducted in a fair and orderly manner;
- The HKEx may not grant listing approval for large scale bonus issues of shares where there is reasonable likelihood of disorderly trading during the ex-entitlement period;
- Generally the HKEx is likely to raise concern about the operation of an orderly market when a company proposes a bonus issue of shares of 200 percent or more of the existing issued shares (or a smaller scale after considering the relevant facts and circumstances); and
- The HKEx will only grant approval for large scale bonus issues of shares (i) in exceptional circumstances (*e.g.*, there are regulatory restrictions for the company to effect a share subdivision under the laws in the place of its incorporation or the requirements of other stock exchange where it is dually listed) and (ii) the company demonstrates that the proposed issue is not likely to give rise to disorderly trading during the ex-entitlement period.

### Timetable for Bonus Issues

- Listed companies should follow the guidance set out in the HKEx's "Guide on Distribution of Dividend and Other Entitlements"; and
- Listed companies also should keep the time interval between the ex-date and the allotment date as short as possible.

### Trading Limits

- A bonus issue of shares (or share subdivision) that violates the principle of Rule 13.64 (which provides that the HKEx has the right to require a company to change the trading method or to proceed with consolidating its securities when the market price of its securities approaches the extremity of HK$0.01, which HKEx considers to be any trading price less than HK$0.1

## HKEx Publishes Its Latest Listing Committee Report

The HKEx recently has published its listing committee report, which provides an account of work of HKEx's listing committee in 2015. The statistics highlighted in this report include the following:

### Listing Applications

- Number of listing applications considered: 112 (2014: 92)
- Number of applications approved: 109 (2014: 91)
- Number of applications rejected (note that this only represents applications formally rejected by the listing committee and not those that have been returned or rejected by the listing division prior to their submission to the listing committee): nil (2014: nil)
- Decisions deferred pending further information: three (2014: one)
- Applications approved and listed in the year: 94 (2014: 91)
- Applications approved in previous year and listed in the year: 10 (2014: 12)
- Applications listed in the year: 104 (2014: 103)
- Average number of business days taken for issuance of the first round of comments: 11 (maximum: 16; minimum: six)

### Disciplinary Matters

- Average time for completion of an investigation for breaches of the listing rules: nine months (2014: 9.9 months)
- Number of requests for documents/information by the SFC and other law enforcement agencies dealt with and witness statements provided: 61 requests and 7 witness statements (2014: 42 requests and 10 witness statements)
- Disciplinary actions taken: five (2014: eight)
- Number of cases regarding alleged breaches of the listing rules considered by the listing committee and concluded in the year: six (2014: all subject to public sanction)
- Number of directors against whom action was taken: 31, including 12 independent non-executive directors (INEDs) (2014: 39, including 17 INEDs)
- Number of disciplinary or settlement cases resulting in an Internal Control Review direction: one (2014: one)
- Number of disciplinary or settlement cases resulting in a Retention of Compliance Adviser direction: one (2014: five)
- Number of disciplinary or settlement cases resulting in a Training of Directors direction: three (2014: five)

In this report, HKEx also highlighted the following matters that it plans to consider during 2016 and beyond:

- review of the IPO settlement cycle
- review of the Growth Enterprise Market
- review of the overseas company listing regime
- review of Chapter 37 on debt issues to professional investors only
- review of Chapters 2A and 2B (*i.e.*, HKEx's disciplinary powers and sanctions and procedural issues relating to committee hearings for disciplinary and non-disciplinary review)
- holistic review and regulations in connection with listed company activities including reverse takeovers and cash companies
- review of the handling of long-suspended companies, delistings and related requirements
- review of the requirements in relation to equity fundraisings of listed issuers
- review related to the government's proposal to improve the regulatory regime for listed companies' auditors

## HKEx Reports on Its Review of Listed Issuers' Corporate Governance Practice Disclosure in Annual Reports for the Year Ended March 2015

In May 2016, the HKEx published its analysis of corporate practice disclosure in 318 annual reports for the year ended March 2015. The relevant listed companies represent approximately 18 percent of all listed companies listed on the HKEx as of 31 March 2015. The report noted that:

- 25 percent of the companies complied with all of the Code Provisions (**CPs**) of the Corporate Governance Code; and
- 99 percent of the companies complied with 70 or more CPs, out of 75.

