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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 the application of cash company rules to large-scale fundraisings
- HKEx publishes results of its latest review of disclosure in issuers' annual reports
- HKEx issues a guidance letter on placings to connected clients and existing shareholders in IPOs
- Hong Kong Exchanges and Clearing Limited rolls out Strategic Plan 2016-18
- HKEx provides guidance on producing simplified listing documents relating to equity securities for new applications
- The Contracts (Rights of Third Parties) Ordinance came into effect on 1 January 2016
- The Takeovers Panel rules on a general offer obligation for The Cross-Harbour (Holdings) Limited
- Recent enforcement actions and penalties

**HKEx Issues Guidance Letter on Application of Cash Company Rules to Large-Scale Fundraisings**

In a move that could potentially curtail the ability of companies to raise funds through the issue of equity to embark on new lines of business, on 21 December 2015, the HKEx issued Guidance Letter HKEx-GL 84-15 in relation to the application of Rules 14.82 to 14.84 of the Hong Kong Listing Rules (**Cash Company Rules**) to large-scale fundraisings. The guidance letter was issued in response to an increase in large-scale equity fundraisings being conducted or proposed by listed companies that involved either a change in ownership control and/or the company using the cash to engage in a line of business that had not previously formed part of its core business strategy. Most issues of equity had been conducted at a deep discount to the current market price of the shares of those companies.

Under the Cash Company Rules, a company whose assets consist wholly or substantially of cash (a **Cash Company**), will not be considered suitable for listing. In such cases, HKEx will suspend the issuer's trading, and the issuer must apply for resumption of trading as if it were a new listing applicant. For many years, the well-known market rule

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of thumb was that a cash level of 90 percent of assets would be problematic. However, the HKEx has now clarified that there is no quantitative threshold for triggering the Cash Company Rules (*i.e.*, equity fundraising of any amount, however modest, could potentially trigger a cash company issue).

The HKEx also has clarified that when assessing whether a company will become a Cash Company following a proposed fundraising, it will not only consider the company's cash level but also take into account other facts and circumstances of the company's business, operations and financial position. Factors taken into account will include:

- whether the company has less than half its assets in cash (as a company with less than 50 percent of its assets in cash will not normally be regarded as having assets consisting wholly or substantially of cash);
- whether the funds raised would be significant to the company's overall assets;
- whether the funds raised would be used for new business purposes unrelated to the company's existing principal business, and if so, whether the new business would be suitable for listing; and
- whether the fundraising would result in a change in actual or de facto control of the company.

The HKEx further noted that:

- a company's cash position is assessed at the date of completing the fundraising;
- any business plans or binding (including signed) agreements to commit cash proceeds toward future uses will not be taken into account in the assessment; and
- separate fundraisings by a company may be aggregated and assessed together and subject to additional conditions, if HKEx considers that the fundraisings would result in the issuer listing a new business not otherwise suitable for listing.

Companies considering large-scale equity fundraisings are encouraged to consult with their advisers (and the HKEx) at the earliest possible opportunity to seek guidance on the application of the Cash Company Rules on a case-by-case basis.

## HKEx Publishes Results of Its Latest Review of Disclosure in Issuers' Annual Reports

On 29 January 2016, the HKEx published a report on the findings and recommendations from its review of listed companies' annual reports for the financial year ended in December 2014

for compliance with the Hong Kong Listing Rules, corporate conduct and disclosure of material events and developments.

To improve transparency and promote a fair, orderly and informed market, the HKEx suggested that companies note the following areas that need improvement:

**Continuing Connected Transactions.** Under the Hong Kong Listing Rules, independent directors must review and monitor continuing connected transactions annually. The new Code Provision C.2.5 of Appendix 14 to the listing rules (or Appendix 15 to the Growth Enterprise Market (GEM) Rules) requires an internal audit review of risk management and internal control systems. Therefore, companies should ensure that their internal audits review continuing connected transactions and the relevant internal control procedures, and provide the findings to independent directors to assist them in performing their annual review.

