



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:

- Signing of a memorandum on the mutual recognition of funds between mainland China and Hong Kong
- SFC emphasizes proper disclosure of inside information
- HKEx publishes report on review of disclosure in listed companies' annual reports
- Updated HKEx Frequently Asked Questions in Relation to Disclosure Requirements for Directors of Listing Applicants
- Listing decision issued by the HKEx regarding whether a company's cash flow generated during a period of noncompliance should be counted toward the calculation of minimum cash flow
- Moving toward paperless securities in Hong Kong
- Recent enforcement actions and penalties

Signing of a Memorandum on the Mutual Recognition of Funds Between Mainland China and Hong Kong

On 22 May 2015, the SFC and the China Securities Regulatory Commission (**CSRC**) entered into a Memorandum of Regulatory Cooperation on Mainland-Hong Kong Mutual Recognition of Funds (**MRF**) and agreed on the implementation principles and the mode and operation of the MRF. Through the MRF, the CSRC and SFC will allow mainland China and Hong Kong funds that meet the eligibility requirements to follow streamlined procedures to obtain authorization or approval for offering to retail investors in each other's market — effectively opening up the vast Chinese retail investor market to Hong Kong-licensed fund managers who meet the eligibility criteria.

On the same date, the CSRC and SFC detailed the eligibility requirements that must be met for fund managers and funds to benefit from the MRF in their respective markets. These requirements relate to the type of fund, minimum assets under management, the maximum portion of the fund that may be distributed in mainland China or Hong Kong, and the track record of the fund and the fund manager. Each Hong Kong fund

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proposing to benefit from the MRF must appoint a mainland Chinese agent (which must be an entity registered with the CSRC) to act on its behalf within mainland China, and must follow certain application procedures and operational requirements. The CSRC and SFC also have established cooperation mechanism for cross-border regulation and enforcement to ensure that mainland and Hong Kong investors will receive equal protection.

The MRF scheme will be implemented on 1 July 2015. The initial investment quota for the MRF will be RMB300 billion for in and out fund flows each way (*i.e.*, RMB300 billion “north-bound” with respect to Hong Kong funds distributed in mainland and RMB300 billion “south-bound” for mainland funds distributed in Hong Kong).

SFC Emphasizes Proper Disclosure of Inside Information

In its recent Corporate Regulation Newsletter, the SFC highlighted a number of concerns regarding disclosures by listed companies, including:

Previously disclosed profit information. The SFC noted an increase in media interest in the “quality” of newly listed companies, with a number of the companies issuing profit warning announcements shortly after listing stating that “significant listing costs” were among the main reasons for the profit decline. The SFC, noting that information on listing costs is required to be published in the company’s prospectus, considers the information already known to the public, and thus not required to be repeated.

Specific new information. Similarly, the SFC commented that an announcement repeating information, which in the prospectus is detailed, unambiguous and quantifiable, is rarely required under the Securities and Futures Ordinance (SFO). However, this would not apply to some of the general comments in a prospectus, such as disclosures in the risk factor section, if a specific risk materializes and disclosure of that fact would have a material effect on the company’s share price.

One-off events. The SFC noted that there have been instances of confusion caused by the repetition of information in announcements described as profit warnings or alerts. For example, the absence of a one-off gain is commonly cited as a reason for a decline in profits compared to the prior year. The SFC considers that, by definition, one-off, extraordinary, discontinued or other similarly described items are not

expected to reoccur, and therefore the fact that they did not reoccur normally would not be considered inside information.

Repeating disclosures. The SFC commented that, if a specific event already has been made known to the public, there is no statutory requirement to refer to or disclose such information again under the SFO. In some instances, if the repeated disclosures were sufficiently vague or unclear, they might cause some investors to think that there were two separate events, and the company may be regarded as having made a misleading announcement.

Inside information not directly related to specific event.

