



# Hong Kong Regulatory Update

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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. In particular, it covers amendments to the Rules Governing the Listing of Securities on HKEx (**Listing Rules**) as well as announcements, guidance and enforcement-related news from HKEx and the Securities and Futures Commission (**SFC**). From time to time it may also cover other recent market developments. It is not our intention to cover all updates that may be relevant, but we welcome feedback, and if there are any other topics of interest that you'd like us to cover in the future, please contact us.

## HKEx Seeks to Enhance ESG Reporting

HKEx is proposing a number of enhancements to the existing environmental, social and governance (**ESG**) reporting regime. The HKEx consultation paper, responses to which are sought by 10 July 2019, contains the following key proposals for public consultation:

- mandatory disclosure requirements in the ESG Reporting Guide to include
  - (i) a board statement setting out the board's consideration of ESG issues; and
  - (ii) applications of relevant reporting principles and boundaries in the ESG report;
- disclosure (subject to "comply or explain") of significant climate-related issues that have impacted and may impact the company;
- disclosure of relevant targets for "environmental" key performance indicators (**KPIs**) and steps taken to achieve them;
- disclosure of "social" KPIs on a "comply or explain" basis;
- requiring ESG reports be published at the same time as annual reports;
- permitting companies to seek independent assurance to strengthen the credibility of their ESG disclosures, and where such independent assurance is obtained, the issuer should describe the level, scope and processes adopted for assurance clearly in the ESG report.

Separately, HKEx has also updated a number of FAQs relating to ESG matters:

- Listed companies should take into account any material risks relating to ESG in their strategic objectives, and establish and maintain appropriate and effective risk management and internal control systems to address those risks;
- Listed companies should ensure adequate resources are made available for their ESG performance and reporting function; and

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- Listed companies should have a governance structure in place for ESG matters that acknowledges the board's oversight role in such matters and provides for the assessment and management of material environmental and social risk issues. The governance structure should be disclosed in their ESG reports.

HKEx has also revised Guidance Letter GL86-16 (which relates to the content of listing documents and prospectuses) to require specific ESG- and diversity-related disclosures.

The momentum toward enhanced ESG disclosures is a global trend and a reflection of the increasing importance placed on them by institutional investors, regulators and other stakeholders. Listed companies should consider making preparations to be in a position to meet these heightened requirements.

## New China Foreign Investment Law Leaves Variable Interest Entities Untouched

On 15 March 2019, the National People's Congress in China passed the Foreign Investment Law (中华人民共和国外商投资法) (FIL), which will become effective on 1 January 2020. The original draft FIL promulgated in 2015 intended to broaden the scope of regulated foreign investment activities to cover the so-called variable interest entity (VIE) structures commonly used by Chinese internet and technology companies when raising capital on international markets. HKEx had been applying the requirements of that earlier draft "as if enacted," which in particular required that the offshore listing applicant have majority control. However, given that the final FIL as enacted has omitted all provisions relating to VIEs, HKEx has indicated to us during a recent roundtable discussion that it will be relaxing its requirements accordingly. As a result, while VIEs will remain in a semiregulated grey area, this is a status quo to which the market has become accustomed and avoids the market disruption that may result from new regulation in this area. This also means that companies with VIE structures will no longer be required to evidence Chinese majority control. An update to the corresponding HKEx listing decision (LD43-3) is likely in the near future.

## HKEx Publishes Listing Decision on Rejected Listing Applications

HKEx recently published another of its regular listing decisions in which it explains reasons why it rejected recent listing applications. This provides key guidance to market practitioners who want to avoid the deal execution risk and reputational fallout of having a rejected application. The decision (LD121-2019) sets out the following factors that led to certain listing applications being rejected:

- **Lack of Commercial Rationale.** Failure to (i) substantiate the commercial basis for the proposed expansion; (ii) explain how application of the initial public offering (IPO) proceeds makes commercial sense; or (iii) demonstrate a genuine funding need.

