



Hong Kong Regulatory Update

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This update 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.

SFC Statement on the Conduct and Duties of Directors When Considering Corporate Acquisitions or Disposals

Shareholder litigation remains very rare in Hong Kong, and, in its absence, the SFC continues to step up its scrutiny of corporate transactions to ensure that directors are properly fulfilling their duties. In July 2019, the SFC published a statement on the conduct and duties of directors of listed companies when considering corporate acquisitions or disposals (the **Statement**).

The Statement highlights some common types of misconduct the SFC has observed during the course of its investigations and serves to remind directors and their advisers to comply with their statutory and other legal duties when evaluating or approving an acquisition or disposal. The Statement identifies the following key areas of concern:

- **Lack of independent professional valuation.** While obtaining an independent professional valuation in relation to a planned acquisition or disposal is not expressly required by law or the Listing Rules, the SFC noted that failure to obtain a professional valuation may expose directors to a heightened risk of failing to exercise the necessary degree of care, skill and diligence.
- **Lack of independent judgment and accountability.** Where an independent professional valuation was obtained, in some cases the directors simply relied on the vendor's forecasts in assessing the consideration for the target businesses, and the valuers also used those forecasts as the basis for their valuation without performing any independent due diligence. The SFC also noted that some valuers had "cherry-picked" comparable companies to justify a predetermined estimate of the target business.
- **Lack of assessment of quality of earnings of targets.** The SFC noted instances where directors or their advisers performed little or no independent due diligence on or assessment of the forecasts, assumptions or business plans that were provided by the vendors or management of the targets. Some apparent risk factors, such as historical losses, sudden and unexplained increases in sales, unjustifiably high margins

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compared to industry peers, suspect nonrecurring items and apparently questionable or unsustainable sources of revenue were largely ignored.

- **Lack of fair presentation of comparables.** Valuers and directors must use their own independent and professional judgment to select companies that have suitably similar characteristics to the target company and ensure that the comparables referred to in the valuation constitute a fair and representative sample.
- **Inadequate assessment of impact of planned acquisitions.** In a number of cases, it appeared that companies would require substantial additional funds to meet the forecasts provided by the vendors, and these cash expenditures would have a substantial impact on the company's financial position.
- **Inadequate protection or compensation sought from vendor.** Many transactions involved companies paying consideration up front based on a profit forecast prepared by the vendor and a bare undertaking by the vendor to compensate the purchaser if the forecast was not met. However, there was inadequate verification performed of the vendor's ability to pay the compensation, or other alternative precautions such as holding funds in escrow, to protect the listed company's interests.
- **Suspicious connected parties.** The SFC also noted suspicious transactions that suggest an undisclosed relationship or arrangement among purported independent third parties, particularly in situations where there are undisclosed arrangements or understandings that cause them to act in a coordinated manner to the detriment of the listed company and its shareholders.

The SFC Statement would seem to fly in the face of the "business judgment rule" applied by courts when assessing the conduct of directors and suggests that Hong Kong's regulators will indeed second-guess the business judgment of directors when scrutinizing the transactions entered into by listed companies. Listed companies and their advisers will need to ensure that the process by which transactions are assessed and approved are properly conducted and fully documented to ensure the decision-making process is able to withstand regulatory scrutiny.

HKEx Publishes Consultation Conclusions on Listing Rule Amendments to Crack Down on Backdoor Listing and Shell Activities

On 26 July 2019, HKEx published conclusions to its consultation paper regarding "backdoor" listings and "shell" companies, continuing listing criteria and other related Listing Rule amendments. The corresponding amendments to the Listing Rules will come into effect on 1 October 2019.

The amendments are intended to crack down on companies that do not have a substantial business (known as shell companies) but maintain their listing status with a view to being purchased

by buyers who wish to go public but are unable or unwilling to go through the "front door" to seek a listing status, and thus achieve their listing by acquiring shell companies and then injecting assets or businesses into them, a process known as a "reverse takeover" (RTO) or "backdoor listing."

For further information on the consultation paper, the proposed amendments to the Listing Rules to combat backdoor listings and shell creation activities, please see our [1 August 2019 Hong Kong Regulatory Update](#). The proposed amendments detailed in that update will be implemented. We set out below the notable amendments.

The fundamental position that an acquisition by a listed company of a target larger than itself within close proximity of a change of control will be treated as an RTO necessitating a new listing application remains unchanged, albeit with some new modifications.

