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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 will also cover other recent market developments. We do not intend to cover all updates that may be relevant, but we welcome feedback, so please contact us if there are other topics of interest you'd like us to cover in the future.

## Status of HKEx Consultation Paper on Corporate WVRs

In January 2020, HKEx issued a consultation paper aimed at updating the rules regarding who may hold "weighted voting rights" (**WVRs**) in a company that is sufficiently innovative and that meets the other listing eligibility criteria to list with a WVR structure pursuant to Chapter 8A of the Listing Rules. The updated WVR rules would permit corporations that meet certain criteria (including having their own listing on HKEx or a short list of other stock exchanges) to hold WVR shares in the company to be listed pursuant to Chapter 8A. The consultation period was initially scheduled to close on May 1, 2020, but was extended through to May 30, 2020. We understand that HKEx is now considering the responses received, and the conclusions are expected to be published in the second half of 2020.

For further details of the consultation paper on corporate WVRs, please refer to [our Hong Kong Regulatory Update published on March 30, 2020](#).

## Consultation Conclusions on the Eligibility of WVR Companies and Secondary-Listed Companies for Inclusion in the HSI and the HSCEI

On May 18, 2020, Hang Seng Indexes published the conclusions to its consultation regarding the eligibility of WVR companies and secondary-listed companies for inclusion in the Hang Seng Index (**HSI**) and the Hang Seng China Enterprises Index (**HSCEI**) as well as various other matters related to the HSI and the HSCEI.

WVR companies and secondary-listed companies from the Greater China region will be included in the HSI and the HSCEI under the following conditions:

- Shares with WVR structures will be considered non-freefloat shares.
- Market capitalization of secondary-listed companies will be based solely on the shares registered in Hong Kong. Any of these shares held by a depository as underlying for overseas depository receipts will be considered non-freefloat shares.
- Individual constituent weighting of the securities of WVRs and secondary-listed companies will be subject to a 5% weighting cap.

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Also, to align the HSCEI constituent selection criteria for all share classes, the existing additional eligibility criteria (including listing history, price volatility and financial performance) introduced in 2018 for red-chip and P-chip companies will be removed. The number of constituent changes in the August 2020 HSCEI index review will be capped at three to control the index turnover at a manageable level. This restriction will be removed starting in the November 2020 index review.

No change will be made to the current positioning of the HSI. The HSI will continue to represent the Greater China companies listed in Hong Kong, and no specific ratio or weighting limits will be set for Hong Kong versus Mainland China constituents or financial stocks. Market representativeness will continue to be the main consideration for any changes in HSI constituents.

The above changes will be implemented starting in the August 2020 index review.

## Updated HKEx Guidance for Biotech Companies Listed Under Chapter 18A of the Listing Rules

HKEx published new guidance letter HKEX-GL107-20 in April 2020, which includes comprehensive guidance on enhanced disclosure that pre-revenue biotech companies should consider in their listing documents, including drafting guidance and disclosure requirements for the summary section, competitive landscape of the core products and other key pipeline products, communication with competent authorities such as China's National Medical Products Administration, and use of proceeds for commercialized core products.

The existing guidance letter HKEX-GL92-18 has been updated with the following major additional listing requirements:

- For a core product that is in-licensed or acquired from third parties, the applicant needs to demonstrate research and development (R&D) progress since the in-licensing or acquisition, such as (i) progression from preclinical stage to clinical stage, (ii) progression from one clinical trial phase to the next or (iii) the obtaining of regulatory approval from the competent authority to market the core product.
- For a core product that has been commercialized in a given market for specified indication(s), the applicant should ideally demonstrate further R&D expenditure on the product in connection with the clinical trials required by a competent authority to either use the product for a new indication or commercialize it in a new regulated market.
- For a biotech company that develops medical devices that use a short development cycle, HKEx will consider the business plan and development stage of the pipeline products to enable the company to allocate a portion of the listing proceeds to establish, for example, facilities to manufacture the core product(s) or sales, marketing and medical teams to commercialize the core product(s).

