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# HONG KONG REGULATORY UPDATE

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This Hong Kong regulatory update is intended to provide 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 (the **HKEx**) and their advisers, including HKEx announcements and rule changes, Securities and Futures Commission (**SFC**) decisions and updates, and both HKEx and SFC enforcement related news. In this update we cover:

- The Shanghai-Hong Kong Connect
- The end of the initial 3-day check of Application Proofs
- The introduction of new rules on “connected transactions” effective 1 July 2014
- The HKEx’s issue of a concept paper on weighted voting rights
- The decision by the Takeovers Panel on SouthGobi Resources Limited
- The SFC’s issue of supplement consultation conclusions on the regulation of IPO sponsors
- Recent enforcement actions and penalties against listed companies and their directors

## The Shanghai-Hong Kong Connect

In April this year the SFC and its Chinese counterpart, the China Securities Regulatory Commission (**CSRC**) issued a joint announcement regarding the establishment of the Shanghai — HK Connect pilot program (the **Shanghai-HK Connect**). The aim of the Shanghai — HK Connect is to provide a mechanism for Hong Kong investors to trade Shanghai-listed securities through Hong Kong-based brokers that are participants of the HKEx, and for mainland Chinese investors to trade Hong Kong-listed securities in Renminbi (**RMB**) through broker members of the Shanghai Stock Exchange.

To begin with, Chinese investors will only be able to invest in constituent stocks of the Hang Seng Composite LargeCap Index, the Hang Seng Composite MidCap Index, and the H shares of any other PRC-incorporated companies that have corresponding listed A shares in Shanghai. Trading will also be restricted to the secondary market (*i.e.*, Chinese investors will be not be able to subscribe for shares in initial public offerings in Hong Kong) and Chinese investors will not be able to short sell, engage in margin financing or stock borrowing or lending. There will also be an initial RMB250 billion cap on the aggregate quota of HKEx-listed securities that may be purchased under the program by mainland Chinese investors (together with a daily cap of RMB10.5 billion) and a corresponding RMB300 billion aggregate quota on the purchase of Shanghai-listed securities by Hong Kong investors. The RMB250 billion cap, equivalent to just over US\$40 billion, represents just over 2% of the turnover on the HKEx during the previous twelve months.

China Securities Depository and Clearing Corporation Limited (**ChinaClear**) will be responsible for settling trades in HKEx-listed securities and converting the RMB funds received from Chinese investors into Hong Kong dollars for settlement through the Central Clearing and Settlement System (**CCASS**) operated by the Hong Kong Securities Clearing Company Limited (**HKSCC**). ChinaClear will also hold all HKEx-listed securities as nominee on behalf of Chinese investors. HKSCC will play a similar role to ChinaClear for “northbound” trades in Shanghai-listed securities by Hong Kong investors.

On 4 September 2014 the HKEx, HKSCC, SSE and ChinaClear entered into a four-party agreement to implement the Shanghai-HK Connect, which followed an initial market readiness test during August that the HKEx announced had proceeded smoothly. Implementation

of the Shanghai — HK Connect remains subject to the satisfaction of numerous conditions including regulatory approvals, and although the April announcement indicated a possible implementation timetable of six months, no fixed date has yet been set for the commencement of trader under the program.

### **The End of the Initial 3-day Check of Application Proofs**

As widely anticipated, the HKEx announced on 5 September 2014 that the initial 3-day check of the initial draft of the prospectus submitted at the time of a listing application (**Application Proofs**) will be discontinued for listing applications filed after 30 September 2014. The HKEx reached this decision on the basis that the return rate for Application Proofs had decreased, citing this as evidence that market practitioners had become familiar with changes to the listing application process that came into effect last October, and after consultation with the SFC. The Application Proofs for listing applications filed on or after 1 October 2014 will be now published on the HKEx website ([www.hkexnews.hk](http://www.hkexnews.hk)) at the time of the filing of the application. The 3-Day Checklist (Table B) found in Guidance Letter HKEx-GL56-13 will be merged with Table A of the same Guidance Letter.