The HKEx noted that companies with medium market capitalization achieved the highest overall compliance rate compared to those with large or small market capitalization. The HKEx expressed concern that there was room for companies to improve the quality of the explanations they provided for the deviations from CPs and noted a certain degree of "boilerplate" style explanations, which were vague and had been repeated year after year.

The five CPs with the lowest compliance rates were:

- separation of the roles of chairman and chief executive;
- non-executive directors being appointed for a specific term, subject to re-election;
- non-executive directors' attendance at general meetings;
- chairman's attendance at annual general meeting; and
- directors appointed to fill a casual vacancy being subject to election by shareholders at the first general meeting, and every director being subject to retirement by rotation at least once every three years.

The HKEx also noted omissions of disclosures of the board diversity policy or a summary of the policy in 28 percent of the 10 percent randomly selected annual reports. The HKEx urged listed companies to take a closer look at their corporate governance reports and rectify any possible omissions in their next report.

## SFC Reminds Issuers to Keep Trading Suspensions to the Minimum

The SFC reiterated the importance to keep trading suspension to the minimum in its March Takeovers Bulletin. In addition to what has already been addressed in HKEx's Guidance Letter 83-15 (which sets out a number of "good practices" for trading halts), the SFC set out certain good practices in relation to suspensions of trading, including to:

- consult the SFC's executive (the **Executive**) early if takeover matters are involved;
- appoint professional advisers;
- maintain confidentiality;
- comply with statutory requirements, such as disclosure of inside information and disclosure of interests; and
- prepare draft announcements ahead of time so that the announcements are ready to be issued promptly if the need arises.

In addition, companies should:

- not sign transactional documents until the parties are ready to announce;
- include all required contents in announcements and circulars; and
- make sure that the first draft submitted to the SFC is comprehensive.

## Guidance on Mandatory Offer Obligation Waivers in Acquisitions of Voting Rights by Members of a Concert Group

The SFC revisited Note 1 to Rule 26.1 of the Takeovers Code. The note states that when changes in the make-up of a concert group that effectively result in a new group being formed or the balance of the group being changed significantly, the executive will apply a set of criteria and require a general offer to be made even when no single member holds 30 percent or more. The SFC stresses in the guidance that Rule 26.1 is strictly regulated. Transfer of voting rights by one member to another in a concert group, causing the purchaser's shareholding to cross a threshold, will "normally" result in an obligation to make a general offer for the outstanding shares.

If an exemption is to be made to the rule under Note 1, a comprehensive submission should be made to the executive early. Exemptions usually will be granted if (i) the acquirer is a member of a group of companies and one member of that group acquired the voting rights from another member; or (ii) if the group contains the individual, his close relatives, trusts and companies controlled by him, his close relatives or related trusts, and the acquirer has acquired to voting rights from another member of such group of persons.

When considering whether a whitewash waiver is to be granted under such circumstances, the SFC would consider a number of factors, including (i) whether the leading shareholder has changed; (ii) the price paid for the shares acquired; and (iii) the relationship between the sponsors acting in concert and how long they have been acting in concert. Applicants for whitewash waivers also are reminded to allow sufficient time for the executive to raise enquiries and analyze the responses.

## SFC Issues a Corporate Regulation Newsletter Regarding Publishing Announcements and Disclosure of Inside Information by Listed Companies

In March 2016, the SFC issued a corporate regulation newsletter (Issue No. 3) regarding publishing announcements and disclosure of inside information by listed companies. The highlights of this newsletter include the following:

### How Inside Information Should be Disclosed

- The SFC noted that posting press releases on corporate websites could make investors who spotted those press releases better off than investors who were not aware of them despite following the listed companies on HKExnews.
- The SFC emphasized the significances of announcements/press releases and the importance of providing sufficient context for readers to understand its impact on the company's affairs.
- The SFC reminded listed companies to ensure simultaneous dissemination of inside information on their websites and the HKExnews system.
- The SFC reminded the officers of listed companies of the responsibility for preventing a breach of confidentiality as required under section 307G of the Securities and Futures Ordinance (the **SFO**) and specifically made reference to the leakage of Twitter's financial results caused by a data mining company using a "web-scraper" software.
- The SFC also noted that the use of social media by key executives for updating the market about their company's operating performance and latest developments could lead to shareholders who do not follow the executives on social media being denied the chance to take the information into account when considering their investment decisions.