- **Unsupported Valuation.** Failure to justify (i) why the forecasted price-earnings ratios were higher than those of industry peers; (ii) the basis on which the peers were chosen; or (iii) how such valuations were reasonable in light of the applicant's history and profit forecasts.

- **Packaging.** Failure to demonstrate that different companies recently restructured under the listing group had operated as a single economic unit during the track record period.

- **Deterioration of Financial Performance.** There was a significant deterioration in performance during the track record period and insufficient basis to believe that the situation would improve.

- **Suitability of Director/Person of Substantial Interest or Controlling Shareholder.** The director/person of substantial interest or controlling shareholder of the applicants having significant influence on the operations and management of the applicants during the track record period had previously been convicted of offences relating to dishonesty.

- **Sustainability of Business.** Examples include (i) a substantial portion of the applicant's revenue during the track record period was derived from a separate business operated by the applicant's controlling shareholders; (ii) the delineation of the applicant's business from its controlling shareholder did not conform with industry norms; or (iii) the arrangements with the controlling shareholder were not on normal commercial terms, and there was uncertainty whether arrangements with independent customers would generate a similar amount of sales.

- **Independence of Sponsor.** The sponsor was previously the applicant's compliance adviser.

## HKEx Issues Guidance on Non-GAAP Financial Measures

HKEx recently published guidance on the presentation of non-GAAP (generally accepted accounting principles) financial measures (GL103-19). This is the first time HKEx has made an authoritative statement on its expectations for non-GAAP measures, and the guidance will in particular be relevant to companies in the high-tech/new economy sector that frequently make use of such measures in their listing documents and periodic financial reports.

The guidance requires non-GAAP financial measures (such as adjusted profit or EBITDA — earnings before interest, tax, depreciation and amortization — among others) to be presented in a manner that is not misleading, and to comply with the following factors in order to ensure reliability and comparability over time:

- The non-GAAP financial measure should be defined, with an explanation of the basis of calculation;

- Companies should have an unbiased purpose in utilizing non-GAAP financial measures;

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- GAAP measures should be featured more prominently compared to non-GAAP financial measures;
- A quantitative reconciliation from any non-GAAP measure to its corresponding GAAP measure should be provided;
- Non-GAAP financial measures should be used consistently over time;
- Companies should exercise judgment regarding what constitutes a normal, recurring operating expense;
- Adjustments should be reconciled on a gross basis before tax; and
- There should be easy access to associated information.

In relation to a listing application, sponsors, reporting accountants and other experts are reminded to perform appropriate level of due diligence to ensure accurate presentation of non-GAAP financial measures in a listing document.

## **HKEx Requires Companies With Adverse Audit Opinion to Suspend Trading**

Under new Listing Rule 13.50A, for financial years commencing on or after 1 September 2019, HKEx will require trading in a company's securities to be suspended if it publishes a preliminary annual results announcement and the auditor has issued, or has indicated that it will issue, a disclaimer of opinion or an adverse opinion on the company's financial statements. The suspension will remain in force until the issuer has addressed the issues giving rise to the disclaimer or adverse opinion, provided comfort that a disclaimer or adverse opinion in respect of such issues would no longer be required, and disclosed sufficient information to enable investors to make an informed assessment of its financial position.

A suspension is not required if:

- the disclaimer of opinion relates only to a going concern issue; and
- the company has addressed all the issues giving rise to the disclaimer of opinion or adverse opinion before publication of the preliminary results announcement, and disclosed sufficient information to enable investors to make an informed assessment of its financial position.

## **Guidance on Accounting Policies**

HKEx has published a guidance letter (GL102-19) for new listing applicants in the following areas on changes of accounting standards or policies, and adoption of accounting standards other than Hong Kong or International Financial Reporting Standards, or China GAAP.

Where a listing applicant has adopted any material change in accounting standards or policies, the prospectus must include sufficient and meaningful disclosure on the effect of such change, and in particular disclose: (i) the change and the expected effective date; (ii) the underlying reasons for the change; and (iii) qualitative and quantitative assessment on the potential impact of the change.

