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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:

- HKEx consultation conclusions on amendments to financial disclosure rules
- HKEx consultation conclusions on risk management and internal controls
- The listing decision issued by the HKEx regarding whether a shareholder falling below 30 percent at IPO would be subject to a post-IPO lock-up
- Amendments to HKEx guidance letters relevant to disclosure in prospectuses/listing documents
- Recent enforcement actions and penalties against listed companies and their directors

## **HKEx Consultation Conclusions on Amendments to Financial Disclosure Rules**

Following the publication of a consultation paper in August 2014, the HKEx published consultation conclusions on its review of Hong Kong Listing Rules regarding disclosure of financial information with reference to the new Companies Ordinance (Chapter 622 of the Laws of Hong Kong) (the **CO**) and Hong Kong Financial Reporting Standards (**HKFRS**) and Proposed Minor/Housekeeping Rule Amendments. The amendments relating to financial information disclosure will apply to accounting periods ending on or after 31 December 2015. The amendments unrelated to financial information disclosure will come into effect on 1 April 2015.

The main changes are to:

- align the requirements for financial information disclosure in Main Board Rules Appendix 16 and equivalent GEM Rules with reference to the disclosure provisions in the CO. This includes streamlining requirements to disclose the names of directors of all subsidiaries and abolishing the requirement to include a business review if the review is included in other parts of an annual report;
- streamline the disclosure requirements and removing duplications with HKFRS. This includes streamlining financial disclosure required by the Hong Kong Listing Rules and providing guidance on how to present ageing analysis on accounts receivable and payable and repealing certain financial disclosure requirements in relation to financial conglomerates and banking institutions;
- introduce new requirements for companies that revise their published financial reports or results announcements to include prior period adjustments due to correction of material errors, by adding new headline categories for such announcements; and
- make consequential changes due to the enactment of the CO and to make minor housekeeping amendments. These include changing the notice period for annual general meetings for companies incorporated in Bermuda and the Cayman Islands to 21 days for annual general meetings and 14 days for other general meetings, or on shorter notice if it accords with the company's articles of association and removal of the use of the term "nominal value."

### Consultation Conclusions on Risk Management and Internal Controls

The HKEx published a consultation paper in June 2014 to seek comments on its proposed amendments to the Corporate Governance Code and Corporate Governance Report (**the code**) relating to internal controls. The HKEx received 57 submissions that were mostly in favor of the proposals. The main changes include:

- incorporating risk management into the Corporate Governance Report. This includes that an assurance be given by the management to the board on the effectiveness of risk management systems;
- defining the roles and responsibilities of the board and management (with the term “management” to be determined by companies themselves);
- clarifying that the board has an ongoing responsibility to oversee a company’s risk management and internal control systems;
- upgrading certain risk management disclosures to mandatory status, including the annual review of the effectiveness of the company’s risk management and internal control systems, and disclosures in the Corporate Governance Report; and
- upgrading to a mandatory provision the requirement that companies should have an internal audit function, and those without such function to review the need for one on an annual basis.

The amendments will take effect to accounting periods beginning on or after 1 January 2016.

### Listing Decision Issued by the HKEx Regarding Whether a Shareholder Falling below 30 percent at IPO would be subject to a Post-IPO Lock-up

This decision states that the controlling shareholder (the **controlling shareholder**) of a listed company (**company A**) is required to be subject to a 12-month lockup of its shares after company A’s listing under Listing Rule 10.07(1) (i.e. maintaining at least the same number of shares as stated in company A’s listing document for 12 months after its listing), even though the controlling shareholder has ceased to be an owner of 30 percent or more of the voting rights in company A after listing due to exercise of the over-allotment option.

In the case discussed in the Listing Decision, company B was one of company A’s controlling shareholders interested in more than 30 percent of company A’s shares on the issue date of company A’s listing document. Company B was established for estate planning purposes by company A’s founder, who also was an executive director and actively involved in the management of company A, although company B was owned by his son. An over-allotment option was granted to the global coordinator of company A’s IPO. Upon full exercise of the over-allotment option after company A’s listing, company B’s interest in company A was diluted to less than 30 percent and company A ceased to be a controlling shareholder of company A as defined under the listing rules.

The HKEx determined that company B, despite ceasing to be company A’s controlling shareholder shortly after listing, was required to be subject to a 12-month lockup of its shares after company A’s listing under Listing Rule 10.07(1). Listing Rule 10.07(1) requires any person or group of persons, being a controlling shareholder or group of controlling shareholders shown by the listing document issued at the time of the company’s application for listing, to demonstrate its commitment to a new applicant and to protect investors by preventing a material change in the shareholding structure to the extent that a controlling shareholder no longer controls the applicant during the first year of the applicant’s listing. In this case, company B was, as of the date of company A’s listing document, its controlling shareholder, and as such, Listing Rule 10.07 (1) would apply to company B.

