



# 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 (**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:

- HKEx tightens up use of the general mandate
- HKEx issues revised guidance on the use of VIE structures
- New listing decision issued regarding sufficient operations or assets after a very substantial disposal
- HKEx issues consultation paper on proposed changes to the Environmental, Social and Governance Reporting Guide
- HKEx issues results of review of listed issuers' financial reports
- New guidance issued on why the HKEx rejected or returned certain listing applications
- HKEx issues new guidance letter on disclosure of financial information in a listing document where the new listing applicant or any of its subsidiaries is listed on another exchange
- Recent enforcement actions and penalties

## HKEx Tightens Up Use of the General Mandate

A general mandate typically entitles a board to issue securities (including shares, options and warrants) in an amount up to 20 percent of those in issue at a discount of up to 20 percent to market price in the case of a placing of securities for cash consideration. Although the HKEx has not publicly stated the impetus, it recently issued Listing Decisions HKEx-LD89-2015 and HKEx-LD90-2015 and Guidance Letter GL80-15, which consolidate the recent policy trend towards significantly tightening up listed companies' use of their general mandates.

In HKEx-LD90-2015, the HKEx stated that warrants – even with an exercise price significantly above the 20 percent discount threshold – may only be issued under a general mandate if the listed company can demonstrate to the satisfaction of the HKEx that the issue price represented fair value by reference to their valuation calculated using a common option pricing model. The clear implication is that any proposed issue

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of warrants under the general mandate must be pre-vetted by the HKEx or run the risk of being unwound, with the onus on the listed company to satisfy the HKEx, and the same principle applied to options. A similar principle was discussed in HKEx-LD89-2015 with respect to warrants issued to senior management.

In GL80-15, the HKEx stated that if a listed company issues convertible securities under a general mandate but does not have complete control over any adjustment of the conversion price, it should use the lowest possible conversion price to calculate the maximum number of conversion shares issuable upon full conversion of the convertible securities. If it is unable to demonstrate that the maximum amount of shares issuable is less than the amount permitted under its general mandate or cannot determine the lowest possible conversion price, it must obtain a specific mandate from its shareholders.

Recent experience suggests that the HKEx will apply similar principles in other contexts, such as issuance of shares as consideration for an acquisition.

## HKEx Issues Revised Guidance on the Use of VIE Structures

The HKEx issued a revised version of its Listing Decision HKEx-LD-43-3 with respect to the suitability for listing of companies with variable interest entity (VIE) structures. Though the listing decision itself does not offer much – merely referring to the fact that there is a draft PRC foreign investment law and advising companies to contact the HKEx at an early stage, we understand from our inquiries with the HKEx that its new policy assumes that the draft law will be implemented “as is.” On that basis, if the following three conditions are met then a company likely will be considered unsuitable for listing:

1. The business(es) held through the VIE structure is/are material to the company;
2. The business(es) held through the VIE structure is/are currently restricted/prohibited from foreign investment (or is/are on the negative listing in the Shanghai Free Trade Zone – irrespective of whether the business is carried out in Shanghai or elsewhere); and
3. The listing applicant is not controlled by a PRC person.

The HKEx also will be requiring the controlling shareholders of listing applicants to undertake not to dilute their interests below 50 percent plus one share. This potentially shuts the door for foreign-controlled companies from using VIE structures since the HKEx by definition only allows them for industries with a clear foreign investment restriction. Although one possible solution is to transfer control to a PRC person, this

may impact ownership continuity, and it is clear that the days of the VIE structure for Hong Kong listings may be numbered.

## HKEx Publishes Decision Regarding Whether a Listed Company Has Sufficient Operations or Assets After a Very Substantial Disposal

Rule 13.24 of the Rules Governing the Listing of Securities on the HKEx (**Listing Rules**) provides that an issuer shall carry out a sufficient level of operations or have tangible assets of sufficient value and/or intangible assets for which a sufficient potential value can be demonstrated to the HKEx to warrant its continued listing. Failure to comply with this requirement may result in suspension of trading. In addition, Rule 6.04 of the Listing Rules provides that the continuation of a suspension for a prolonged period without the company taking adequate action to obtain restoration of listing may lead to the HKEx cancelling the listing.