### Incomplete or Misleading Statements

- The SFC reminded listed companies of the requirement in Section 307B of the SFO to ensure that inside information disclosed must not be false or misleading as to a material fact, or false or misleading through the omission of a material fact.
- The SFC cited three examples of instances where corporate communications contained piecemeal, unbalanced or inaccurate information, which could make them sufficiently false or misleading to be regarded as a breach of the SFO:
  - A listed company announced that it had signed a major contract without disclosing any details of the terms (the share price of the company rose significantly after the announcement) and later published the financial statements, which revealed that the profit generated from this contract was minimal (after which the share price drifted downwards).
  - A listed company posted its operating statistics on its corporate website, which showed an increase in sales volume. A few days later, the company published a warning disclosing a significant drop in its net profit for the year despite the increased sales volume, due to a substantial fall in its selling price.
  - A senior executive of a company mentioned the product sales target in a call with analysts and the target indicated a substantial slowdown of business. The company subsequently issued an announcement clarifying that the sales target quoted by the executive was a personal view and the company had not prepared such a figure.
- The SFC noted that sometimes companies make statements of serious and questionable validity, which could be regarded as false or misleading as to a material fact, or false or misleading through the omission of a material fact in most extreme cases. In particular, the SFC specifically noted that it would be misleading to describe an issue of bonus shares to be "a reward" or having the effect of "widening the capital base of the company."
- The SFC reiterated the importance of accurate, clear and balanced disclosure without glossing over or omitting any material facts, which should contain sufficient details for investors to make a reasonable and realistic assessment of the company's affairs.

### Companies Listed in Multiple Jurisdictions

- The SFC stressed the importance of imposing simultaneous suspensions in different jurisdictions.
- Where a suspension is requested on the grounds that the listed company has inside information to disclose, the SFC may take action to determine what the inside information is and the reasons why it cannot be disclosed immediately.

- The SFC may either write formally to request or use statutory powers to ask the listed company to provide the details of the information that cannot be announced immediately.
- It is possible for the trading of securities listed in Hong Kong to resume while the trading of other securities in other jurisdictions remains suspended if there is no further inside information to be disclosed or the inside information is announced.

## Recent Enforcement Actions and Penalties

### Takeovers Panel Rules on Breach of Takeovers Code by a Subsidiary of Alibaba Group Holding Limited (Alibaba)

In January 2014, Alibaba proposed to subscribe for new shares in 21CN, a company listed on the HKEx, at a price of HK$0.30 per share (the **Alibaba Subscription**), which would result in Alibaba acquiring a majority interest in 21CN. This triggered an obligation for Alibaba to make a mandatory general offer under Rule 26 of the Hong Kong Takeovers Code, unless a waiver from the executive and the approval of independent shareholders (commonly referred to as a **whitewash waiver**) were obtained. At the time the Alibaba Subscription was announced, Chen Xiao Ying (**Ms. Chen**) was one of the largest shareholders, an executive director and the vice chairman of 21CN. Ms. Chen's brother, Chen Wen Xin (**Mr. Chen**) was not involved in the management of 21CN but held a small shareholding in 21CN. Alibaba claimed that it did not know that Mr. Chen was a shareholder in 21CN at the time.

One of 21CN's principal operations is the development of a Product Identification, Authentication and Tracking System (**PIATS**) for the health care and other industries. This is the only such system available to the health care industry in the PRC. Mr. Chen was the sole shareholder in a company called Hebei Huiyan Medical Technology Co., Ltd. (**OpCo**), which was developing a business-to-consumer drug transaction platform on which online pharmacies could sell over-the-counter drugs and related products. OpCo had applied to the China Food and Drug Administration (**CFDA**) for a permit to allow it to operate an online transaction platform between online pharmacies and consumers for over-the-counter drugs and related products. In late 2013, OpCo was awarded the permits but Alibaba was unsuccessful in its application. On the same day the Alibaba Subscription was announced, Mr. Chen entered into agreements with Alibaba (the **OpCo Agreements**) providing for the sale of OpCo by Mr. Chen to Alibaba, the transfer to the internet platform operated by OpCo of Alibaba's over-the-counter-drugs sales business, and the reorganization of OpCo into an offshore shareholding platform in which Mr. Chen would hold a minority interest and which would be the sole vehicle for Alibaba to sell over-the-counter drugs online in the PRC.

The executive was not consulted about the OpCo Agreements at the time it granted the whitewash waiver, and neither 21CN's shareholders' circular or announcements referred to OpCo or the OpCo Agreements. The Alibaba Subscription was completed and resulted in a significant increase in 21CN's share price.