### Amendments to HKEx Guidance Letters Relevant to Disclosure in Prospectuses / Listing Documents

In January 2015, the HKEx updated four guidance letters governing the disclosure requirements in listing documents for IPO transactions, namely HKEx-GL62-13, HKEx-GL65-13, HKEx-GL27-12 and HKEx-GL41-12. A brief summary of these letters and the relevant updates are set out below.

***Directors, Supervisors and Senior Management Section (HKEx-GL62-13)***

The section of a listing document setting out directors, supervisors and senior management biographies should contain information about those individuals that are accurate and complete in all material respects and not misleading or deceptive. It must follow the disclosure requirements set out in HKEx-GL62-13, otherwise the listing document may be considered not substantially complete as required under the Listing Rules. The section must include a table setting out certain prescribed information of each director, supervisor and senior manager and relationship among them. It must also contain a biography of each director, supervisor and senior manager covering his/her academic background, professional qualifications, relevant previous working experience, and current and past directorships in any listed companies in the last three years. The section should also disclose the role, composition and chairperson of each board committee, the directors, supervisors and senior management's remuneration, incentive plan for senior management, and key employees and any deviation from the Code Provisions of the Corporate Governance Code and Corporate Governance Report.

It is clarified in the revised guidance letter that any references to directors of the company that were not directors or senior management of the applicant or any of its subsidiaries during the track-record period are not required to be included in the table of directors' remuneration in the accountants' report.

***Property Valuation Report and Market Report (HKEx- GL65-13)***

A company that has included a property valuation report and a market report (if any) in its listing document should ensure that sufficient disclosure is made in its listing document in respect of the bases and justifications of assumptions adopted in both reports and must ensure that the information in both reports does not contradict each other. In relation to a property valuation report, the bases and justifications of the key assumptions (in the case of the discounted cash flow method) and details of comparable properties and the bases why they are selected, how the valuation of a company's properties differ from those of comparable properties and reasons for material differences (in the case of the comparison method) must be disclosed. In relation to a market report, the listing document must include the bases and justifications of key assumptions specific to a company's business. A company should also benchmark the assumptions adopted with historical data for a prolonged period of time to enable investors to assess the reasonableness of the assumptions and explain their material fluctuations. Certain disclosure must also be made in the "Summary" and "Risk Factor" sections and, where possible, a sensitivity analysis on the valuation of the properties must be included.

The revised guidance letter clarifies that in the property valuation report, the company is expected to disclose, among other things, clear references to tenure and other specific factors such as title defects and special requirements imposed on the properties by the land grant contracts and the associated value implications, if material.

***Summary and Highlights Section (HKEx-GL27-12)***

The "Summary" section in a listing document should (i) be comprehensible and readable, (ii) be concise, easy to read and in plain language and (iii) enable investors to decide whether they might be interested in the offer, and therefore wish to read the rest of the listing document. The section should only include information that is considered relevant and necessary and should be a high-level overview drafted separately instead of including paragraphs that have been extracted from elsewhere in the listing document. Specifically, the section should not include detailed description of a company's competitive strengths and business strategies as well as multiple pages of financial statements.

It is clarified in the revised GL27-12 that:

- when updating its financial position since the latest audited financial period, a company should disclose in the "Summary" section qualitative/quantitative information with commentary relating to its financial performance, and the disclosure must enable investors to have a sense of materiality of the recent developments;



- the disclosure of comparative financial information to any nonprofit forecast financial information is not compulsory. If a company chooses to disclose comparative financial information to nonprofit forecast financial information in its listing document, this should be reviewed by the sponsor; and
- the total amount of listing expenses relating to the offer (including underwriting commission) is recommended to be disclosed in the “Summary” section.

#### **Disclosure of Material Changes in Financial, Operational and/or Trading Position After Trading Record Period (HKEx-GL41-12)**

A listing document should disclose updated information relating to a company’s financial, operational and/or trading position after the trading record period. It must include a statement by the directors of any material adverse change in the financial or trading position of the group since the end of the period reported on in the accountants’ report, or an appropriate negative statement. In assessing whether a piece of information constitutes a material adverse change, sponsors and companies should consider, at a minimum, whether there is any adverse change that has taken place or is expected to take place in the near future, in the technological, market, economic, legal or operating environment in which the applicant operates.