Where an applicant wishes to adopt accounting standards other than one of the above three generally accepted by HKEx, they must apply for a waiver, which HKEx will assess on a case-by-case basis. Such waiver will usually be subject to the following conditions:

- Financial reports must include a reconciliation statement showing the financial effect of the use of different accounting standards, which will be audited or reviewed by its auditors; and
- The applicant must revert to one of the above three acceptable accounting standards as soon as practicable if there is a change in the circumstances under which the waiver was granted (for example, if a company that is dual-listed in Hong Kong and the U.S. and choosing to adopt U.S. GAAP subsequently delisted from the U.S. stock exchange).

The prospectus will need to disclose (i) a description of the material differences between the accounting standard adopted and the generally acceptable accounting standards; and (ii) a reconciliation statement.

## **Sanctions Risks for Listing Applicants**

HKEx has provided guidance on its approach to listing applicants subject to international sanctions that may be a concern to HKEx as it evaluates the applicant's suitability for listing. The guidance applies to any form of economic, financial or trade-related sanctions imposed by overseas governments that have an extraterritorial effect, such as those imposed by the U.S. Office of Foreign Assets Control. An applicant will not be suitable for listing if it is (i) itself a target of sanctions; (ii) located in a country that is subject to sanctions; or (iii) conducting a material portion (10% or more) of its business with sanctioned targets and sanctioned country persons.

For other listing applicants that have any interaction with sanctioned countries or entities, the new guidance letter (GL101-19) provides as follows:

- An applicant engaging in primary sanctioned activity (being one that has a nexus to the sanctioning jurisdiction) shall (i) obtain a legal opinion on whether such activity violates any applicable sanctions laws/regulations or results in material sanctions risks to the listing applicant together with



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its investors and shareholders; (ii) assess the impact on the listing applicant's financial position and business operations if such activity is ceased; and (iii) cease such activity prior to listing if it violates applicable laws/regulations.

- An applicant engaging in secondary sanctioned activity (being one that may result in the imposition of sanctions against the listing applicant despite it not being incorporated/located in the sanctioning jurisdiction and not otherwise having any nexus with the sanctioning jurisdiction) shall obtain a legal opinion on whether the conduct of such activity will likely result in the imposition of sanctions on the listing applicant and its investors and shareholders.

## HKEx Publishes Guidance on Competing Businesses

HKEx has generally taken a flexible, disclosure-based approach where the controlling shareholder of a listing applicant has competing business interests. In March 2019, the HKEx published new guidance on how it approaches these situations.

The first approach is to distinguish the controlling shareholder's business from that of the listing applicant. This might be done by reference to (i) different business models, with the two sides selling the same or similar products but to different customers; (ii) the production/provision of nonsubstitutable products or services in the same industry; or (iii) operating in different geographical markets. It is worth noting that HKEx has specified that companies selling substitutable products via different channels or platforms (such as online versus physical stores) are not considered fully delineated, as their products are substitutes for each other and their potential customers have a high degree of overlap.

The second approach is for the controlling shareholder to take various measures to ameliorate the competing interest, for example by (i) executing a noncompetition undertaking in favour of the new applicant, (ii) granting a right of first refusal to the new applicant with respect to new business opportunities; and (iii) providing the new applicant with a call option to acquire the competing business.

Finally, the listing applicant should consider adopting one or more of the following conflict of interest management measures: (i) minimizing any overlap of senior management participating in management of both the listing applicant's and the competing business; (ii) limiting the number of overlapping directors holding executive roles in both the new applicant and the controlling shareholder group; (iii) having a sufficient number of independent directors who are expected to advise on the conflicted transactions and business decisions; and (iv) engaging additional independent consultants to provide advice to the independent nonexecutive directors where needed.