Amendments Relating to Backdoor Listings:

- a number of rules previously contained in Guidance Letters published by HKEx have now been codified into the Listing Rules. These include the six RTO assessment criteria set out in Guidance Letter GL78-14 (*i.e.*, transaction size, target quality, nature and scale of issuer's business, fundamental change in principal business, change in control/de facto control, and series of transactions or arrangements to list the acquisition targets); and the "extreme VSA" (very substantial acquisition) in Guidance Letter GL78-14;
- amending existing RTO rules to capture VSAs of assets from a controlling shareholder and/or its associates within 36 months of a change of control (compared to the existing 24 months), and to restrict disposals (or distributions in specie) of all or a material part of a listed company's business within 36 months after a change in control or de facto control;
- broadening the previous assessment criteria relating to the "issue of restricted convertible securities providing de facto control";
- two additional factors will be used in assessing whether a change in control or de facto control has occurred will be incorporated into Listing Rule 14.06, namely (a) any change in control of the controlling shareholder of the listed company, and (b) any change in the single largest substantial shareholder who is able to exercise effective control over the listed company, as indicated by factors such as a substantial change to its board of directors and/or senior management;
- adoption of a new Listing Rule to prevent large scale issues of securities for cash, where there is, or the issue will result in, a change of control or de facto control of the issuer, and the proceeds will be applied to acquire and/or develop new business;

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- listed issuers conducting extreme transactions will be required to appoint a financial advisor who must conduct a due diligence process similar to that for an IPO and for them to give the same declaration to HKEx as that given by a listing sponsor, including that the target meets the new listing requirements; and
 - a new Guidance Letter GL104-19 will provide guidance on the application of the revised RTO rules described above.

Amendments Relating to Shell Companies:

- amending Listing Rule 13.24 to require a company to carry out a business with a sufficient level of operations **and** (previously “or”) have assets of sufficient value to justify its continuing listing; and
- extending the definition of “short-dated securities” under Rule 14.82 (commonly known as the “Cash Company Rule”) and renaming them “short-term investments.”

A transitional period of 12 months will apply to listed issuers that do not comply with the new shell company rules.

HKEx Publishes Consultation Paper on ‘Codification of General Waivers and Principles Relating to IPOs and Listed Issuers and Minor Rule Amendments’

On 2 August 2019, HKEx published a consultation paper on “Codification of General Waivers and Principles relating to IPOs and Listed Issuers and Minor Rule Amendments” (**Paper**). The Paper proposes to codify certain waivers from strict compliance of the Listing Rules that are commonly granted to new applicants and issuers, helping to clarify the Listing Rules and simplify the listing process consistent with current market practice.

Among the various amendments to the Listing Rules and codification of waivers and market practices contained in the Paper, key proposals include the following:

Financial disclosure

- new applicants may apply for a waiver to exclude from their accountants’ report the historical financial information of a business acquired, or to be acquired, after the trading record period:
 - a. if the acquisition is not material (*i.e.*, the highest applicable percentage ratio is less than 5%);
 - b. where the acquisition is to be financed by the listing proceeds, a certificate of exemption is obtained from the SFC; and

c. with respect to:

- new applicants whose principal activity is to acquire equity securities (*e.g.*, an investment company), (a) the new applicant would not gain control or significant influence over the target, and (b) the listing document discloses the reasons for the acquisition and includes a confirmation that the counterparties are independent of the new applicant and its connected persons; or
 - the acquisition of a business or a subsidiary other than in the circumstances covered above, if (a) the historical information is unavailable and it would be unduly burdensome to obtain the information, and (b) the listing document satisfies the disclosure requirements under Rule 14.58 and 14.60.
- changes in financial year end during the trading record period would not affect a new applicant’s suitability for listing if (a) the new applicant is an investment holding company and the change is to align its financial year with a majority of its operating subsidiaries, (b) the change is not designed to circumvent the requirements under Listing Rule 8.05 and (c) the change would not materially affect the financial information disclosed or omit any material information.
 - newly listed issuers may apply for a waiver exempting them from publishing their first preliminary results announcement and distributing the corresponding financial report to shareholders if (a) the financial results are already included in the listing document, and (b) in relation to annual reports, the listing document already discloses the new applicant’s compliance with the Corporate Governance Code or the reasons for any deviations.