- For a pharmaceutical or a biological core product, the applicant must have completed at least one regulated clinical trial on human subjects, or, in the case of an in-licensed or acquired core product, explain why no clinical trial has been completed and whether substantive R&D work and processes equivalent to the completion of one clinical trial have been performed.
- In the absence of an obvious regulatory regime, a biotech product can be classified as an "other biotech product" based on HKEx's consideration of nonexhaustive factors such as (i) the number, selection process and diversity of the test sampling population and availability of data from preclinical and clinical trials; (ii) the time frame and impediments to commercialization; (iii) the impact factor of journals if preclinical and clinical results have been published; and (iv) a comparable framework and/or objective indicators under guidelines published by the competent authorities.

The "Existing Shareholders Conditions" in the guidance letter HKEX-GL85-16 do not apply to biotech companies given their significant funding needs and the importance of existing shareholders in meeting such needs. HKEx further clarifies that (i) an existing shareholder holding less than 10% of the shares in the biotech company may subscribe for shares in the IPO as either a cornerstone investor or as a placee; (ii) an existing shareholder holding 10% or more of the shares in the biotech company may subscribe for shares in the IPO as a cornerstone investor; and (iii) an existing shareholder may exercise its contractual anti-dilution right and subscribe for shares in the IPO.

## HKEx Listing Decision LD126-2020 Regarding Rejected Listing Applications

In 2019, HKEx rejected 6% of listing applications (compared with 6.45% in 2018), most of which were rejected on the basis that the listing applicants failed to demonstrate a commercial rationale for the proposed listing, leading HKEx to believe that the listing applicant, if permitted to list, would likely become a shell company for a backdoor listing. A listing applicant should therefore present convincing evidence that the proposed listing would advance the development of its underlying business or assets or that its size and prospects would justify the costs or purposes associated with a public listing. Together with the narrowing of the backdoor listing rules that the exchange undertook in 2019, HKEx is sending a clear message that it has more regulatory tolerance for larger listings.

HKEx also clarified that if a listing applicant can demonstrate genuine funding needs, the company will not be prejudiced by having strong cash flows, internal sources of funding or banking facilities. Listing applicants should therefore clearly explain how their proposed listings would further their business development and how their proposed use of proceeds are commensurate with their historical business strategies.

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## HKEx Listing Decision LD127-2020 Regarding Returned Listing Applications

HKEx returned several listing applications in 2019 due to the omission of financial information as required by Listing Rule 4.04(1), pursuant to which a main board listing applicant should include in the accountants' report its consolidated results for each of the three financial years (or two financial years in the case of a biotech company) before the issue of the listing document. HKEx will normally use the proposed listing date indicated in the A1 filing to determine the corresponding track record period that should be covered in the accountants' report in the final prospectus. HKEx may, however, accept an application proof with an accountants' report covering a shorter period depending on when the listing application is filed, provided that certain conditions are satisfied.

Assuming the most recent financial year ended on December 31, 2020, and the intended listing date is on or after April 1, 2021, the final prospectus should at least cover the three financial years ended December 31, 2020. For the purpose of the application proof:

- If the listing application is filed before the end of the most recent financial year (*i.e.*, before December 31, 2020), the application will be returned if the submission only includes results for two full years and an appropriate stub period because the applicant has yet to complete the last full financial year of its track record period.
- If the listing application is filed between January 1, 2021, and February 29, 2021, the applicant can include an accountants' report with a shorter period (*i.e.*, the two financial years ended December 31, 2019, and the nine months ended September 30, 2020) in the application proof, with the final prospectus to be updated with the complete accountants' report covering the three years ended December 31, 2020.

If a listing applicant expects to be listed within three months after the end of the most recent financial year of its track record period, it may omit the full financial information for its most recent financial year if it applies for and obtains a waiver from strict compliance with Listing Rule 4.04(1). The application proof should include an accountants' report covering the three financial years ended December 31, 2018, and at least the six months ended June 30, 2019.