**Contractual Arrangements.** Guidance Letter HKEx-GL 77-14 recommends that companies keep their shareholders informed of material business operations that are controlled through contractual arrangements (often referred to as VIE arrangements). However, many companies adopting contractual arrangements fail to disclose details of their business activities or provide a summary of the major terms under the relevant structured contracts and explain their significance. Given the risks associated with such arrangements, companies should consider HKEx-GL77-14 in preparing future annual reports.

**Disclosure of Significant Changes to Issuers' Financial Performance and Reliance on Key Customers.** Although many companies have provided more detailed discussions relating to significant changes in revenue, profit margin and tax positions, the HKEx is of the view that more in-depth discussion about compliance with relevant laws and regulations, capital requirements and financing plans for capital requirements, and key relationships with customers could be provided. For preparation of a business review, companies may also refer to guidance materials issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Institute of Directors.

**Equity Fundraising.** Companies conducting equity fundraisings should provide meaningful updates in their annual reports on the actual use of proceeds from such fundraisings, including details of the application and a breakdown of how the funds were allocated among different uses, in order to provide accountability to shareholders.

The full report is available [here](#).

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## HKEx Issues a Guidance Letter on Placings to Connected Clients and Existing Shareholders in IPOs

The placing guidelines in Appendix 6 to the listing rules provide that, without the consent of the HKEx, initial public offering (IPO) underwriters cannot place shares to (i) their “connected clients” or to (ii) existing shareholders of the company being listed or their close associates. The HKEx’s guidance letter HKEx-GL 85-16 clarifies that connected clients and existing shareholders or their close associates are permitted to participate either as cornerstone investors or as placees in IPOs, subject to certain conditions. These conditions

are primarily designed to address any actual or perceived preferential treatment given to connected clients and existing shareholders or their close associates.

The HKEx has set out three general conditions: (i) “Nondiscretionary Basis Conditions” for connected clients holding securities on a nondiscretionary basis on behalf of independent third parties, (ii) “Discretionary Basis Conditions” for connected clients holding securities on a discretionary basis on behalf of independent third parties, and (iii) “Existing Shareholders Conditions” for current shareholders or their close associates. The three conditions are summarized below:

	Nondiscretionary Basis Conditions	Discretionary Basis Conditions	Existing Shareholders Conditions
Securities are held on behalf of independent third parties	✓	✓	N/A
The applicant shall confirm to the HKEx that the cornerstone investment agreement does not contain any material terms which are more favourable to the connected client/existing shareholder or its close associates	✓	✓	✓
<b>Confirm to the HKEx that no preferential treatment has been, nor will be, given; such confirmation to be given by:</b>			
- applicant	✓	✓	✓
- connected broker/distributor	✓	✓	N/A
- bookrunners	✓	✓	✓
- connected client	✓	✓	N/A
- sponsor	✓	✓	✓
<b>Confirm to the HKEx that the connected broker/distributor is not participating in decision-making process/discussion relating to connected client; such confirmation to be given by:</b>			
- applicant	N/A	✓	N/A
- connected broker/distributor	N/A	✓	N/A
- bookrunners	N/A	✓	N/A
<b>Existing shareholder</b>			
- is interested in less than 5% of an applicant’s voting rights	N/A	N/A	✓
- is not a core connected person or its close associate	N/A	N/A	✓
- does not have the power to appoint directors or any other special rights	N/A	N/A	✓
<b>Allocation to the existing shareholder or its close associates will not affect the applicant’s ability to satisfy the public float requirement</b>	N/A	N/A	✓

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The HKEx has made it clear that connected clients, whether or not holding securities on behalf of independent parties, and existing shareholders or their close associates cannot participate both as cornerstone investors and as places. Furthermore, no consent will be given for allocation of shares to a connected client for its proprietary account unless there are exceptional circumstances that will be considered on a case-by-case basis.