The SFC remarked that there are circumstances other than those relating to a specific transaction or event that may give rise to the creation of inside information and specifically referred to trading performance as an example. Determination of when information regarding a company’s trading performance needs to be disclosed pursuant to the inside information requirements of the SFO requires a judgment call to be made by management. According to the SFC, management generally must consider at least the following factors when making its determination:

- **Certainty.** In general, the company should provide precise figures for expected long-term earnings; however, this does not mean that the company needs to know the level of profit for a period to the nearest dollar before deciding whether it constitutes inside information. The company also should assess carefully whether an apparent change in results is merely short-term or indicative of a longer-term trend.
- **Expectations.** The company should consider how results match expectations. Under normal circumstances, if trading profits for the period were substantially lower than the previous period, this very likely would constitute inside information; however, if the company already has sufficiently disclosed to investors that such an outcome is expected due to loss of a significant contract, then it is much less likely to be inside information.
- **Materiality.** Simply because one month’s trading results are higher than expected might not be sufficient to justify an announcement; however if that month’s sales figures are of particular importance (*e.g.*, December sales or holiday sessions that contribute a significant portion of the company’s annual trading results) and the trading performance in that month can mean the difference between a good year and a bad year, then a trading update would be warranted.

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HKEx Publishes Report on Review of Disclosure in Listed Companies' Annual Reports

The HKEx issued its third report on findings and recommendations after its review of listed companies' annual reports and corporate communications as part of its ongoing monitoring and compliance activities. The main recommendations made by HKEx are as follows:

Fund raisings through issue of equity/convertible securities and subscription rights. Companies conducting equity fund raisings should clearly disclose their intended use of the proceeds at the time of the fund raisings and report back to shareholders in their annual reports on how these proceeds were actually applied, including details of the application and, where applicable, a breakdown of how the funds were allocated among different uses. Companies should avoid generic descriptions where possible.

Updates on material changes after acquisitions. In cases of material changes or significant asset impairments after the acquisitions of businesses, companies must (i) timely announce the material changes to the newly acquired businesses; (ii) properly make any impairment to the assets; and (iii) discuss in their annual reports the matters that gave rise to the impairment. Where the asset impairment is supported by an independent valuation, the HKEx required additional details and any subsequent changes to be disclosed. In the event that a company records material asset impairments shortly after their acquisition, the HKEx may query whether the directors had properly discharged their duties and whether disclosures had been accurate.

Results of performance guarantees on acquisitions. As part of the terms of acquisition agreements, some companies require the vendors to guarantee the performance of the acquired business. Where a performance guarantee by a connected person is not met, the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (**Listing Rules**) require a company to publish an announcement and disclose it in its next annual report. The HKEx believes equivalent disclosure should be made where the guarantee is provided by an independent party.

Significant changes to financial performance. The Listing Rules require disclosures on the discussion and analysis of financial performance and the material factors underlying a company's results and financial position. The HKEx recommended disclosures in (i) significant changes in revenue and/or profit margin; (ii) reliance on a small number of key customers and material changes in trade receivables; and (iii) abnormal effective tax rates or significant tax balances. The HKEx also provided a list of specific information that issuers should disclose in respect of each of these significant changes.

Adoption of HKFRS 10/IFRS 10. These accounting standards, which were issued in 2011 and have applied to annual reports since 1 January 2013, establish new guidance on the principle of control (which is the basis for consolidation). Companies are required to disclose an assessment of the financial impact of such accounting standards on their accounts.

Biological assets. Companies engaging in agricultural activities are subject to material risks relating to the valuation of biological assets. Where companies engaged valuers and experts to perform site inspections and prepare valuations, the HKEx recommended disclosures on the qualification of valuers/experts, their valuation methodology and assumptions, material inputs including bases and assumptions used in the valuation, and a sensitivity analysis. Where specific licenses are required to carry out the relevant agricultural activities, companies should disclose relevant details of licenses, including the type of licenses required, the expiry dates of the licenses and the application or renewal status (if applicable).

Companies listed in 2012 and 2013. Repeating the comments of the SFC noted above, the HKEx has stated that companies publishing profit warning announcements under the inside information provisions of the SFO should ensure that the information represents material developments subsequent to the date of the prospectus that has not previously been disclosed. Furthermore, companies should disclose confirmations of their major shareholders' compliance with any noncompetition undertakings given at the time of listing.