In Listing Decision HKEx-LD88-2015, a company and its subsidiaries (the **Group**) were principally engaged in the manufacture and sale of certain machinery and equipment (the **Original Business**). The Group also carried out the production and sale of certain pharmaceutical products (the **Remaining Business**) through a subsidiary which the company acquired a few months before its proposed disposal of the Original Business (the **Disposal**).

The HKEx ruled that the company would not have sufficient operations or assets to meet the Rule 13.24 requirements upon completion of the Disposal because:

**The scale of operation of the Remaining Business was insufficient to justify a listing.** The Remaining Business would be the principal business of the Group upon completion of the Disposal. Despite the Remaining Business having been in operation for more than 10 years prior to its acquisition, possessing its own production facilities, over 100 employees, a number of trademarks and licenses for its products, and a recently obtained good manufacturing practice (**GMP**) accreditation, the HKEx considered the revenue and profits (around HK\$50 million and HK\$0.4 million, respectively) to be insufficient. In addition, although the Group was developing new products and taking steps to expand the sales network for its Remaining Business, it had not provided any credible financial forecasts or budgets to substantiate its future plan and had not demonstrated a proven ability to expand the Remaining Business.

**The operation of the assets of the Remaining Business could not generate sufficient revenue and profits to justify a listing.** Similarly, the net asset value of the Remaining Business was only HK\$50 million. Despite its ownership of a number of

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intangible assets such as trademarks and licenses and the GMP accreditation, the company had not provided sufficient information to demonstrate its value. In addition, the fact that the Remaining Business was acquired at less than the fair value of its net assets indicated that the Remaining Business did not command much or any intrinsic value.

**There were no concrete details to demonstrate that the other assets retained would enable the group to substantially improve its operations and financial performance after the Disposal.** Other assets retained by the Group would mainly be cash, including the proceeds from the Disposal. The company said the proceeds would be used to reduce the Group's liabilities, and it was seeking new business opportunities to diversify its business scope and might use the cash to acquire other businesses. However, there were no concrete details to demonstrate that the cash retained by the Group would enable it to substantially improve its operations and financial performance after the Disposal.

## **HKEx Publishes Consultation Paper on Review of the Environmental, Social and Governance Reporting Guide**

The HKEx issued a consultation paper in July 2015 seeking views and comments on proposed changes to the Environmental, Social and Governance Reporting Guide (the **ESG Guide**). The proposals seek to encourage more widespread and standardized ESG reporting among issuers, and help issuers meet greater demand and expectations for non-financial information from investors and other stakeholders. The main proposals are as follows:

**Adoption of "comply or explain" provisions.** It is proposed that Listing Rule 13.91 be amended to require the issuer to state in its annual or ESG report whether it has complied with the "comply or explain" provisions set out in the ESG Guide for the relevant financial year. Where the issuer deviates from the "comply or explain" provisions, it must give considered reasons in its ESG report.

**Revision of the introductory section of the ESG Guide.** This aims to provide more guidance on reporting and bring the relevant requirements more in line with international standards.

**Re-arrangement of the ESG Guide into two subject areas.** The ESG Guide is proposed to be re-arranged into two sections, namely "A. Environmental" and "B. Social."

**Upgrading of the general disclosure requirements and revision of wording relating to directors' report requirements.** The proposals seek to upgrade the "General Disclosures" section under each aspect of the two subject areas to "comply

or explain" provisions and revise certain wording to ensure consistency with the directors' reporting requirements under the new Companies Ordinance (Chapter 622 of the Laws of Hong Kong) (the **New CO**), which have been incorporated in the Listing Rules.

**Upgrading of key performance indicators.** The HKEx proposes to up-grade the "Key Performance Indicators" section under the "Environmental" subject area to "comply or explain" provisions.

**Revision of the wording of the ESG Guide's voluntary provisions.** This aims to bring the voluntary provisions more in line with international standards of ESG reporting by incorporating disclosure of gender diversity.