Under the Takeovers Code, the grant of a whitewash waiver by the executive is subject to compliance by the person seeking the waiver with a number of the Takeovers Code's Rules, including Rule 25, which prohibits "special deals" between an offeror or its concert parties and target shareholders that have favorable conditions that are not to be extended to all shareholders.

The executive referred the matter to the panel to determine (i) whether the OpCo Agreements constituted a special deal under Rule 25, (ii) if they did, whether the whitewash waiver granted to Alibaba in respect of the Alibaba Subscription was invalidated, and (iii) whether a mandatory general offer obligation had been triggered for the shares in 21CN not owned by Alibaba and its concert parties and, if so, at what price the mandatory general offer should be made.

The panel emphasized the fundamental importance of the principle of equality of treatment and rejected the contention that the OpCo Agreements were not related to the Alibaba Subscription, given the valuable nature of the permit held by OpCo, which was seen as essential to the development of Alibaba's over-the-counter-drugs online platform. The panel found that given the proximity of the relationship between Mr. Chen and his sister, Alibaba's legal advisers should have been concerned that the OpCo Agreements fell within the ambit of General Principle 1 and Rule 25, even if Mr. Chen was not a shareholder and should have consulted with the takeovers executive. Alibaba or its advisers should have been put on notice that Mr. Chen had become a shareholder in 2002 and could have asked whether he was still a shareholder, which they had failed to do.

In this case, it was clear that the sale of OpCo in exchange for cash and a minority interest in Alibaba's over-the-counter-drugs online platform resulted in Mr. Chen receiving a positive consideration, which was sufficient for the Panel to conclude that the OpCo Agreements constituted a special deal and invalidated the whitewash waiver. The question then arose as to the price at which Alibaba should make the mandatory offer. The executive argued that the appropriate offer price should be the market price at the time the whitewash waiver was invalidated, which was HK$5.11 per 21CN share. However, the panel concluded that the starting point for any offer must be HK$0.30 per share, being the price of the Alibaba Subscription. The panel was mindful that the price at which 21CN's shares were trading was at a substantial premium to its tangible asset value, and this increase in share price was in large part attributable to the market's expectation of the value that

Alibaba could bring to 21CN. It would not be fair or reasonable to require Alibaba to make an offer at the market price that would result in it paying a substantial amount for the value that was largely attributed to its anticipated contribution to 21CN. Further, any additional value that the panel may have determined should be added to the base offer price of HK$0.30 was unlikely to be material in the context of the prevailing market price or the prices at which 21CN's shares had traded since the Alibaba Subscription. Hence, the panel decided to waive the mandatory general offer obligation that otherwise would have arisen for Alibaba on the invalidation of its whitewash waiver.

### HKEx Censures China Kingstone Mining Holdings Limited (China Kingstone) and Its Directors for Breaching Listing Rules and/or Director's Undertaking

China Kingstone was listed in March 2011 and was engaged in the production and sale of marble and marble-related products in the PRC. China Kingstone's annual results for the year 2011 and a subsequent announcement disclosed that it had entered into various transactions (**Transactions**) comprising three entrusted loans (**Entrusted Loans**), six structured deposits (**Structured Deposits**), an investment in a company (**GJ**) and two loans provided to GJ that took place between June 2011 and November 2011. The Entrusted Loans and the Structured Deposits constituted very substantial acquisitions and the investment in and loans to GJ constituted major transactions. A circular was issued in October 2012 for the extraordinary general meeting to ratify the Transactions, but the shareholders voted against the resolutions. Ms. Chen, Mr. Lin, Mr. Liao and Mr. Xiong were the directors of China Kingstone. Ms. Chen asserted that she followed the instructions of Mr. Huang, the then controlling shareholder, when arranging the Transactions. She did not procure the company's compliance with the listing rules as Mr. Huang threatened to replace the board and asserted that any disclosure would cause market over-reaction and share price fluctuations. Mr. Lin, Mr. Liao and Mr. Xiong were asked by Ms. Chen to sign the board minutes approving the Transactions after the event. China Kingstone used the IPO proceeds to fund the Entrusted Loans and Structured Deposits, contrary to the stated use of proceeds in its prospectus.

The listing committee found China Kingstone to have breached the requirements (i) to comply with the announcement, circular and independent shareholders' approval requirements in respect of the Transactions, (ii) to consult its compliance adviser when the Transactions were contemplated, and (iii) to disclose a change in the use of the IPO proceeds. The listing committee also found the directors to have breached (i) the requirement under Listing Rule 3.08 to fulfill their fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law and (ii) the declaration and undertaking given in the form set out in Appendix 5B of the listing rules. The listing committee also found that, given their conduct, the directors willfully and persistently failed to discharge their responsibilities under the listing rules.