Periodic disclosure of mining or petroleum assets. Mineral companies and nonmineral companies that publicly disclose information about resources and/or reserves must give an update on resources and reserves in their annual reports. Mineral companies also must disclose details of their exploration, development and mining production activities, and a summary of expenditures incurred in such activities in their annual reports. In case of insufficient disclosures, HKEx may require companies to issue supplemental announcements.

Updated HKEx Frequently Asked Questions in Relation to Disclosure Requirements for Directors of Listing Applicants

The HKEx revised its Frequently Asked Questions Series 1 in May 2015 (**Revised FAQ**) in relation to disclosure requirements where a director of a listing applicant is subject to an investigation, hearing, proceeding or judicial proceeding in respect of which disclosure is prohibited by law (**Proceedings**). Appendix 1A Paragraph 41(1) of the Listing Rules requires brief biographical details to be provided in the listing document regarding the directors, proposed directors, senior managers and proposed senior managers of the issuers, which

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should include all “such other information which shareholders should be aware, pertaining to the ability or integrity of such persons.”

The Revised FAQ clarifies that where a director of a listing applicant is subject to an investigation, hearing, proceeding or judicial proceeding in respect of which disclosure is prohibited by law, he or she should assess whether the Proceedings relate to his or her ability or integrity. If the answer is yes, the director should seek consent from the relevant authority to confidentially disclose details of the Proceedings to the HKEx for assessment of his or her suitability as director of a listing applicant. If the director is unable to obtain the relevant consent, or the HKEx determines (following confidential disclosure by the director) that the Proceedings give rise to material concerns about his or her ability or integrity, the listing document will not be able to comply with Appendix 1A Paragraph 41(1) of the Listing Rules, and he or she should resign from the position as director of the listing applicant. The HKEx further sets out that if the director’s position in the listing applicant is so material that his or her resignation will result in the listing applicant not being able to comply with the Listing Rules (such as the management continuity requirement under Chapter 8), the listing applicant should postpone its listing application to HKEx until the Proceedings involving the director have been resolved.

Listing Decision Issued by the HKEx Regarding Whether a Company’s Cash Flow Generated During a Period of Noncompliance Should Be Counted Toward the Calculation of Minimum Cash Flow

In this listing decision, the HKEx determined that the cash flow generated during a period of noncompliance should not count toward the calculation of minimum cash flow under the Growth Enterprise Market (**GEM**) Rule 11.12A(1) and that the company at issue therefore was not eligible for listing. GEM Rule 11.12A(1) states that an applicant must have an adequate trading record of at least two financial years comprising a positive cash flow of at least HK\$20 million in aggregate for the two financial years generated from operating activities in the ordinary and usual course of business.

The company in the listing decision was in a business that required compliance with certain regulations that stipulated that no person shall carry on the business unless all the requirements under the regulations had been complied with. Any breach of the regulations was an imprisonable offence. The company did not comply with the regulations for 22

months during its track-record period and would not meet the minimum cash flow requirement under GEM Rule 11.12A(1) if the cash flow generated from the business during the period of noncompliance was excluded.

The HKEx determined that, given that the company did not comply with the relevant regulations during the period of noncompliance, the regulations were fundamental to the company’s business, and the serious breach of regulations had occurred for a substantial part of the track-record period, the noncompliant cash flow could not be regarded as being generated in the ordinary and usual course of business and therefore should be excluded from the calculation of minimum cash flow.

Moving Toward Paperless Securities in Hong Kong

Currently, the securities market in Hong Kong is largely paper-based. For instance, the Companies Ordinance (**CO**) (Cap. 622) requires the issue of paper certificates and the use of paper instruments of transfer in respect of shares and debentures. However, investors can hold and transfer securities in listed companies in electronic form through the Central Clearing and Settlement System (**CCASS**). The existing immobilized securities system has its shortcomings. First, it is not completely electronic. Some transactions still require the use of paper — such as, to some extent, the IPO process. In addition, the paper securities deposited into the CCASS depository are registered in the name of HKSCC Nominees Limited (**HKSCC**) and legal title to them remains vested in HKSCC, meaning that investors only hold a beneficial interest and must exercise their voting rights by submitting instructions indirectly via their broker/bank/custodian.