Subject to responses to the consultation, the HKEx intends to implement the new rules and new ESG Guide for financial years commencing on or after 1 January 2016, which means issuers would need to start gathering the necessary information for the purpose of publishing their ESG reports under the new ESG Guide in 2017.

## **HKEx Publishes Financial Statements Review Programme Report 2014**

The HKEx completed its review of issuers' published financial reports for compliance with the disclosure requirements of the Listing Rules and accounting standards and issued its report in July 2015. There were no significant breaches of the Listing Rules or accounting standards, but the HKEx highlighted the following areas where companies can continue to improve their disclosures:

**Relevant disclosure requirements.** The HKEx reminded companies of the relevant disclosure requirements in accounting standards and related financial information which can be found primarily in Appendix 16 of the Listing Rules, and also the recent Listing Rules amendments with reference to the New CO that are effective for accounting periods ending on or after 31 December 2015.

**Significant events or material balances and transactions.** Companies should ensure that additional information is presented in annual and interim reports when there are significant events or material balances and transactions.

**Quality of disclosure of judgments and estimates.** Companies should improve the quality of their disclosure of the judgments and estimates they made in applying the accounting policies. The information should be clear, understandable and entity-specific.

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**Note to issuers who are not early adopters of new or revised accounting standards.** HKEx noted that when companies are not early adopters of new or revised accounting standards that have been issued but are not yet effective, they should state this and provide the known or reasonably estimable information needed to assess the possible impact that application of the new or revised standards will have on the company's financial statements in the period of their initial application.

**Robust asset impairment review processes.** Companies should ensure that robust asset impairment review processes are in place, and more should be done to improve the quality of disclosures under HKAS 36 relating to impairment of assets, particularly where the recoverable amount was based on value in use.

**Entity-specific information in preparing financial risk information.** Companies should provide entity-specific information rather than boilerplate text in preparing financial risk information under HKFRS 7 relating to disclosures of financial instruments to enable investors and other users to understand what management thinks are the key financial risks and how they have adequately managed those risks.

**Disclosure requirements relating to fair value measurement.** Companies should follow the disclosure requirements under HKFRS 13 relating to fair value measurement, which are designed to help investors and other users assess the valuation techniques and inputs used in fair value measurements, particularly those based on significant unobservable inputs, and the effect on financial statements.

The overarching principle for financial reporting should be "information provided is relevant and material" so that companies' communication through financial reports is clear and concise.

## **HKEx Issues Listing Decisions on Why It Rejected and Returned Certain Listing Applications in 2013 and 2014**

In HKEx-LD92-2015, the HKEx set out the reasons why it rejected certain listing applications between 1 October 2013 and 31 December 2014. Chapter 8 of the Main Board Rules and Chapter 11 of the GEM Rules set out detailed eligibility requirements which a new applicant must fulfill and state that both the applicant and its business must, in the opinion of the HKEx, be suitable for listing. Further, Main Board Rule 2.06 and GEM Rule 2.09 state that suitability for listing depends on many factors.

As set out in the listing decision, 16 listing applications were rejected by the HKEx. The key reasons for rejection included, among other things:

- issues with the sustainability of the applicant's business model
- deteriorating financial performance
- material non-compliance incidents
- issues as to a director's suitability
- undue reliance on a major customer
- issues as to the relationship with the controlling shareholders
- a sponsor's lack of independence

Most of the cases noted were rejected by the HKEx based on different combinations of the reasons set out above, while a smaller number were rejected on a single basis (*e.g.*, reliance on a major customer, non-compliance and sponsor's non-independence).

In Listing Decision HKEx-LD91-2015, the HKEx explained that 12 listing applications had been returned during the same period because the applications were not considered to be substantially complete. In order to fully assess suitability for listing, the HKEx requested these companies to provide further disclosure in different aspects, including but not limited to:

- their business model
- director suitability
- non-compliance incidents and relevant risk factors
- details of connected transactions
- competition with and/or reliance on the controlling shareholders
- their financial liquidity status
- ownership continuity

The industry sectors in which these rejected and returned listing applicants were engaged include mining, regulated businesses, gaming, software solutions, the manufacture and sale of consumer goods, wholesale and retailing, commodities trading, property leasing and development, money lending, financial services and securities.