### **The Introduction of New Rules on “Connected Transactions” Effective July 1, 2014**

Following a consultation process conducted during 2013, amendments to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (**Listing Rules**) came into effect on 1 July 2014. The principal changes implemented include:

- An exemption from the independent shareholder approval requirement for all connected transactions between a company listed on the HKEx or any of its subsidiaries, on the one hand, and a person who is connected solely at the level of a subsidiary (*e.g.*, a CEO, director or 10% shareholder of a subsidiary) on the other hand. However, such transactions would remain subject to the approval of the board of the company and confirmation from the independent non-executive directors of the company that the terms of the transactions are normal commercial terms that are fair and reasonable and in the interests of the company and its shareholders as a whole;
- The exclusion from the definition of “connected persons” any persons who are only connected with an “insignificant subsidiary”. An “insignificant subsidiary” is a subsidiary whose total assets, profits and revenue represent less than (i) 10% of those of the listed company in latest three financial years; or (ii) 5% under the percentage ratios for the latest financial year;
- Clarifying that trustees of any scheme of which a CEO, director or 10% shareholder is a beneficiary will not be treated as a connected person, provided that the collective interest of connected persons in the scheme do not exceed 30%;
- The monetary limit for “de minimis” connected transactions exempt from all requirements under the connected transactions rules was raised from HK\$1 million to HK\$3 million;
- The 1% cap on the exemption available for transactions with a connected person involving the provision or receipt of consumer goods on normal commercial terms was removed; and
- An additional exemption from the connected transactions requirements related to the granting of an indemnity to a director against liabilities incurred in the course of the performance of his/her duties was implement, subject to the indemnity being consistent with Hong Kong law (or the laws governing director indemnities in the place of incorporation).

### **The HKEx’s Issue of a Concept Paper on Weighted Voting Rights**

On 29 August 2014 the HKEx issued a concept paper seeking views from market participants on whether the HKEx should allow governance structures that give certain persons voting power or other related rights disproportionate to their shareholding interest (which it refers to as “weighted voting rights”). Hong Kong’s “one-share, one-vote” policy has been in place since 1989, with only one HKEx-listed company (Swire Pacific Ltd.) having two classes of shares that carry different voting rights, a structure that it implemented in 1972. The paper is, in part, a reaction to the perceived loss of the Alibaba IPO to the United States due to

Hong Kong regulators' reluctance to allow Alibaba to adopt a weighted voting rights structure. The paper noted that of the 12 listings of mainland Chinese companies in the United States in 2014, nine of those employed weighted voting rights structures.

The paper does not itself recommend any particular rule changes or methods of implementing weighted voting rights for HKEx-listed companies, and the HKEx made a point of highlighting that it has not itself formed any view on the issue. Instead, the HKEx indicated that, subject to the views received being supportive of such rights, the HKEx would then conduct a formal consultation process on the details of the scope and language of any proposed changes to its rules. The paper did not mention whether, if weighted voting rights were ultimately permitted, the HKEx intended to allow companies that are already listed on the HKEx to implement such structures.

### **The Decision By the Takeovers Panel on Southgobi Resources Limited**

On 30 June 2014 the Hong Kong Takeovers and Mergers Panel (**Panel**) issued a ruling that SouthGobi Resources Limited (**SouthGobi**) should be considered a "public company" for the purposes of the Codes on Takeovers and Mergers and Share Buy-backs (**Codes**). SouthGobi was listed on the HKEx on 29 December 2010 via a secondary listing of its shares, with its primary listing remaining on the Toronto Stock Exchange. Consistent with other secondary listing applicants, at the time of its listing on the HKEx SouthGobi had applied for a confirmation from the SFC that it would not be treated as a public company under the Codes; which meant that if a takeover offer was made for its shares the Codes would not apply (and, instead, only the laws, regulations and rules applicable to companies incorporated in British Columbia, Canada and listed on the Toronto Stock Exchange, would apply). The Panel noted that at the time the initial confirmation was given, it was made clear to SouthGobi that if there were any material changes to the information provided or representations made by SouthGobi that its status under the Codes may be reconsidered.

In deciding that SouthGobi should be considered a public company for the purposes of the Codes, the Panel stated that the primary factors to be taken into account are the number of Hong Kong shareholders (or security holders) and the extent of trading in Hong Kong. At the time of its initial application, SouthGobi estimated that approximately 6.8% of its shares would be held in Hong Kong and that trading volume would not exceed that in Canada. However, by the time of the Panel's decision over 30% of SouthGobi's shares were held in Hong Kong and over half of the overall trade in SouthGobi's shares took place on the HKEx. In reaching its conclusion, the Panel also noted that there had been a significant shift in management from Canada to Asia since SouthGobi's listing on the HKEx, with the CFO, COO and company secretary all spending a considerable proportion of their time in Hong Kong. Although SouthGobi remained a Canadian tax resident, substantially all of its assets were located in Mongolia, and the shareholder protections in British Columbia and Canadian had not experienced any material change, the Panel did not consider these to be factors of any material bearing in reaching its decision.