The changes in the updated GL41-12 include:

- a company is expected to make disclosure in the “Summary” section regarding the adverse changes affecting its financial, operational and/or trading position after the trading record period, and the disclosure must enable investors to have a sense of materiality of the adverse changes;
- the disclosure of comparative financial information to any nonprofit forecast financial information is not compulsory. If a company chooses to disclose comparative financial information to nonprofit forecast financial information in its listing document, this should be reviewed by the sponsor; and
- any adverse changes should be highlighted in the “Risk Factors” and “Financial Information” sections of the listing document.

#### **Recent Enforcement Actions and Penalties Against Listed Companies and Their Directors**

- **Winding-up order for China Metal Recycling:** On 26 February 2015, the Court of First Instance ordered that China Metal Recycling (Holdings) Limited (**China Metal Recycling**) be wound up on the application of the SFC with reasons for its decision to be delivered in due course. China Metal Recycling’s shares were listed on the Main Board on 22 June 2009, raising IPO proceeds of about HK\$1,685 million. Trading in shares of China Metal Recycling has been suspended since 28 January 2013. This is the first time that the SFC obtained a court order to wind up a Hong Kong-listed company under section 212 of the Securities and Futures Ordinance (**SFO**), which permits the SFC to apply for a winding-up order against companies if it appears to the SFC that it is desirable in the public interest to do so to protect the company’s minority shareholders, creditors and the investing public, and the court may grant the order on the ground that it is just and equitable to wind up those companies. The SFC alleged that the affairs of China Metal Recycling involved a highly complex, sophisticated and dishonest scheme spanning Hong Kong, Macao, mainland China and the United States (U.S.). The scheme inflated China Metal Recycling’s performance, revenue and profit dating back to the time of its IPO prospectus in 2009 and becoming larger and more complex in the subsequent years until it was brought to an end when the SFC commenced these proceedings in July 2013. The aggregate revenue and gross profit of China Metal Recycling for the years 2007 to 2009 appears to have been overstated by around 46 percent or over HK\$8 billion and 72 percent or over HK\$1 billion respectively. The scheme involved the use of China Metal Recycling’s wholly owned offshore subsidiary in Macao, Central Steel (Macao Commercial Offshore) Limited (**Central Steel Macao**), which was the conduit for a substantial part of the company’s annual profits between 2007 and 2012 and produced false documents and instruments by which these profits were falsified. It also involved fake shipments of scrap metal between

the U.S. and the mainland, false shipping documents, false accounts and highly complex round-robin transactions spanning continents. By way of illustration, Central Steel Macao made 431 payments totaling around US\$2.4 billion to its purported key suppliers in the U.S. and Hong Kong in 2012. Approximately 98 percent of the funds were passed on to its purported customers and eventually circulated back to Central Steel Macao through a multitude of bank accounts, all through multiple entities set up around the world yet controlled centrally within China Metal Recycling.