## Hong Kong Exchanges and Clearing Limited Rolls Out Strategic Plan 2016-18

On 21 January 2016, the parent company of the HKEx announced its Strategic Plan 2016-18 (the **Plan**), outlining its development road map for the HKEx and Hong Kong's financial markets. The goals for the Plan are to extend and deepen the HKEx's value proposition against the backdrop of China's accelerating capital market internationalization. The Plan includes the HKEx's business strategy for its three asset classes:

### 1. Equity

- Grow and strengthen HKEx's core franchise as a compelling listing and fundraising venue;
- Significantly expand mutual connectivity especially with Shanghai and Shenzhen; and
- Launch new derivatives products in mainland China, Hong Kong and international underlying assets.

### 2. Commodities

- Expand suite of products both on the London Metal Exchange (**LME**) and in Hong Kong into adjacent commodities;
- Build a convenient channel for Asian liquidity to access the LME market and products;
- Develop a spot commodities trading platform in the mainland market in order to service the real economy; and
- Pursue cross-border connectivity with mainland commodities exchanges and products.

### 3. Fixed Income and Currency

- Launch new exchange-traded derivatives in Hong Kong on renminbi and onshore interest rates;
- Offer a broader product suite in OTC Clearing Hong Kong Limited, delivering tangible benefits to market users; and
- Explore mutual market access with the mainland in the institutional cash bond market through a "bond connect" scheme.

The Plan also covers the HKEx's goals in client relationship management and platform enhancement as well as market microstructure and regulation. The HKEx is aiming to reach its new strategic goals over three years, though it expects accomplishment of some of the goals may take longer because it has an ambitious plan, and development of financial markets is subject to many factors beyond HKEx's control. We understand that as part of the Plan, the HKEx is also considering revamping the GEM market, options for a possible third board and overhauling the process of listing international companies with an existing listing on another market.

## HKEx Provides Guidance on Producing Simplified Listing Documents Relating to Equity Securities for New Applications

On 2 February 2016, the HKEx published Guidance Letter HKEx-GL 86-16, titled "Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications" (the **Listing Document Simplification Guide**).

The objectives of the Listing Document Simplification Guide include:

- assist applicants and their advisers in producing listing documents that fulfill the general principles that potential investors be given sufficient information to enable them to make a properly informed assessment of an applicant (Main Board Rule 2.03(2)) and that information contained in a listing document be clearly presented and in plain language format (Main Board Rule 2.13);
- improve investors' ability to find and understand information in a listing document necessary to make a properly informed assessment of an applicant; and
- consolidate and update guidance on listing document simplification.

The Listing Document Simplification Guide is divided into two parts. The first part provides general guidance on producing clear and concise listing documents, including general drafting principles and practical suggestions for the drafting process. There is a particular focus on removing unnecessary information, simplifying language, avoiding defined terms and the importance of structure and presentation of information. The second part provides consolidated and updated versions of a number of the HKEx's guidance letters on disclosures in listing documents. Standalone guidance letters that have been consolidated into the Listing Document Simplification Guide will be withdrawn after 30 April 2016.

The Listing Document Simplification Guide also notes that the "Summary of the Constitution and Laws of Place of Incorporation" section in a listing document should be the same or

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very similar for most applicants from the same jurisdiction. As a result, the HKEx has prepared specimen versions of this section and the corresponding standard articles of association or bylaws for applications incorporated in Bermuda, the Cayman Islands and mainland China. These are for reference only and should be reviewed and amended as necessary.

## Contracts (Rights of Third Parties) Ordinance Went Into Effect on 1 January 2016

The Contracts (Rights of Third Parties) Ordinance went into effect on 1 January 2016 and will apply to Hong Kong law governing contracts entered into on or after 1 January 2016. The ordinance confers rights on third parties (regardless of whether they have given consideration) and enables them to enforce the terms of an agreement to which they are not a party if:

- the contract expressly provides that the third party has such a right; or
- the term purports to confer a benefit on the third party and is intended to be enforceable by the third party on a proper construction of the contract.