## Enforcement Matters

### HKEx censured former directors of Champion and Kantone

The case highlights that directors must exercise their fiduciary duties and duties of skill, care and diligence to a sufficiently high standard when making investment decisions or acquiring assets on behalf of the company. Where the company proposes to acquire significant valuable assets, directors are expected to obtain a professional valuation and take all necessary steps to

ensure that the interests of the company and its shareholders are protected. Also directors must take care not to simply rubber-stamp recommendations of other directors, but to always exercise independent judgement and raise concerns and queries where necessary.

During 2015 and 2016, Champion Technology Holdings Limited (**Champion**) and its subsidiary, Kantone Holdings Limited (**Kantone**, and together with Champion, the **Group**), acquired a large number of Tianhuang stones for trading, which were recorded as approximately 92% of the total assets of the Group at the time. In 2017, the Group's auditors requested professional assessments of these cultural products and subsequently issued disclaimer opinions for the 2017 and 2018 financial years, writing off over 99% of the value of the stones. There was no evidence that the boards of Champion and Kantone procured any professional authentication or valuation of the cultural products prior to purchasing them.

From 2000 to 2003, Champion acquired shares in four private companies based outside Hong Kong but was subsequently unable to establish communications with the management of these companies. As a result, the auditors recorded a full impairment loss of the value of these companies in Champion's results for the 2017 financial year in the sum of approximately \$418 million.

HKEx found that the significant impairment losses were caused by the failure of (i) the company directors to conduct sufficient due diligence on the authenticity and value of the cultural products and to seek prior board approval; (ii) the then chief financial officer (who was also a director) of Champion and Kantone to ensure proper accounting and internal control; (iii) the other board directors of Champion and Kantone at the time to exercise independent judgement by raising inquiries and taking a diligent interest in the information presented to the board; and (iv) the directors to monitor overseas investment.

### HKEx censured former directors of China Ding Yi Feng Holdings Limited

HKEx censured the former directors of China Ding Yi Feng Holdings Limited for the following issues:

- **Appointing new directors in a nontransparent manner.** Mr. Y. Yao introduced to the company Mr. Z Yao, who is Mr. Y. Yao's brother, and Mr. Shi, who is a relative of Mr. Y. Yao's spouse, for directorships. The independent nonexecutive directors at the time, who were also members of the nomination committee, had indicated that more information was required before they could consider the appointments; however, a board meeting was convened to approve the proposed appointments based on limited information about their qualification and experience. HKEx determined that the appointment process was not duly conducted or transparent.

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## - Providing false information as directors upon appointment.

Mr. Y. Yao had previously been imprisoned and appeared on a “list of wanted economic fugitives/internet wanted persons” issued by the Guangzhou Police Department; Mr. Z. Yao appeared on a “list of persons who lack credibility” on the Guangzhou Judgment website; and Mr. Shi failed to disclose the familial relation connecting his interests to the board. These facts were not disclosed to the company or in its announcement in accordance with the disclosure requirements of the Listing Rules, which deprived the company and its investors of information pertaining to suitability considerations.

- **Suspected misappropriation.** Mr. Y. Yao led the company’s investment in a RMB 30 million bill of exchange (**30m bill**) in late 2015, which was redeemed early by way of swapping this with three RMB 10 million bills of exchange (**10m bills**). The bill replacement was completed one evening at a last-minute suggestion of Mr. Y. Yao and was approved by an executive director based on telephone images of the three 10m bills. No board approval was sought for the replacement and no further due diligence was carried out. When auditors later found that the 10m bills were likely to have been forged, they impaired the full acquisition cost of the 30m bill. The investigation by the auditors also resulted in a nearly 15-week delay in the publication of the company’s annual results and annual report for the 2015 financial year, which in turn resulted in an extended trading suspension of company shares.

- **Failure to cooperate with HKEx’s investigation.** Mr. Y. Yao, Mr. Z. Yao and Mr. Shi were removed as directors in July 2016. HKEx subsequently sent inquiry letters to each of them and also reminder letters to their last known addresses, but did not receive any responses.