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## **HKEx Publishes Guidance Letter on Disclosure of Unaudited Quarterly/Interim Financial Information Where the New Listing Applicant or Any of Its Subsidiaries Is Listed on Another Exchange**

Where a new listing applicant or any of its subsidiaries is listed on another exchange and has published unaudited quarterly/interim financial statements in accordance with the other exchange's rules and regulations that covers a period more recent than that required under the Listing Rules (see Main Board Rule 8.06/GEM Rule 11.11), the company's Hong Kong listing document must include such unaudited information in the manner provided below.

### **Contents of Unaudited Financial Statement**

- At a minimum, the company's (or its subsidiary's) revenue and income information must be disclosed, even if that information is not published as part of a complete set of the company's (or its subsidiary's) financial statements.
- Such information may be in a condensed form with major line items from the company's (or its subsidiary's) latest audited financial statements, including major components of its assets, liabilities, and equity (in the case of the balance sheet); income and expenses (in the case of the income statement); and the major subtotals of cash flows (in the case of the cash flow statement).
- Comparative statements for the company's (or its subsidiary's) corresponding prior financial period must be included. The requirement for a comparative balance sheet information may be satisfied by presenting the year-end balance sheet.
- Selected note disclosure that provides an explanation of events and changes that are significant to an understanding of the changes in financial position and performance of the company (or its subsidiary) since the reporting date of the last audited financial information must also be included.

### **Reconciliation Statement**

- The disclosure must include (i) a description of the ways, if any, in which the company's (or its subsidiary's) accounting principles, practices and methods used in preparing such unaudited quarterly/interim financial information vary materially from those prepared using Hong Kong Financial Reporting Standards (HKFRS), International Financial Reporting Standards (IFRS), China Accounting Standard for Business Enterprises (CASBE), as the case may be, and (ii) quantification of any material variations.

### **Level of Assurance of the Unaudited Financial Information**

- The disclosure must include an auditor's report on the unaudited quarterly/interim financial information prepared in the manner provided below:
  - At least reviewed by an independent auditor in accordance with the standards established by (i) the Hong Kong Institute of Certified Public Accountants (either Hong Kong Standard on Review Engagements 2400 "Engagement to Review Historical Financial Statements" or Hong Kong Standards on Review Engagements 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"); or (ii) the International Auditing and Assurance Standards Board (either International Standard on Review Engagements 2400 "Engagement to Review Historical Financial Statements"; or International Standards on Review Engagements 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity"), as amended from time to time; and
  - In any of the above cases, include as part of the review the financial effect of the material differences between the unaudited quarterly/interim financial information and financial statements prepared using HKFRS, IFRS or CASBE, as the case may be.

### **Recent Enforcement Actions and Penalties**

The SFC has commenced proceedings in the Market Misconduct Tribunal (MMT) against AcrossAsia Limited (AcrossAsia) for failing to disclose inside information as soon as reasonably practicable; and against the chairman and CEO of AcrossAsia for their reckless or negligent conduct causing the alleged breach by AcrossAsia. These proceedings represent the first formal prosecution pursued by the SFC since the inside information provisions of the SFO became effective on 1 January 2013. The SFC's allegations arise from litigation in Indonesia between AcrossAsia and its subsidiary PT First Media in relation to the alleged failure by Across-Asia to repay money owed to PT First Media. The litigation involved insolvency-related proceedings in Indonesia against AcrossAsia and could have led to it being put into liquidation. Documents relating to the litigation were received by AcrossAsia's Hong Kong office on 2 January 2013, with English translations circulated to the chairman and CEO on 4 January 2013. However, AcrossAsia did not announce the information by way of public announcement until 17 January 2013, after the Indonesian court had made insolvency-related orders against AcrossAsia on 15 January 2013. AcrossAsia's share price fell by 22.5 percent after trade in its shares resumed following publication of the news. The SFC is alleging that the information was specific, not generally known to the investing public and highly price sensitive in nature.