As a result, China Kingstone and its directors were publicly censured. In the event that the directors sought to be directors of other listed companies in the future, their conduct in this matter will be taken into account in assessing their suitability under Listing Rule 3.09. The directors also were required to attend 24 hours of training on the listing rules, compliance and director's duties.

### SFC Commences MMT Proceedings Against Mayer Holdings Limited and Its Senior Management over Late Disclosure of Inside Information

In one of the very first cases brought by the SFC for breach of the inside information provisions of the SFO, the SFC has commenced proceedings in the Market Misconduct Tribunal (**MMT**) against (i) Mayer Holdings Limited (**Mayer**) for failing to disclose price sensitive information as soon as reasonably practicable, and (ii) 10 current and former senior executives for their reckless or negligent conduct causing the alleged breach by Mayer of the provisions of the statutory corporate disclosure regime. Trading of Mayer's shares has been suspended since 9 January 2012.

Between April and August 2012, while auditing Mayer's financial statements for the year ended 31 December 2011, the then auditors of Mayer repeatedly communicated with Mayer's management about issues they identified including: (i) the suspicious nature of the disposal of a wholly owned subsidiary of Mayer for HK$15.5 million, (ii) Mayer did not control the projects it bought for HK$620 million in Vietnam and their valuations appeared to have been inflated, and (iii) two subsidiaries of Mayer's jointly controlled entity had made substantial prepayments of US$10 million and US$4 million, respectively, without security to suppliers, which appeared to be irrecoverable (the **outstanding audit issues**).

On 23 August 2012, Mayer's then auditors indicated they would qualify their audit opinion for the financial statements for the year ended 31 December 2011 if the outstanding audit issues were not resolved. Mayer received a resignation letter from its auditors on 27 December 2013 but only disclosed the resignation letter together with brief details of the outstanding audit issues on 23 January 2013.

The SFC alleged that the auditors' resignation, the outstanding audit issues, the potential qualified audit report and the US$10 million prepayment to the supplier were specific information regarding Mayer that was price sensitive and not generally known to the public at the material time. The information should have been disclosed as it would have been viewed negatively by the investors and were of sufficient gravity to affect Mayer's share price.

### SFC Commences MMT Proceedings Against Yorkey Optical International (Cayman) Limited, Its CEO and Financial Controller for Late Disclosure of Inside Information

On 6 April 2016, the SFC commenced proceedings in the MMT against: (i) Yorkey Optical International (Cayman) Limited (**Yorkey**) for failing to disclose price sensitive information as soon as reasonably practicable, and (ii) Mr. Nagai Michio and Mr. Ng Chi Ching, the chief executive officer and financial controller of Yorkey, respectively, for their reckless or negligent conduct causing the alleged breach by Yorkey of the provisions of the statutory corporate disclosure regime or their failure to take all reasonable measures to ensure that proper safeguards exist to prevent the alleged breach.

The SFC stated that, contrary to the published expectations of Yorkey's management of significant growth and increasing profitability for the second half of 2012 as compared to the first half of 2012, Yorkey in fact sustained material losses in the second half of 2012 and its financial performance deteriorated significantly and there was a substantial year-on-year decline in its 2012 profits on a full-year basis. More specifically, Yorkey recorded a net profit of US$1.25 million in its unaudited interim results for six months ended 30 June 2012 and a net profit of US$60,000 in its 2012 Final Results. The net profit of US$60,000 for 2012 represented a decline of 99 percent when compared to the net profit of US$6.685 million in 2011.

The information about Yorkey's material losses and the significant deterioration in its financial performance were apparent from the figures contained in the internal management accounts and such information came to the knowledge of Yorkey and its CEO by mid-January 2013 at the latest, but only was disclosed to the public in Yorkey's 2012 audited annual results on 25 March 2013.

The SFC alleges that the information about Yorkey's material losses in the second half of 2012 and the significant deterioration in its financial performance was specific information regarding Yorkey that was price sensitive and not generally known to the public at the material time. Had the information been known to the investing public, it would likely materially affect Yorkey's share price. Yorkey's share price fell 21.25 percent over a three-day period from HK$0.80 on 25 March 2013 to HK$0.63 on 28 March 2013.