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Skadden

Contacts

Christopher W. Betts
Partner / Hong Kong
852 3740 4827
christopher.betts@skadden.com

Paloma Wang
Partner / Hong Kong
852 3740 6888
paloma.wang@skadden.com

Antony Dapiran
Of Counsel / Hong Kong
852 3740 4762
antony.dapiran@skadden.com

Anthony Pang
Counsel / Hong Kong
852 3740 4831
anthony.pang@skadden.com

Prepared with the assistance of associates Joanne Loi, Steven Lee, Paul Lau and Gabriel Lee.

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Four Times Square
New York, NY 10036
212.735.3000

42/F Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong
852.3740.4700

This edition provides an overview of key regulatory developments in the past three months relevant to companies listed (or planning to list) on The Stock Exchange of Hong Kong Limited (**HKEx**) and their advisers. The update covers amendments to the Rules Governing the Listing of Securities on HKEx (**Listing Rules**) and announcements, guidance and enforcement-related news from HKEx and the Securities and Futures Commission (**SFC**), as well as other recent market developments.

Stock Connect to Open to WVR Companies

HKEx announced that it has reached an agreement with the Shanghai and Shenzhen Stock Exchanges to permit companies with dual-class share structures listed in Hong Kong — referred to as weighted voting rights (**WVRs**) companies — to be traded by Mainland-based investors through the Stock Connect program. This will be welcome news to the two WVR companies currently listed in Hong Kong — Xiaomi Corporation and Meituan Dianping (Skadden advised on both these IPOs in 2018) — as well as other aspiring WVR listing applicants. HKEx is working on detailed rules to implement the agreement, and these rules should be announced to the market for implementation by mid-2019.

The Stock Connect program enables Mainland-based investors to trade directly in certain HKEx-listed securities (southbound trading) while also permitting Hong Kong-based investors to trade directly in certain securities listed on the Shanghai and Shenzhen stock exchanges (northbound trading). To qualify for southbound trading, the company must be a constituent of the Hang Seng Composite Index. Hang Seng Indexes Company Limited, the company responsible for formulating the Hang Seng indexes, already had announced that "Greater China" WVR companies, including those with either a primary or secondary HKEx listing, are eligible for inclusion in the Hang Seng Composite Index. The forthcoming rules following this latest HKEx announcement will be the final step in opening these companies to Mainland investors through Stock Connect.

Annual Reporting Season: HKEx Guidance on Annual Reports and ESG Reporting

As listed companies move into annual reporting season, HKEx has issued helpful guidance in the form of its annual review of listed companies' annual reports and new guidance on environmental, social and governance (**ESG**) reporting.

HKEx reported the following as key areas where there is room for improvement:

- **Business review in MD&A**: Companies should ensure the management discussion and analysis (**MD&A**) section of their annual report contains sufficient disclosure of their business model/the revenue recognition methodology of each core business;

unique characteristics of their operation processes; relationships with key customers and suppliers; principal risks affecting operations and measures to manage such risks; and strategies (including operations strategies and treasury policies) for meeting their business objectives.

- **Material intangible assets:** Companies should ensure the quality of their disclosures relating to intangible assets and ascertain whether the processes for assessing impairment are sufficient and appropriate, in particular when there are significant goodwill and intangible assets with indefinite useful lives.
- **Disclosures on material "other expenses"**: Companies with material "other expenses" or "other operating expenses" should provide appropriate detailed breakdown of those items to enhance shareholders' understanding.
- **Financial statements with auditors' modified opinions**: Companies with auditors' modified opinions should disclose their audit committee's views of the modifications and proposed plans to address them.

HKEx has also updated its **how-to guide on preparation of ESG reports**, which is required under Appendix 27 of the Listing Rules. The guide suggests the following steps:

- establishing an ESG working group, bearing in mind that the board retains overall responsibility;
- understanding the ESG reporting requirements and the company's particular ESG risks, and identifying gaps in sources of data and information;
- determining the scope of business to be reported on (such as particular geographical or business segments);
- engaging with stakeholders potentially affected by the company's decisions on ESG matters;
- conducting internal and external assessments of the ESG issues that are material to the company; and
- preparing the ESG report.

Updated frequently asked questions (**FAQs**) provide additional guidance on ESG reporting where companies adopt other international standards or guidelines. In particular, the FAQs provide specific references to provisions in international standards or guidelines that are comparable to, and enable compliance with, the ESG Reporting Guide. Other international standards or guidelines that companies may consider are:

- Global Reporting Initiative's Sustainability Reporting Standards
- CDP's Climate Change Questionnaire and Water Security Questionnaire
- Recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures
- the International Organization for Standardization's Guidance on Social Responsibility
- the Corporate Sustainability Assessment for inclusion in the Dow Jones Sustainability Indices

HKEx also clarified that printed copies of the ESG report need not be sent to shareholders (unless specifically requested) if the report is in the form of a standalone report or published on the company's website.