Share option schemes

- Listing Rule 17.05 will be amended to state clearly that the restricted period for grant of share options would cover the trading day after the announcement is made with respect to inside information. This prevents abuses where option grantees can gain an unfair advantage through the grant as the prevailing share price has not reflected the inside information if the grant takes place immediately after the announcement of inside information but before shares are traded to reflect the effect of the inside information.
- PRC incorporated issuers dual-listed on the HKEx and a PRC exchange may set the exercise price under Chapter 17 share option schemes with reference to the market price of A shares if (a) the scheme only involves A shares, and (b) the exercise price is no less than the prevailing market price of the A shares on the PRC exchange at the time of grant.

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Company Secretaries

- for issuers applying for a waiver to appoint a company secretary who does not meet Rule 3.28 qualifications, the HKEx would take into account (a) whether the issuer's principal business is outside of Hong Kong, (b) the reasons why the directors believe the candidate is suitable to act as the issuer's company secretary and (c) whether a person who meets Rule 3.28 qualifications would assist the candidate during the waiver period (*i.e.*, not more than three years).

Financial Institutions

- new applicants that are banking companies regulated by an overseas regulator similar to the Hong Kong Monetary Authority (**HKMA**) may apply for a waiver exempting compliance with HKMA's "Guideline on the Application of the Banking (Disclosure) Rules" if the applicant can demonstrate to the HKEx (a) that the overseas banking regulator provides adequate supervision to the new applicant; and (b) alternative disclosure is sufficient for potential investors to make a fully informed investment decision;
- new applicants and issuers that are banking or insurance companies are exempted from providing a working capital confirmation in their listing document or circular (as appropriate) where there is sufficient alternative disclosure on solvency.

The Paper also proposes codifying the following general waivers into the Listing Rules:

- an issuer's stock code may be displayed in the "corporate information" or "shareholder information" section of the annual or interim report instead of on the cover;
- bonus or capitalization issues by PRC incorporated issuers would be exempt from shareholder approvals at general and separate class meetings; and
- for PRC incorporated issuers with domestic shares listed on a PRC exchange, the "consideration ratio" for assessing notifiable transactions may use the market price of its A or B shares (as opposed to H shares) to calculate the market capitalization (denominator for the consideration ratio).

HKEx Welcomes Public Consultation by SSE and SZSE on WVR-Related Rules Changes

As noted in our *Hong Kong Regulatory Update (April 2019)*, HKEx 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 (southbound trading) through the Stock Connect program .

In preparation for the inclusion of WVR companies in southbound trading of Stock Connect, the Shanghai and Shenzhen Stock Exchanges have proposed corresponding changes to their business rules. Such changes include requiring WVR companies to satisfy the following additional requirements before being admitted to the Stock Connect program:

- a. be listed on HKEx for at least 6 months and 20 trading days;
- b. market capitalization of not less than HK\$20 billion;
- c. total trading turnover of not less than HK\$6 billion over the most recent 183 days;
- d. compliance with relevant laws, regulations and policies by the issuer and its WVR beneficiaries; and
- e. other requirements identified by the Shanghai and Shenzhen Stock Exchanges.

Stock Connect Inclusion Arrangements Agreed Upon for A+H Companies Listed on STAR Market

HKEx and Shanghai and Shenzhen Stock Exchanges have agreed on arrangements for including companies with dual listings on HKEx and the Shanghai Stock Exchange's Sci-Tech Innovation Board (**STAR Market**) in the Stock Connect program. Shanghai Stock Exchange's new STAR Market is different from its main board in terms of trading, regulations and investor eligibility.

Currently, A+H companies listed on the HKEx and Shanghai or Shenzhen Stock Exchanges are eligible for trading via Stock Connect. This arrangement will be extended to include A+H companies listed on the STAR Market. A date for inclusion in the northbound trading and subsequently the southbound trading will be announced in due course.

Signing of Tri-Partite MoU on Audit Working Papers by Ministry of Finance, CSRC and SFC

The Ministry of Finance of the People's Republic of China (**MOF**), the China Securities Regulatory Commission (**CSRC**) and the SFC have entered into a Memorandum of Understanding (**MoU**) concerning access to audit working papers in Mainland China arising from the audits of Hong Kong-listed Mainland Chinese companies. Access by Hong Kong regulators to audit working papers kept in the Mainland in the past has not been straightforward as Mainland Chinese laws contain restrictions against transfer of documents outside of the jurisdiction, including those that contain state secrets. The MoU will facilitate the SFC's access to audit working papers — created by Hong Kong accounting firms in their audits and kept in Mainland China — when conducting investigations into Mainland Chinese based issuers or listed companies, and

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their related entities or persons. Under the MoU, the MOF and the CSRC will provide the fullest assistance in response to the SFC's requests for investigative assistance regarding the provision of audit working papers.