## HKEx reiterated the primacy of sanctions requiring directors to attend trainings

Among the sanctions imposed in previous disciplinary proceedings against Kiu Hung International Holdings Limited (**Kiu Hung**) and nine of its then current and former directors, HKEx directed Mr. Zhang Yun, an executive director of Kiu Hung, to attend 18 hours of training on compliance with the Listing Rules and director’s duties (including four hours of training on financial reporting obligations). Mr. Yun refused to complete the training despite repeated reminders and ultimately retired as an executive director of Kiu Hung in June 2019.

In response, HKEx criticized Mr. Yun for his refusal to undertake the training and indicated that this blatant disregard suggested Mr. Zhang Yun would be unsuitable to act as a director of any issuer listed, or to be listed, on HKEx. Although limited in its ability to enforce disciplinary sanctions, the exchange nevertheless sought to emphasise that intentional failure to comply with directions will not be tolerated and severe consequences will follow such a breach.

## Kong Sun criticized for internal control failures

Kong Sun Holdings Limited (**Kong Sun**) and its subsidiaries were directed by the companies’ chief operating officer (**COO**) and financial controller (**FC**) to issue more than RMB 1.5 billion in interest-free unsecured loans and advances. Neither the COO nor the FC were directors of Kong Sun, and these loans and advances were made without the board’s knowledge or approval. Even after Kong Sun’s auditors informed the board of directors of such loans and advances, and the FC was told to cease making all further loans and advances, the COO and FC managed to issue an additional RMB 85 million in loans and advances without board knowledge or approval.

Under the Listing Rules, the loans and advances were required to be disclosed and subject to shareholders’ approval. Although the company eventually disclosed the loans and advances, it failed to obtain shareholders’ approval. Moreover, the loan and advances exposed financial management inadequacies that, in part, led to the resignation of Kong Sun’s auditors as well as late publication of its annual report, annual results and interim results.

HKEx criticized Kong Sun and its then directors for their failure to disclose the loans and advances, to seek shareholder approvals and to publish timely financial results and approval. The decision was upheld by both the review committee and the appeals committee. HKEx also noted a number of internal control deficiencies, including the following:

- The directors failed to take reasonable steps to understand the company’s management accounts.
- The directors failed to establish and maintain an effective and appropriate internal control procedure and risk management system.
- Kong Sun had no written internal control procedures with respect to (i) approval and disclosure of contracts; (ii) reporting and recording of contracts/loans and advances; (iii) management, use and storage of its chops/seals; and (iv) remittance of large amount of funds via internet banking.
- Kong Sun gave the COO and the FC significant authority without sufficient controls; for example, the FC was able to authorize internet banking remittances of up to RMB 800 million on his own.
- The directors failed to apply a suitable level of scrutiny and follow up on anything unfavorable that came to their attention. (The exchange stipulates that although directors may delegate functions, they remain responsible for applying the required levels of skill, care and diligence.)
- The directors failed to ensure Kong Sun’s staff (including the COO and the FC) received adequate and appropriate training on the Listing Rules. (Merely providing to staff a copy of the Listing Rules, without explanation or training, is inadequate.)

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- The directors collectively did not take sufficient or effective steps to respond to audit-related issues, leading to the resignation of the company's auditors and delay in publication of annual and interim results.
- After being informed of the loans and advances, the directors of Kong Sun failed to take sufficient or effective action to stop the COO and the FC from authorizing further loans and advances, thus failing to take account of the severity of the prior breaches in adopting a heightened awareness of company activity.

## **The SFC obtained court orders against Shandong Molong**

This case highlighted the SFC's expectation that key financial information in all results announcements of listed companies must reflect the companies' actual financial position.

Shandong Molong Petroleum Machinery Company Limited (**Shandong Molong**) disclosed false and misleading key financial information in its unaudited quarterly and half-yearly results announcements for the first three quarters of 2015 and 2016. The unaudited results falsely and misleadingly portrayed a healthy picture of Shandong Molong's financial position when in fact the company was suffering losses. The SFC obtained a court order requiring the company to reconstitute its audit committee and to appoint an independent external auditor to review its internal control and financial reporting procedures. The SFC also sought disqualification orders against seven current and former senior officers allegedly responsible for inflating the company's financial position or acquiescing and/or turning a blind eye to revenue overstatement and costs understatement for financial years 2015 and 2016.