## SFC Fines Sponsors for IPO Diligence Failures

The SFC has reprimanded and fined two sponsors as a result of their failures to discharge their duties as joint sponsors with respect to the listing application of China Metal Recycling (Holdings) Limited (**China Metal**) filed in 2009. In particular, the SFC found:

- The sponsors failed to perform reasonable due diligence in relation to one of China Metal's largest customers, where there were red flags raised as to the genuineness of the transactions and the status of that customer. (The company had been de-registered, and there was some confusion as to whether another company China Metal said was part of the same group of companies was indeed the same entity.)
- The sponsors interviewed China Metal's suppliers by telephone but did not verify the telephone numbers or the identities of the representatives they spoke to.
- In interviewing the customers of China Metal, the sponsors did not properly verify the identities or authority of interviewees or the premises where the interviews took place. The customer interview records were substantially incomplete, with no answers recorded for the majority of the questions asked in most cases.

In addition, the SFC concluded that one of the joint sponsors failed to (i) follow up on a red flag raised by China Metal's reporting accountant in relation to certain third-party payments; and (ii) keep a proper written record of their due diligence work.

## Market Misconduct Tribunal Fines Fujikon and Its Officers for Late Disclosure of Inside Information

The Market Misconduct Tribunal fined Fujikon Industrial Holdings Limited (**Fujikon**), its chairman and CEO, its chief financial officer and its company secretary after finding that they had failed to disclose inside information to the public as soon as reasonably practicable.

On 12 April 2014, Fujikon was notified by one of its top customers that the customer would discontinue headphone production with Fujikon. However, the company did not announce this information to the market until 6 June 2014 — a delay of more than seven weeks. The SFC alleged that this information was specific, price sensitive and not generally known to those who were accustomed to dealing in Fujikon shares, and would likely have materially affected Fujikon's share price had it been known to those investors.

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## SFC-ICAC Operation Leads to Charges Against Former Director of Convoy Global

Alleged failure by a director to disclose material information of his personal interest in a listed company's transaction has led to his being charged with conspiracy to defraud following a joint operation undertaken by the SFC and the Independent Commission Against Corruption (ICAC). Cho Kwai Chee, at the time an executive director of Convoy Global Holdings Limited (**Convoy Global**), introduced the potential acquisition of a company (**Target**) to Convoy Global while failing to disclose his own 55% shareholding in that Target. The Target's principal asset was its interests in two investment funds that required continuous capital commitments. By causing Convoy Global to acquire the Target, Cho made a profit from the transaction and was relieved from having to make further capital commitments into the investment funds. By causing Convoy Global to make the acquisition, Cho allegedly defrauded the HKEx as well as the board of directors and shareholders of Convoy Global by dishonestly (i) failing to disclose his stake and interest in both Convoy Global and the Target; (ii) failing to disclose the acquisition of the Target as a connected transaction; and (iii) causing the acquisition of the Target without convening the required company meeting or complying with the relevant Listing Rules.

## SFC Seeks Disqualification Orders Against Directors of Luxey

SFC has commenced legal proceedings in the Court of First Instance to seek court orders to disqualify Joseph Lau Chi Yuen, the chairman and executive director of Luxey International (Holdings) Limited (**Luxey**), and Chung Man Wai, the company's former CEO and executive director. Lau and Chung are alleged to have conducted the company's business or affairs in a manner involving fraud, misfeasance or other misconduct.

The allegation relates to Luxey's acquisition of Ratio Knitting Factory Limited (**Ratio**). SFC alleges that Lau breached his director's duties to Luxey by utilising a nominee company, Big Good Management Limited (**Big Good**), and its sole shareholder and director, Ma Hoi Cheuk, who acted on Lau's instructions, to acquire Ratio for \$50.1 million before Ratio was resold to Luxey for \$390 million. Lau allegedly obtained a profit as a result, and allegedly concealed that profit and his material interest in the transactions from Luxey and its shareholders.

Chung allegedly breached his director's duties by failing to make sufficient enquiries about the relationships among Lau, Ma and Big Good, and failing to take steps to prevent Luxey from acquiring Ratio at a substantially higher price.

SFC further alleges that Lau and Chung were responsible for the publication of false statements in Luxey's announcement and circular relating to the acquisition by falsely disclosing that Big Good and Ma were independent third parties and that the transaction was an arm's length transaction on normal commercial terms that were fair and reasonable and in the interests of Luxey and its shareholders as a whole.