HKEx has indicated it intends to publish a consultation paper on proposed changes to the ESG reporting framework in mid-2019. Listed companies should be alert to future changes in this evolving area.

Updates to Corporate Governance Code

HKEx listed companies will need to ensure they have updated their corporate governance policies to take account of changes to HKEx's Corporate Governance Code (**Code**) and related Listing Rules that came into effect as of 1 January 2019. The key changes are as follows:

Mandatory changes:

- Companies must adopt a diversity policy and disclose that policy or a summary of it in their corporate governance report.
- There are now more stringent independence criteria for independent non-executive directors (**INEDs**), including: (i) a one-year cooling off period for persons with "material interests" in the company (previously there was no cooling off period), (ii) a two-year cooling off period for former professional advisers of the company (previously one year), and (iii) an assessment of the independence of immediate family members of a potential INED.
- Companies must disclose their director nomination policy.

"Comply or explain" matters (Code Provisions):

- The chairman must meet at least annually with all INEDs.
- When proposing an INED candidate for election, boards will be required to set out (i) the process by which the candidate was identified, (ii) reasons why the candidate should be elected, (iii) reasons the candidate is independent, (iv) the perspectives, skills and experience the candidate brings, and (v) how the candidate will contribute to diversity of the board.
- Where an INED candidate is being nominated to a seventh (or more) listed company directorship, the company must explain how the director will be able to devote sufficient time to his/her role.

- Companies must adopt and disclose a dividend policy.

Recommended best practices (for which compliance is voluntary):

- Companies are encouraged to disclose INED's cross-directorships or other significant links with other directors.
- Listing candidates are encouraged to formally appoint INEDs at least two months before listing. (Current market practice is often formally to appoint the INEDs at a later stage in the IPO process only after the company is reasonably assured the IPO will be completed.)

New Accounting Standards for Lease Transactions Impact Listing Rules

Changes to the accounting treatment of leases under recent amendments to HKFRS/IFRS have implications for how these transactions will be treated under the Listing Rules. Under new HKFRS/IFRS 16, a lessor continues to account for a lease as either an operating lease or a finance lease. However, a lessee should recognise a right-of-use asset (its right to use the leased asset) and a lease liability (its obligation to make lease payments).

HKEx has published a set of frequently asked questions (**FAQs**) on the implications of these changes for lessees where the lease transactions are notifiable or connected transactions under Chapters 14 and 14A of Listing Rules. The most notable points for listed companies entering into lease transactions as lessees are as follows:

- A lease transaction (being recognition of a right-of-use asset) constitutes an acquisition of assets and cannot benefit from exemption under Chapter 14 for transactions of a revenue nature in the ordinary course of business.
- Where a lease involves both a fixed amount (**Fixed Lease Payment**) and a variable amount (**Variable Lease Payment**) (*e.g.*, a percentage of sales generated from the property), the Fixed Lease Payment constitutes an acquisition of assets while the Variable Lease Payment constitutes an expense of revenue nature. As the Variable Lease Payment constitutes an ongoing expense, it can benefit from the revenue exception.
- A fixed term lease agreement with a connected person will constitute a one-off transaction, while a framework lease agreement covering multiple assets and time periods will constitute a continuing connected transaction.
- Leasing from a connected person for both fixed and variable amounts will be treated as two transactions, with two sets of percentage ratios to be calculated: (1) a one-off transaction constituting an acquisition of an asset for the Fixed Lease Payments; and (2) a continuing connected transaction for the ongoing expense of the Variable Lease Payments. The higher of the resulting classifications will then be applied to the transaction.
- A framework lease agreement providing for both fixed and variable lease payments must include annual caps on (i) the total value of right-to-use assets subject to Fixed Lease Payments and (ii) the Variable Lease Payments to be made each year.

These changes will apply only to new lease agreements entered into following the adoption of HKFRS/IFRS 16 for financial years commencing on or after 1 January 2019.

SFC Sanctions Sponsors for Failure to Conduct Proper Due Diligence

The SFC recently sent a strong message to the market that it will not hesitate to hold sponsors accountable for their conduct by reprimanding and fining several banks an aggregate amount of HK$786.7 million for failing properly to discharge their obligations as sponsors in recent IPOs. The SFC also partially suspended one bank's licence to advise on corporate finance for one year and the licence of an individual sponsor principal for two years.

The SFC's statements on these enforcement actions provide some key indications of the standard of due diligence expected of sponsors under the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC and the Practice Note 21 to the Listing Rules.