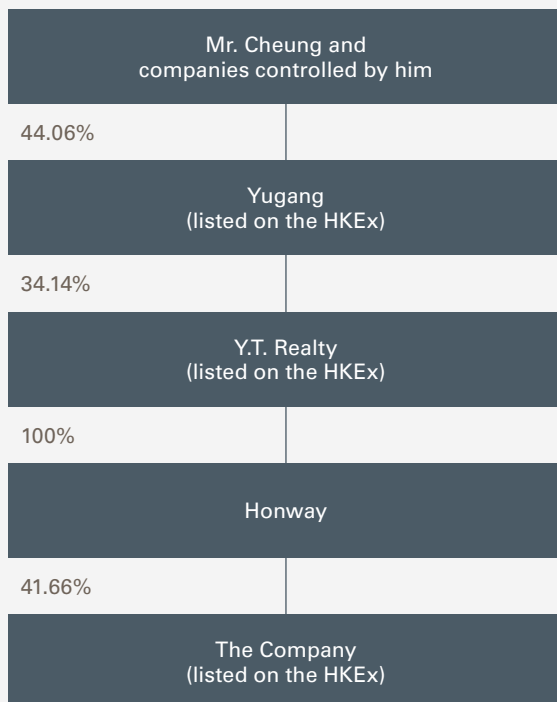
The third party must be expressly identified by name in the contract, as a member of a class or as answering a particular description. Once the rights of the third party are “crystallised” either by (i) the receipt of a notice of assent by the promisor or (ii) actual reliance by the third party (and the promisor is aware of or can reasonably be expected to have foreseen such reliance), the contract cannot be rescinded or varied without the consent of the third party. The third party will be entitled to the same remedies as if they were a party to the contract (including equitable remedies and specific performance). The requirement of having the consent from third parties to vary the terms of a contract after “crystallisation” renders contract formation or variation uncertain. However, it is possible to opt out of the application of the ordinance either partially or entirely by including express clauses in the contract.

## Takeovers Panel Rules on General Offer Obligation for The Cross-Harbour (Holdings) Limited

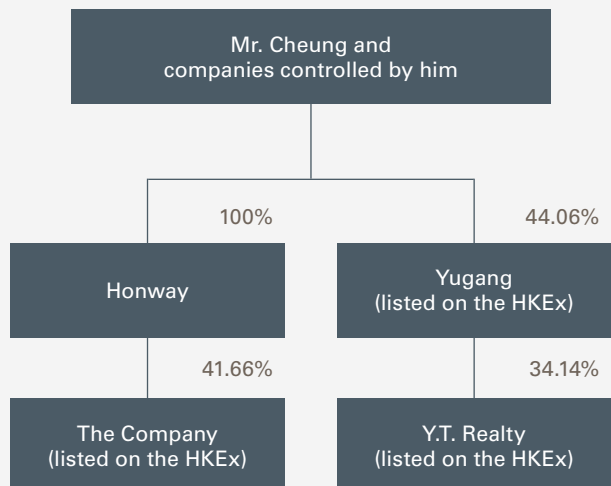
The Takeovers Panel recently ruled that a general offer obligation would be triggered as a result of the “chain principle.” In the case considered by the Takeovers Panel, Mr. Cheung Chun Kiu, through a company controlled by him, proposed to

### Mr. Cheung’s Transaction Structure

#### Before the proposed transaction



#### After the proposed transaction



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purchase the entire issued share capital of Honway Holdings Limited from Y.T. Realty Group Limited. Honway holds a controlling shareholding in The Cross-Harbour (Holdings) Limited (the **Company**). The charts illustrate the structure of Mr. Cheung's proposed transaction:

The Takeovers Panel had to rule whether a general offer obligation would be triggered as a result of the completion of the prospected transaction and whether a waiver from the general offer obligation would be granted under Note 6 to Rule 26.1 of the Takeovers Code.