### **The SFC's Issue of Supplement Consultation Conclusions on the Regulation of IPO Sponsors**

In May 2012 the SFC issued its Consultation Paper (the **2012 Paper**) on the regulation of sponsors of Hong Kong listing applications. Among other things, the SFC sought views on whether the prospectus liability provisions of the then Companies Ordinance (the **CO**, now known as the Companies (Winding Up and Miscellaneous Provisions) Ordinance) should be amended to make it clear that those provisions applied to the sponsors of Hong Kong listings. Responses to the paper on the issue of prospectus liability were mixed, with some arguing that changes were unnecessary as the CO liability provisions were already drafted in a manner that applied to sponsors, with others arguing the opposite. In its consultation conclusions issued in December 2012, the SFC stated that the diverging views and the lack of case law on the issue demonstrated the need to amend the CO so that it was clear that the civil and criminal prospectus liability provisions applied to sponsors. The SFC therefore proposed to implement its recommendations to clarify the CO prospectus liability of sponsors, although no specific timetable was set.

In an announcement issued on 22 August 2014, and notwithstanding the 2012 consultation conclusions, the SFC announced that it had reaffirmed its view that its "original position" in the 2012 Paper that sponsors are already liable for prospectuses under the existing CO. On this basis, the SFC concluded that the proposed legislative amendments to the CO need not be pursued as they would serve no purpose.

### Recent Enforcement Actions and Penalties Involving HKEx-Listed Companies

- The SFC commenced proceedings in the Hong Kong Court of First Instance and the Market Misconduct Tribunal (**MMT**) against HKEx-listed CITIC Limited (**CITIC**) and five of its former executive directors in relation to alleged disclosure of false and misleading information. On 12 September 2008 CITIC issued a circular stating that there had been no material adverse change in its financial situation since the end of 2007, but shortly thereafter CITIC disclosed a massive unrealized mark to market loss from leveraged foreign exchange contracts, which led to a 55% fall in its share price. The SFC alleges that CITIC and the directors were aware of this unrealized loss prior to 12 September 2008 and is seeking orders that CITIC and the directors compensate investors for their losses.
- The SFC commenced proceedings in the MMT against Ms. Salina Yu Lai Si (**Ms. Yu**), the former CEO of HKEx-listed Water Oasis Group Limited (**Water Oasis**) for alleged insider dealing in Water Oasis shares. Ms. Yu had sold shares in Water Oasis on January 20, 2012, shortly after finding out about the termination of an important distributorship contract. Water Oasis did not announce the termination of the contract until after market close on the same day.
- The Hong Kong Court of First Instance granted a freezing order over 107,290,000 shares in HKEx-listed Hisense Kelon Electrical Holdings Limited which it alleges are held for the benefit of Mr. Gu Chujun (**Mr. Gu**), the former chairman and CEO of HKEx-listed Greencool Technology Holdings Limited (**Greencool**). Mr. Gu and other members of Greencool senior management are the subject of ongoing proceedings under Section 213 of the Securities and Futures Ordinance in relation to alleged gross overstatements of the financial position of Greencool.
- Long Success International (Holdings Limited) and certain of its directors were publicly censured by the GEM Listing Committee of the HKEx for failing to obtain shareholders' approval for material changes to transactions that had been previously approved by shareholders.
- OTO Holdings Limited (**OTO**) and certain of its directors were publicly censured by the Listing Committee of the HKEx for failing to disclose a significant deterioration in the financial performance of OTO as soon as reasonably practicable. OTO had issued a profit warning announcement on 16 March 2012, but the Listing Committee found that the board of OTO had been in possession of information for a period of at least nine days prior to the issued of the profit warning, and should have acted sooner.
- Changfeng Axle (China) Company Limited and its executive and non-executive directors were publicly criticized by the Listing Committee for failing to publish an announcement disclosing the significant deterioration in its financial performance as soon as reasonably practicable.