HKEx Listing Committee Censures Shandong Molong and Some of its Former Directors for Disclosing Inaccurate Financial Information

In a recent case, the HKEx Listing Committee censured Shandong Molong Petroleum Machinery Company Limited (**Shandong Molong**), which is also listed in the Shenzhen Stock Exchange, and certain of its former directors and supervisors in connection with inaccurate financial disclosures. In 2017, Shandong Molong made various revisions to the financial information contained in a series of results announcements and interim reports from 2015 and 2016, revealing significant discrepancies between the actual amounts and the financial information initially disclosed.

The Listing Committee found:

- Shandong Molong did not maintain adequate and effective risk management and internal control systems to ensure that the financial disclosures were accurate and to enable the proper discharge of a director's duties;
- certain former directors breached their directors' duties given (a) one director had no knowledge about the company's operations and yet he approved the financial disclosures (this director willfully and persistently failed to discharge his responsibilities as an executive director and chairman under the Listing Rules for a prolonged period (between 2005 and February 2017), as he delegated his responsibilities to his son and only attended board meetings of the company by teleconference, and no one reported to him anything about the company's operations or financial performance save for the provision of its quarterly, interim and annual results to him), and (b) the two other directors were aware of adjustments to the financial results having been made but chose to approve the incorrect disclosures;
- former directors failed to ensure that Shandong Molong had adequate and effective risk management and internal control systems. There was no evidence that these former directors took any steps to (a) ensure that there were proper reporting procedures of Shandong Molong's affairs; (b) make any enquiries or consider whether there were any internal control implications given the significant discrepancies when red flags should have been raised; (c) make any enquiries as to what had caused the discrepancies; (d) consider whether there were any risk management and internal control deficiencies, or how to address such deficiencies; or (e) consider whether there were any Listing Rule implications;

The case serves to remind listed companies and their directors, among other matters:

- to ensure adequate and effective risk management and internal control systems are implemented;
- that delegation of responsibility to a director or other staff does not absolve other directors individually or collectively from taking all reasonable steps to monitor the execution of the delegated task, and to take prompt and effective remedial action where deficiencies in execution are noted;
- to read, understand and focus on the contents of its disclosure of financial information, and to take all reasonable steps to ensure that the financial information to be disclosed is accurate, and, where necessary, to make further enquiries and follow up on anything untoward that comes to their attention; and
- to review the contribution and ability required of each director in order for him to be able to discharge his director's duties and responsibilities. Unless a director, the board of directors and the listed issuer are satisfied that the relevant director can devote sufficient time and attention required of him in due performance of his director's duties, he should resign — HKEx is of the view that a director does not satisfy the required levels of skill, care and diligence required from him under the Listing Rules if he only pays attention to the issuer's affairs at formal meetings.

Takeovers Panel Rules Against Waiver of General Offer Obligation in Proposed Maanshan Iron Acquisition

The Takeovers and Mergers Panel has declined to grant a requested waiver from the general offer obligation under the Takeovers Code in relation to the proposed acquisition of a controlling shareholding interest in Maanshan Iron & Steel Company Limited (**Maanshan Iron**) from the Anhui province state-owned Assets Supervision and Administration Commission (**Anhui SASAC**) by China Baowu Steel Group Corporation Limited (**China Baowu**) at nil consideration.

The panel considered and ruled, among other things, that:

- waivers to the general offer obligation under Rule 26.1 of the Takeovers Code should only be granted in a comparatively narrow range of circumstances;
- the application in the present case had been made under Note 6(a) to Rule 26.1. The Panel ruled that a waiver from the general offer obligation under Note 6(a) may be granted, if in the true sense of the words there is not a change in control in question, and, on the basis that a concert party group was, as a matter of fact, in existence in the first place. However, the parties in the present case have not been able to demonstrate that China Baowu and Anhui SASAC had been acting in concert at any relevant time prior to the proposed acquisition;

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- even if China Baowu and Anhui SASAC had been acting in concert, China Baowu would become the new leader of a concert group as a result of the proposed transaction and there would be a fundamental change in the balance of the shareholding in Maanshan Iron; and
- waiver from the mandatory general offer obligation that would be triggered upon completion of the Proposed Acquisition will not be granted.