The Takeovers Panel ruled that, pursuant to Note 8 to Rule 26.1 of the Takeovers Code (*i.e.*, the chain principle), a general offer obligation would have arisen on the sale of Honway to Mr. Cheung or a company controlled by him. On the sale, Mr. Cheung or a company controlled by him would acquire statutory control of Honway, which holds more than 30 percent of the voting rights of the Company. Honway has no material assets other than its shareholding in the Company.

The Takeovers Panel further ruled that no waiver from general offer obligation should be granted under Note 6 to Rule 26.1 of the Takeovers Code based on the following:

- Note 6(a)(i) to Rule 26.1 of the Takeovers Code (*i.e.*, the SFC would normally grant a waiver for intragroup reorganizations) is not applicable since even if the company acquiring Honway is the same company through which Mr. Cheung controls Yugang, the proposed transaction would not be a group reorganization because Yugang is not a subsidiary of that company and Y.T. Realty is not a subsidiary of Yugang;
- Note 6(a)(ii) to Rule 26.1 of the Takeovers Code (*i.e.*, the SFC would normally grant a waiver for transactions involving concert party groups that comprise family members, family controlled companies and family trusts) is not applicable since the arrangements contemplated by Mr. Cheung are not arrangements for the transfer of voting rights between him and members of his family, whether held directly or through related family trusts or family-controlled companies;
- When Note 6(a)(i) and (ii) did not apply, the three factors set out in Note 6 to Rule 26.1 of the Takeovers Code were taken into account in considering whether to grant a waiver from general offer obligation:
  - **The Leadership of the Concert Group and the Balance of the Shareholdings.** Although the leadership of the group is held by Mr. Cheung, the largest shareholding of the Company and the balance of the shareholdings of the Company would change fundamentally if the proposed transaction was implemented. On completion, the previous controlling shareholder, Y.T. Realty, would hold no shares in the Company and Mr. Cheung would hold indirectly through Honway a controlling interest in it;

- **The Price Paid for the Shares Acquired.** The proposed transaction does not envisage any premium control, as Y.T. Realty would be selling a controlling interest in the Company to its own controlling shareholder; however, this did not appear to be determinative in all the circumstances of this case; and
- **The Duration of the Concert Party and the Relationship Between Its Members.** The concert group lasted for a relatively long period. However, the chain of control endured only because of the acquiescence of the holders of a majority of the shares in Y.T. Realty and Yugang, the continuation of which is beyond Mr. Cheung's control.

Taking all these factors into account, the Takeover Panel ruled that no general offer obligation waiver would be granted.

## Recent Enforcement Actions and Penalties

### Court Dismisses Substantial Shareholder's Appeal of Convictions for Failure to Disclose Interests

The Court of First Instance dismissed an appeal by Mr. Lam Fai Man of the Eastern Magistracy's 30 June 2015 decision. In one of the first cases involving an SFC prosecution of a failure to report a disclosable interest in a listed company, the court found that Mr. Lam did not satisfy the disclosure and notification obligations under Part XV of the Securities and Futures Ordinance (Cap. 571) (SFO) when he failed to disclose changes in his shareholding of Victory Group Limited, of which he was a substantial shareholder at the time. The court rejected Mr. Lam's argument that he did not contravene the disclosure and notification obligations as he had delegated the performance to another person (a stockbroker). The court held that Mr. Lam bore ultimate responsibility and liability for failing to comply with the disclosure and notification requirements, as he had an obligation to ensure that the delegated tasks were properly performed. Mr. Lam was originally fined HK\$12,000 by the Eastern Magistracy for his breaches.