On 27 March 2015, the government published the Securities and Futures and Companies Legislation (**Uncertificated Securities Market Amendment**) Ordinance 2015 (**Amendment Ordinance**), which provides for a legal framework to enable the introduction of an uncertificated (*i.e.*, paperless) securities market regime and is mainly based on practice in the U.K. and Australian stock markets. Under the Amendment Ordinance, investors will be able to hold and transfer securities without paper documents and register the securities in their own names, thus enjoying the full benefits of legal ownership. The Amendment Ordinance mainly amends the SFO and the CO to stipulate the broad framework for the regulation of the uncertificated securities market. Its main provisions will commence operation on a date to be determined by the secretary for Financial Services and the Treasury.

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The initial stage of the uncertificated securities market regime will cover only shares of Hong Kong companies that are listed or to be listed on the HKEx. The government and SFC are initiating discussions on this with the relevant jurisdictions and studying their laws, so that companies from more jurisdictions may be covered by the uncertificated securities market regime.

Recent Enforcement Actions and Penalties

Takeovers Panel finds Chow Yei Ching, Oscar Chow Vee Tsung and Joseph Leung Wing Kwong in breach of the Takeovers Code. The Takeovers Panel found that Chow Yei Ching (Dr. Chow), Oscar Chow Vee Tsung (Mr. Chow), Joseph Leung Wing Kwong and the late Nina Kung were acting in concert and in breach of Rule 26 of the Takeovers Code by acquiring shares in ENM Holdings Limited (**ENM**), a wholesale and retail fashion company. Dr. Chow was the chairman of Chevalier International Holdings Limited, Oscar Chow is the son of Dr. Chow and Joseph Leung was a director of ChinaChem. Dr. Chow and the late Ms. Kung, the chairperson of ChinaChem, were business partners. Ms. Kung began acquiring shares in ENM until her shareholdings reached 10 percent in 2000 (the threshold for disclosure of interest at that time). Subsequently, her interest rose to 34.9 percent, just below the mandatory general threshold at that time (35 percent). In 2001, Ms. Kung asked Dr. Chow and Mr. Chow to purchase BVI companies and transfer shares acquired by the Chows to these BVI companies. Additional purchases were made, and the shares were held by the BVI companies. The Takeovers Panel found that Ms. Kung, Dr. Chow and Mr. Chow, among others, were acting in concert with Ms. Kung, based on their past business relationships and their knowledge in Ms. Kung's holdings in ENM. Mr. Leung, a director of ChinaChem, also was held to be a concert party and in breach of the Takeovers Code, as he played an active role as a member of the concert group in handling the reimbursement of funds from Ms. Kung to Dr. Chow. Based on their aggregate shareholdings, the Takeovers Panel found that a mandatory offer obligation had been triggered under Rule 26.

Market misconduct proceedings in respect of alleged insider dealing in the shares of Warderly International Holdings Limited. The SFC alleges that a company secretary and a potential investor of Warderly International Holdings Limited (Warderly) were in breach of insider dealing rules, because they were aware that Warderly was in a perilous

financial position when they sold the company's shares in 2007 and, as a result, avoided a total loss of approximately HK\$12 million. Warderly began to have cash flow problems in mid-2006 due to raw material costs and the settlement of a tax claim from the Inland Revenue Department. From July 2006 onward, Warderly experienced a number of material events concerning its financial position, including tightening of banking facilities and rescheduled payments. The SFC alleged that the company secretary and investor knew the financial crisis facing Warderly was material, highly price sensitive and not generally known to the market, and therefore they acted in breach of the insider dealing rules.