Some of the key lessons on due diligence standards to emerge from these enforcement actions include the following:

- **Site inspection**: The SFC expects sponsors to conduct physical site inspections, especially where landed properties account for a substantial portion of the assets of an applicant. The sponsor should properly document how it verified the existence of these assets. When other professional parties are involved in the site inspection process, clear instructions should be given to them as to what they should check. Sponsors also should consider whether suitable experts should be engaged to produce a written report for the sponsors. In addition, steps should be taken to authenticate the genuineness of the title documents, and sponsors should not rely solely on external counsel (*i.e.*, the relevant government departments that issued the title documents should be independently contacted). If any mismatch is found between the name of the assets as disclosed in the prospectus and that as set out in the corresponding title documents, this calls for further inquiries.
- **Compliance with laws:** Sponsors should independently verify any compliance certificate issued by government authorities and should not rely on external counsel to conduct the due diligence. Steps must be clearly documented as to how the authenticity of the written confirmations are checked and verified.

- **Documentary due diligence:** The SFC expects sponsors to review the due diligence documents and identify and resolve any inconsistencies. Depending on the importance of any particular issue or area of concern, the sponsor must also independently verify the authenticity and existence of the relevant contract/document (*e.g.*, asking the insurer if it has issued the particular insurance coverage if insurance is an area of concern in a particular case).
- **Customer diligence:** Sponsors should independently verify the existence of key customers and the identity of their representatives at their place of business, with a clear written record of how these processes are carried out. The interview records must show the full name of the interviewees, the identity of the interviewers and other persons attending the interview, and the telephone number of any of the customers interviewed. Further inquiries may be necessary if, for example, (i) an applicant resists the sponsor's efforts to arrange and conduct the interviews independently (*e.g.*, the applicant does not permit sponsors to have direct contact with customers, arranges the interviews at the applicant's place of business or does not permit a face-to-face interview), (ii) if the interviewee refuses to produce his/her identity and business cards, or (iii) if there are circumstances to suggest that the interviewee does not have appropriate authority or knowledge to respond to the interview questions. If any irregularities are noted during the interview, they must be adequately explained and resolved.
- **Reliance on experts:** Sponsors must specifically give instructions to experts to focus on any particular topic of concern and understand how an expert arrives at its conclusion (including methodologies and assumptions used). Sponsors must carefully consider the assumptions underlying the work product of an expert or professional party to satisfy themselves that the assumptions are fair and reasonable.

SFC Takes Action Against Late Profit Warning Announcements

The SFC has commenced proceedings in two cases where listed companies delayed publishing profit warning announcements in a timely manner, as required under the disclosure of inside information regime set out in the Securities and Futures Ordinance (Cap. 571) (**SFO**). Proceedings also were commenced against directors of those companies for failing to take reasonable measures to ensure that proper safeguards existed at the companies to prevent the alleged breaches, or for their reckless or negligent conduct causing the alleged breach by the companies.

In the proceedings against CMBC Capital Holdings Limited (formerly known as Mission Capital Holdings Limited (**Mission Capital**)), the SFC alleges that the directors of Mission Capital were in possession on 13 October 2014 of unaudited management accounts for the five months ending 31 August 2014, which showed a significant improvement in financial performance against prior periods, but did not issue a profit alert announcement until 7 November 2014.

In the proceedings against Health and Happiness (H&H) International Holdings Ltd (formerly known as Biostime International Holdings Ltd (**Biostime**)), the SFC alleges that Biostime's consolidated management accounts for the first five months of 2015 became available in mid-June 2015 and revealed that both the revenue and the net profit had significantly decreased (by 13.7 percent and 28.9 percent, respectively) when compared with the corresponding period in 2014, but the directors of Biostime did not issue a profit warning until 23 July 2015.

These proceedings show that the SFC takes listed companies' obligations to disclose inside information "as soon as reasonably practicable" seriously and that delays of even a few weeks will be regarded as a breach of those obligations.

HKEx Listing Committee Censures Shenji Group and a Former Director for Omissions in an Announcement

Listed companies and their directors are reminded (i) to ensure all announcements are accurate and complete in all material respects and not misleading or deceptive, and (ii) to cooperate with the HKEx on regulatory investigations, in order to avoid potential enforcement actions.

Shenji Group Kunming Machine Tool Company Limited (**Shenji Group**) published an announcement in November 2015 relating to a potential disposal of shares in Shenji Group by a substantial shareholder. The announcement did not disclose (i) the conditions precedent to the share transfer, including the need for approval from certain PRC authorities, and (ii) the long stop date beyond which the share transfer agreement would terminate automatically if those conditions were not fulfilled. Shenji Group subsequently announced on 5 February 2016 that the necessary approvals had not yet been obtained and that the share transfer was actually subject to a three-month long stop date that would expire on 8 February 2016. On 17 February 2016, Shenji Group announced the termination of the share transfer agreement. The former director, who was involved in preparing and publishing the

announcement, did not cooperate with the HKEx in a responsive manner during the investigation process. The Listing Committee decided to censure Shenji Group and the former director for the omissions in the announcement.