## **The SFC obtained disqualification orders against former directors of Long Success**

Five former directors of Long Success International (Holdings) Limited (**Long Success**) were disqualified from being directors or being involved in the management of any listed or unlisted corporation in Hong Kong, without leave of the court, for a period of two to five years for breach of their fiduciary duties and common law duties to act in the interest of the company and/or to exercise due and reasonable skill, care and diligence in the course of acting as directors of the company.

The underlying transaction involved the acquisition of equity interest in Jining Gangning Paper Co. Ltd. (**Jining Gangning**) in 2009 by Mr. Wong Kam Leong, the former chairman and executive director of Long Success. The seller, Mr. Chook, had guaranteed that he would compensate Long Success if Jining Gangning failed to meet a minimum profit after tax of RMB 60 million for each of the two years ended December 31, 2010, and December 31, 2011. Jining Gangning failed to achieve the agreed profit in both years, and Mr. Wong signed confirmation

letters with Mr. Chook initially agreeing that the profit guarantee would be deferred and then further agreeing to forfeit the profit guarantee.

The SFC alleged that Long Success had no objective, rational or commercial reason to agree to the terms of these confirmation letters since the terms were detrimental to Long Success's financial position. The commission obtained a disqualification order against the former directors, including the three independent nonexecutive directors, for their failure to prohibit Mr. Wong from exercising domination and control of the affairs of Long Success and of the board of directors for his personal advantage. Additionally the SFC is pursuing proceedings against other former directors.

## **The SFC obtained disqualification orders against former directors of EHL relating to the misapplication of funds**

The Court of First Instance found that three former directors of EganaGoldpfeil (Holdings) Ltd. (**EHL**) had approved transactions and signed checks, including payments to at least seven debtors that were under the control of one of the directors. The SFC determined the directors failed to carry out proper inquiries and perform appropriate due diligence before causing or permitting EHL to enter into the transactions, which were not genuine commercial transactions. The directors were disqualified from being directors or taking part in the management of any corporation in Hong Kong for periods of six to nine years without the leave of the court.

The SFC also sought compensation orders against the three former directors for a payment of HK\$622 million to EHL, equivalent to EHL's payment of HK\$622 million to a company owned by the family of the EHL's then chairman, to fund its purchase of some of EHL's shares. The court analyzed Section 214 of the Securities and Futures Ordinance and determined that a compensation order can be made irrespective of whether a respondent has received any financial benefits. However, the court in this case declined to issue the order, taking the view that EHL's liquidators should assess whether it would be beneficial to bring proceedings in the name of EHL against any party.

## **The SFC sought to wind up Combest Holdings Limited**

The SFC petitioned to the Court of First Instance to (i) wind up Combest Holdings Limited (**Combest**), (ii) disqualify two of its executive directors and a suspected shadow director and (iii) appoint provisional liquidators.

The SFC stated that the alleged executive and suspected directors caused Combest and its subsidiaries to enter into two overpriced acquisitions, comprised of: (i) the acquisition of a company engaged in money lending, provision of credit, provision of lending consultancy services and provision of secretarial services at a consideration of \$70 million in January 2016; and

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(ii) the acquisition of a 51% equity interest in a fund management business at a consideration of \$170 million in April 2017. The commission determined that Combest overstated its revenue by 84% to 99% during various accounting periods between 2016 and 2019 by including revenue resulting from the two artificial and/or fictitious businesses.

## **The SFC censured the chairman of Macrolink Capital for breach of the Takeovers Code**

The SFC has censured the chairman of Marcolink Capital Holdings Limited (**Marcolink Capital**) for acquiring its shares

within six months after the close of an offer at prices above the offer price, in breach of Rule 31.3 of the Codes on Takeovers and Mergers and Share Buy-backs. He has since submitted that the breach was unintentional and accepted the disciplinary action against him.

Rule 31.3 of the code affords equality of treatment to shareholders in an offer. This provides shareholders with certainty that an offeror will not pay a price higher than the offer price for the shares in the offeree company in the six-month period after the close of an offer, and thus ensures that all shareholders of the offeree company are treated even-handedly.