Disqualification order against former director. The Court of First Instance issued a disqualification order against Lam Yick Sing (Mr. Lam), a former executive director of Tack Fat Group International Limited (**Tack Fat**), from being a director or being involved in the management of any listed or unlisted corporation for a period of six years effective from 27 March 2015. Lam admitted that he (i) failed to ensure that Tack Fat gave its shareholders all the information they might reasonably expect and to comply with the disclosure requirements under the Listing Rules; (ii) abdicated his responsibilities as a director of a publicly listed company; (iii) breached his duties as a director in failing to exercise reasonable care and diligence in the management of Tack Fat, to act in good faith and the best interests of Tack Fat, and to implement a sound and prudent system of financial control so as to minimise the risk of misappropriation of company assets; and (iv) was partly responsible for the business or affairs of Tack Fat having been so conducted. Lam also admitted that he signed documents pledging the company's and subsidiary's assets to secure loans to related parties that were improperly hidden from shareholders. He further signed attendance sheets for two board meetings in which Tack Fat approved a sham transaction involving an undisclosed connected party in an acquisition of 40 percent of a Cambodian timber company. Lam admitted that he did not know anything about the vendor or other details of the transaction. He conceded that he did what he was told without any due exercise of independent commercial judgment and that he was not clear on the duties of disclosure by a listed company. In granting the order, the Honourable Mr. Justice Lam said a six-year disqualification period was appropriate because Lam was demonstrably lacking in diligence, competence and independence as a director, and had disregarded the responsibilities he owed to the company and those who had interests in it.

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Disqualification and compensation orders sought against former chairman and directors. The SFC has commenced legal proceedings in the Court of First Instance against the former chairman and directors of Inno-Tech Holdings Limited (**Inno-Tech**) over alleged misconduct that caused the company to lose more than HK\$125 million. The SFC alleges that Inno-Tech's former chairman and director, Wong Yuen Yee, and three former directors, Robert Wong Yao Wing, Wong Kwok Sing and Lam Shiu San, breached their duties as directors in relation to the acquisitions and/or disposals of interests in three hotels and a gold mine on the mainland between 2007 and 2010, resulting in substantial and material losses to Inno-Tech. Specifically, the SFC alleges that the four former directors failed to (i) carry out adequate investigation into or due diligence prior to the acquisitions of the interests in the hotels and gold mine; (ii) negotiate the consideration for acquiring the interests in the hotels and gold mine; (iii) assess or obtain any independent assessment of whether an investment in the gold mine was commercially suitable or appropriate for Inno-Tech; (iv) assess the purchase price of the interests in the gold mine properly; (v) give adequate consideration to who would be appropriate to appoint as directors and/or to put in charge in respect of gold mining matters; and (vi) supervise the running of the gold mine properly. The SFC is seeking orders that the four former directors be disqualified as company directors and that Inno-Tech bring proceedings against the four for compensation or, alternatively, that the four be ordered to pay compensation to Inno-Tech directly.

Issuing advertisement without SFC's authorization. The Court of Final Appeal (**CFA**) upheld an appeal by Pacific Sun Advisors Limited (**Pacific Sun**) and its director Andrew Pieter Mantel in relation to issuing advertisements to promote a collective investment scheme (**CIS**) without the authorization of the SFC. Pacific Sun and Mantel were charged in 2013 with issuing unauthorized advertisements to the public at large to subscribe for interests in a CIS in contravention of Section 103 of the SFO, which requires any advertisement, invitation or document containing an invitation to the public to acquire securities or interest in a CIS to be authorized by the SFC unless it falls within a specified statutory exclusion. Pacific Sun and Mantel were acquitted after successfully arguing that they could rely upon an exclusion contained in Section 103(3)(k), which applies if the securities are or are intended to be disposed of only to professional investors. The CFA has decided that the exclusion applies even if the intention to dispose of the securities or interests in a CIS only to professional investors is not expressed in the advertisement, invitation or document. The CFA made it clear that the burden of establishing that the exclusion applies rests on the defendant and not on the SFC and that the professional investor exemption would not apply if a person published an unauthorized offer to the public and sold the advertised securities to a retail investor. The ruling means advertisements of CISs that may be unsuitable for retail investors can be issued to the general public even if the issuer only intends to sell them to professional investors. It also means a contravention of Section 103, which occurs upon issue of a relevant unauthorized offer to the public, only can be established well after the offer to the public has been issued.