Further, the panel ruled that the applicable offer price would be the volume-weighted average price of Maanshan Iron's H shares on the last trading day before its possible offer announcement pursuant to Rule 3.7 of the Takeovers Code.

Market Misconduct Tribunal Fines Health and Happiness and its Officers for Late Disclosure of Inside Information

Listed companies are reminded to make profit warning announcements in a timely manner, and that the SFC will take action against companies that delay informing the market about a deterioration in their profits. In a recent case, Health and Happiness International Holdings Ltd (**Health and Happiness**) and its chairman and executive director, Mr. Luo Fei, became aware on or around 23 June 2015 of the company's financial deterioration for the five months ended 31 May 2015 compared with the same period in the previous year. However, the company did not announce such financial deterioration to the market until 23 July 2015 when it issued the profit warning — a delay of four weeks. The SFC said that this information was specific, price sensitive and not generally known to the public at the material time, and would likely have materially affected Health and Happiness' share price had it been known to the investing public. The Market Misconduct Tribunal found that Health and Happiness and Luo had failed to disclose inside information to the public as soon as reasonably practicable, and levied fines upon both.

Current Regulatory Landscape of Security Token Offerings in Hong Kong

Since 2017, the SFC has issued a number of statements with the aim of regulating digital token offerings within Hong Kong's existing framework of securities laws and regulations.

Initial coin offerings (**ICOs**) typically have concerned digital tokens that had characteristics of "virtual commodities," such as cryptocurrencies (designed to act as fiat currencies and used for payment purposes) and utility tokens (which gave token holders access to certain services, similar to a loyalty points system). This was typical of the majority of fundraisings taking place in 2017 and the first-half of 2018. Over time, digital token offerings evolved such that issuers began

offering digital tokens that had terms and features similar to "securities," "futures contracts" or "debentures" (collectively, *security tokens*), for example, giving token holders an equity or ownership interest in a project, or offering tokens that represented an acknowledgement of debt or liability owed by the issuer. The SFC has termed this latter type of offering "security token offerings" (**STOs**).

On 28 March 2017, the SFC issued its latest policy statement, "Statement on Security Token Offerings," making clear that certain types of digital tokens, depending on the purpose for which they are, or are intended to be, offered or purchased, may be considered "securities," "futures contracts," "debentures" or "complex products" and also may constitute "collective investment schemes." If a digital token is classified as a security token, dealings concerning the digital token would fall within Hong Kong's existing framework of securities laws and regulations.

Regulated or Supervised Activities in Hong Kong

The following are regulated and/or supervised activities concerning security tokens in Hong Kong:

- distributing from funds that invest in either "virtual commodities" or "security tokens" in Hong Kong (collectively, **virtual assets**). This includes persons licensed to engage in a Type 1 regulated activity (dealing in securities);
- persons licensed to engage in a Type 9 regulated activity (asset management) that manages a fund that invests in security tokens, subject to a *de minimis* exemption if the fund intends to invest less than 10% of the portfolio's gross asset value (**GAV**) in virtual assets; and
- dealing in security tokens, which falls within the scope of a Type 1 regulated activity (dealing in securities).

The following are currently outside of the scope of regulated or supervised activities:

- managing a fund that only invests in virtual commodities (being virtual assets not characterised as security tokens), or invests in virtual assets but falls within the *de minimis* exemption (or exceeds the 10% threshold only due to an increase in the value of the virtual assets within the portfolio); and
- operating a trading platform for virtual commodities only.

Relevant Regulation Surrounding Regulated or Supervised Activities

- Security token offerings are regulated by the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (**SFO**), as well as the prospectus regime under Part II and Part XII of the Companies (Winding Up and Miscellaneous Provisions) Ordinance.

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- Licensed persons or persons engaged in a regulated or supervised activity in Hong Kong (including intermediaries, such as wallet holders, and platform operators) should be aware of their existing obligations and licensing requirements under the SFC's code of conduct, guidelines, circulars and FAQs, issued from time to time, and, most notably, be aware of their obligations under the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (October 2013) (**Code of Conduct**), as well as publications issued by the SFC that specifically concern virtual assets.
 - In particular, licensed persons or persons engaged in a regulated or supervised activity in Hong Kong should observe their obligations on suitability requirements under paragraph 5.2 of the Code of Conduct, as supplemented by two suitability FAQs, and ensure that a recommendation or solicitation involving virtual assets is suitable for their clients, typically being "professional investors" (including "professional institutional investors"), in all circumstances.