- **Disqualification order against former CEO:** The Market Misconduct Tribunal (MMT) has made a disqualification order against Ms. Salina Yu Lai Si (**Ms. Yu**), former chief executive officer of Water Oasis Group Limited (**Water Oasis**), pursuant to Section 257(1)(a) of the SFO, which prohibits her from being a director or being involved in the management of any listed corporation for a period of two years, and ordered her to disgorge HK\$281,346, being the benefit she received in avoiding a loss through insider dealing, pursuant to Section 257(1)(d) of the SFO. Ms. Yu admitted to insider trading in the shares of Water Oasis when she possessed insider information regarding the imminent termination of Water Oasis' exclusive distributorship of H2O Plus, LLC's products in mainland China and Taiwan.
- **Market misconduct proceedings against author of allegedly false short seller report:** The SFC has commenced proceedings in the MMT against Mr. Andrew Left (**Mr. Left**), head of Citron Research, alleging market misconduct involving the publication of a research report on Evergrande Real Estate Group Limited (**Evergrande**), which contained false and misleading information. The report stated, among other things, that Evergrande was insolvent and had consistently presented fraudulent information to the investing public. Its share price fell sharply following the publication of the report. The SFC alleges that Mr. Left short sold 4.1 million shares of Evergrande shortly before publishing the report and realized a total profit of approximately HK\$1.7 million.
- **Directors ordered to disgorge funds:** The Court of First Instance has ordered three current and former directors (Mr. Wang Wenming (**Mr. Wang**); current chairman, Mr. Lee Yiu Shun (**Mr. Lee**); and current CEO and former chairman Mr. Richard Yin Yingneng (**Mr. Yin**) of First China Financial Network Holdings Ltd. (**First China**) to pay a total sum of RMB18,692,000 with interest as compensation to First China following findings of misconduct. Following a contested trial, the court found that Mr. Wang, Mr. Lee and Mr. Yin breached their duties to First China when they agreed to pay a special dividend of RMB18,692,000 to Fame Treasure Ltd (**Fame Treasure**). First China's announcement stated that the special dividend payment was part of a mutual understanding and arrangement with Fame Treasure at the time of First China's acquisition of GoHi Holdings Ltd. The court found that this was not the case and there had never been such mutual understanding and arrangement. The court held that Mr. Wang, Mr. Lee and Mr. Yin caused First China to make an unnecessary payment and ordered them to repay this amount to First China. During the trial, it was revealed that a written resolution was passed recently by a non-executive director and four independent non-executive directors of First China to provide an indemnity to Mr. Wang and Mr. Lee for all professional and legal fees incurred by them concerning the defence of SFC's petition and all legal costs claimed by the SFC as a result. The court found that the indemnity was plainly inappropriate and a poor reflection on First China's corporate governance. Consequently, Mr. Wang and Mr. Lee either have repaid or are in the course of repaying the legal costs First China paid on their behalf. A further hearing will be scheduled to determine whether disqualification orders pursuant to Section 214 of the SFO should be made against Mr. Wang, Mr. Lee and Mr. Yin.
- **Public criticism of shareholder:** The SFC publicly criticized Mr. Wen Yibo (**Mr. Wen**) for acquiring shares in Sound Global Limited (**Sound Global**) within six months after the close of an offer at above the offer price in contravention of Rule 31.3 of the Takeovers Code. In September 2013, Sound Global and Sound (HK) Limited (a wholly owned subsidiary of Sound Group Limited, an entity beneficially owned as to 99.83 percent by Mr. Wen and his wife) issued a joint announcement about the voluntary delisting of Sound Global from the Official List of the Singapore Exchange Securities Trading Limited. In order to facilitate the delisting, Sound (HK) Limited made a conditional cash offer for all the shares

in Sound Global at an offer price of HK\$4.37 (SG\$0.7) per share. The offer closed in January 2014. However, Mr. Wen and Sound Water (BVI) Limited (a company beneficially owned by Mr. Wen and his wife) acquired a total of 5,600,000 Sound Global shares from March to May 2014 at prices ranging from HK\$5.94 to HK\$7.55 per share in a series of on-market purchases. Mr. Wen admitted that he has breached Rule 31.3 of the Takeovers Code due to his inadvertent oversight and that he was not aware of such prohibition. He also agreed to the disciplinary action against him under s. 12.3 of the Introduction to the Takeovers Code. Rule 31.3 of the Takeovers Code is a fundamental provision which provides shareholders with certainty that the offeror will not pay a price higher than the offer price for the shares in the offeree company in the six-month period after the close of the offer, with a view to ensuring all shareholders of the offeree company are treated even-handedly.

- **License of regulated person suspended:** The SFC has suspended the license of Mr. Dick Ma To Fuk (**Mr. Ma**) in all regulated activities and approval for him to act as responsible officer for eight months pursuant to Section 194(1) of the SFO for failures relating to his role in the initial public offering of Powerlong Real Estate Holdings Limited (**Powerlong**) in 2009. Mr. Ma was formerly a responsible officer of ICBC International Securities Limited (**ICBI Securities**), which acted as one of the joint lead managers in the listing of Powerlong. The SFC found that some of the placees for the subscription of Powerlong's shares allotted through its listing were referred by Powerlong to ICBC International Capital Limited (one of the joint sponsors and bookrunners in the listing of Powerlong), which in turn referred them to its affiliate ICBCI Securities to open accounts for the placees' subscription. Mr. Ma accepted the subscriptions without conducting know-your-client due diligence as required under the Code of Conduct for Persons Licensed by or Registered with the SFC (**code of conduct**) and failed to find out their financial situation or confirm their independence from Powerlong. Some of the placees were found to be family and friends of Powerlong. Mr. Ma also failed to perform ongoing scrutiny to ensure that the subscriptions were consistent with his knowledge of the placees' financial situation and that any instructions from the placees indeed originated from the placees themselves. Mr. Ma also signed and filed a confirmation that the placees were all independent as required by the Stock Exchange under the Listing Rules, despite knowing that he did not have sufficient evidence to make the confirmation. Moreover, in further breach of the code of conduct, the SFC's investigation revealed that Mr. Ma did not diligently supervise his subordinates to carry out the same due diligence procedures. The SFC's enforcement action against Mr. Ma highlights the regulator's focus on the behavior of senior management.