HKEx Listing Committee Censures Golden Meditech and Two Directors for Failing to Comply With Disclosure and Shareholders' Approval Requirements

It is crucial that companies and their directors seek proper legal advice on compliance with the Listing Rules whenever entering into new transactions. Recently, the Listing Committee censured Golden Meditech Holdings Limited (**Golden Meditech**) and two executive directors, and criticized four other directors, for failure to comply with the disclosure and shareholders' approval requirements with respect to a complex series of transactions involving Golden Meditech's interest in a company called Funtalk China Holdings Limited (**Funtalk**), which ultimately resulted in Golden Meditech making an impairment provision in the amount of approximately HK$760 million.

The Listing Committee found that (i) the two executive directors had relied upon incorrect calculation of the "size tests" under the Listing Rules, resulting in the transactions being wrongly classified, and the company mistakenly believing that disclosure and shareholder approval were not required; in addition, those directors had failed to understand fully or consider the implications of all aspects of the transaction, and had not obtained any proper professional advice nor consulted the board of directors; and (ii) the four other directors of Golden Meditech had failed to apply their own independent judgment by relying upon the information provided by the two censured executive directors and failed to consider Golden Meditech's compliance with the Listing Rules.

SFC Intervenes in IPO Applications and Listed Company Transactions

On 21 February 2019, the SFC published *SFC Regulatory Bulletin: Listed Corporations* (**Bulletin**) to highlight some of the SFC's recent actions against market misbehaviour. The case studies illustrate how the SFC intervenes at an early stage where it has serious concerns about IPO applications or post-IPO corporate transactions.

In the IPO cases, the SFC queried the robustness or sustainability of listing applicants' business models. In the two cases highlighted:

- a retailer explained that significant revenue growth in its most recent year was a result of marketing efforts and sales to a wholesaler that on-sold its products to an e-commerce platform. The SFC noted that the marketing activities were only launched towards the end of the track record period, the amount of such activities was insignificant and the sales of its products on the relevant e-commerce platform appeared to be minimal. The SFC had concerns about the accuracy of the applicant's financial information and asked the applicant to further explain its significant revenue growth; and
- an applicant engaged in the transport business chartered its vehicles to a third party that was not licensed to operate them, and the third party in turn instructed the applicant to operate the vehicles. This arrangement appeared to contravene the conditions of the applicant's license. The SFC questioned the legality of the arrangement and whether the historical financial information included in the listing application was representative of the applicant's business model going forward, since the arrangement was terminated shortly after the end of the track record period.

In both cases, the applicants were unable to provide satisfactory responses to the SFC queries and their listing applications were withdrawn or lapsed.

In the cases relating to companies already listed on HKEx, the SFC has actively intervened in a number of proposed transactions by listed companies:

- A listed company proposed to acquire a company engaged in research and development of artificial intelligence and big data technology. The listed company proposed to issue new shares at a premium of 79 percent to the latest closing price as consideration. The target company did not record any revenue and was loss-making in the most recent financial year. The listed company did not seek any independent financial advice or an independent valuation. The SFC commenced inquiries under section 179(1) of the SFO (**Section 179 Inquiries**), and it was revealed that the target's largest shareholder was a relative of the listed company's chairman. The SFC issued a letter of concern requesting an explanation, and the listed company terminated the acquisition.
- A listed company proposed to acquire a loss-making company that was developing robotics. The SFC commenced Section 179 Inquiries and found material issues with the draft valuation report on the target and its cash flow forecast report. The company was unable to provide a reasonable explanation for the basis and assumptions used to determine the target's projected revenue, profit margin and valuation. The target had not yet commenced operations for its core business. The SFC issued a letter of concern requesting an explanation.
- A listed company proposed to acquire an 80 percent interest in a finance leasing company. The target had been incorporated one year earlier, and its only business was to enter

into financial lease agreements with its vendor. The target recorded minimal revenue in the latest financial period. The SFC commenced Section 179 Inquiries concerning the target's minimal track record and client base. The SFC requested the company to explain why, given low entry barriers in the financial leasing market, it chose to enter this business by acquiring the target. The company did not address the SFC's concerns and subsequently announced the termination of the transaction.

- A listed company proposed to raise funds through a general mandate placing. The placing price was set at an 80 percent discount to its net asset value per share. From the latest interim financial results of the company, the company appeared to have sufficient cash to fund its operations and had minimal borrowing. The SFC raised concerns about the reasons for such a deeply discounted placing. The company subsequently terminated the placing.

The Bulletin reminds directors to exercise reasonable care, skills and diligence when evaluating, proposing or approving corporate transactions. Directors have a duty to exercise their own judgement and should not over-rely on third-party opinions or advice.