### The Listing Committee Censures New Sports Group Limited and Its Directors

In January 2016, the Listing Committee of the HKEx censured New Sports Group Limited (NSGL, formerly known as Sinocom Software Group Limited) and certain current and former directors for breaching the Hong Kong Listing Rules. Between July 2012 and February 2013, one of NSGL's subsidiaries made a series of substantial cash advances to three borrowers, all of whom the Listing Committee later deemed to be connected persons under Rule 14A.11 of the listing rules. The advances were approved by two directors of the subsidiary, including Mr. Li Jian, who also was an executive director of NSGL at the time, without NSGL board knowledge or approval. It later transpired that at around the same period of time, the three borrowers also were making loans to SJI

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Inc., the ultimate controlling shareholder of NSGL. Mr. Li was at relevant times also a director and shareholder of SJI. It was not until late 2012 that the NSGL board became aware of the advances and the relevant loans to SJI. In 2013, NSGL publicly acknowledged that the advances and the loans to SJI were related, that the borrowers were deemed connected persons of NSGL and that the advances therefore constituted connected transactions. All sums involved were repaid in February 2013.

The Listing Committee concluded that NSGL breached a number of listing rules, including Rules 13.13 and 13.14 in relation to disclosure of relevant advance to an entity. NSGL also breached (i) the announcement requirement in relation to certain advances under Rule 14.34 and (ii) the shareholder approval requirement under Rule 14.40 as each of the advances constituted either a disclosable or major transaction under the listing rules. Furthermore, the Listing Committee concluded that it was appropriate to deem the borrowers connected persons under Rule 14A.11 of the listing rules because, among other things, (i) a significant part of the advances to the borrowers were channeled to SJI for SJI's benefit through the borrowers' loans to SJI, (ii) the materials available suggested Mr. Li was the initiator of the scheme of loans with the borrowers, and (iii) NSGL effected indirect financial assistance to SJI. According to the Listing Committee, there was no discernible reason why NSGL could not have provided the financial assistance to SJI directly instead of entering into the various arrangements to disguise and conceal the indirect financial assistance given by NSGL to SJI and circumvent the listing rules related to connected transactions.

The Listing Committee concluded that Mr. Li breached Rules 3.08(a), (b), (d), (f) and Appendix 5B undertaking of the listing rules (the **Undertaking**). The Listing Committee also found that Mr. Li exhibited a willful disregard of, or at least a willful blindness to, the listing rules. The Listing Committee further stated that Mr. Li had been far from truthful, complete and open in the course of NSGL's investigation of the matter, including by making untrue statements. Mr. Li's conduct gave rise to serious concerns about his integrity and character, and about his lack of ability and willingness to perform the duties of a director of a listed issuer required under the listing rules.

The Listing Committee further stated that in the event that Mr. Li should wish to become a director of any issuer listed on the HKEx in the future, his conduct in this matter would be taken into account in assessing his suitability under Rule 3.09 of the listing rules. The rest of the directors involved were censured or criticized for their breach of Rule 3.08(f) and their Undertakings.

## **Court Finds Two Solicitors Engaged in Insider Dealing and Fraud or Deception**

On 15 January 2016, the Court of First Instance issued a landmark decision on the interpretation of Section 300 of the SFO, which prohibits the use of fraudulent or deceptive schemes in transactions involving securities. The court found that Mr. Eric Lee Kwok Wa and Ms. Betty Young Bik Fung, both solicitors, and Ms. Patsy Lee Siu Ying, the sister of Mr. Lee, contravened insider trading provisions of the SFO by dealing on nonpublic, confidential and materially price-sensitive information (**Inside Information**). In September 2006, Ms. Young gained Inside Information when she came across a tender offer proposed by her then-client for Hsinchu Bank while seconded to the client by her employing law firm. Ms. Young shared the information with Mr. Lee and Ms. Lee and acquired shares in Hsinchu Bank. The court found that Ms. Young breached duties owed to her employer and their client, which amounted to fraud or deception in contravention of Section 300 of the SFO. In February 2007, Mr. Lee gained Inside Information concerning the proposed privatization of Asia Satellite. Mr. Lee shared the information with Ms. Young and Ms. Lee and acquired shares in Asia Satellite. The court held that Mr. Lee's actions constituted insider dealing in contravention of Section 291 of the SFO. The court exercised its powers under Section 213 of the SFO, ordering that the profits be returned to the victims of the transactions. A copy of the judgment was delivered to the Law Society of Hong Kong, of which both Ms. Young and Mr. Lee were members at the time.