



# 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**). Other recent market developments may also be included. We do not intend to cover all updates that may be relevant, but we welcome feedback, so please contact us if you'd like to see analysis of other topics in the future.

### **HKEx Consults on a Paperless Listing and Subscription Regime, Online Display of Documents and Reduction of the Types of Documents on Display**

Several recent high-profile initial public offerings (IPOs) have adopted a paperless IPO process, eliminating the need to print thousands of physical prospectuses and application forms, and using instead online applications. However, conducting a paperless IPO currently involves applying first for waivers and exemptions from various regulatory requirements. Consistent with its ongoing initiative to promote environmentally friendly practices, HKEx is proposing to codify the paperless IPO process, as well as replace the requirement to make physical copies of various documents available with a requirement to make such documents available online. HKEx invited public comments by September 24, 2020, on their proposals, which include:

- requiring listing documents for new listings (excluding mixed media offers) to be published solely in an electronic format and new listing subscriptions to be made only through online channels;
- replacing the requirement for physical display of documents with a requirement for uploading the documents to both the websites of HKEx and the listing applicant/ listed company for the same period of time as is presently required for hard copies; and
- in relation to notifiable and connected transactions, removing the requirement to display (i) other material contracts (excluding contracts entered into in the ordinary course of business) entered into within the recent two years and directors' service contracts that are not directly related to the transaction; and (ii) constitutional documents, audited accounts and previously published transaction circulars.

We expect the proposals to be met with broad support and to be adopted in the near future.

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## HKEx Consults on Review of Disciplinary Powers and Sanctions

HKEx is proposing to enhance the present disciplinary regime under Chapter 2A of the Listing Rules. HKEx proposes to strengthen its power to hold individuals, including members of the senior management teams of listed companies who are not directors, accountable for misconduct and breaches of the Listing Rules. Key proposals include:

- broadening the scope of HKEx to issue public statements that the retention of office by a particular individual is prejudicial to the interest of investors (a **Prejudicial Statement**);
- enhancing follow-on actions in cases of more serious misconduct by providing the Listing Committee or Listing Review Committee with the ability to deny market facilities to listed companies for a certain period or to suspend or cancel their listings if an individual subject to a Prejudicial Statement remains in office;
- requiring listed companies to reference any applicable Prejudicial Statements in all announcements and communications until the named individuals cease to be directors or members of senior management;
- removing the requirement of “wilful” or “persistent” failure by a listed company to discharge its responsibilities under the Listing Rules such that the company could be denied the facilities of the market even if a failure is not wilful or persistent;
- introducing director unsuitability statements against individuals such that if a director or member of senior management demonstrates “serious or repeated failure” to discharge his or her duties, follow-on actions and publication of Prejudicial Statements could apply;
- introducing secondary liability for breaches of Listing Rules such that senior management of listed companies and subsidiaries, chief executive officers, chief financial officers, chief operating officers, board secretaries, substantial shareholders, professional advisers, financial advisers and guarantors of debt issuance or structured products could be liable if they have caused a breach by action or omission, or knowingly participated in the violation;
- providing sanctions for the failure to comply with requirements imposed by the Listing Division, the Listing Committee or the Listing Review Committee (which can further be imposed on the other relevant parties through secondary liability);

- creating an obligation to provide accurate, complete and up-to-date information and explanations in response to inquiries or investigations by HKEx; and
- defining “senior management” within listed companies and their subsidiaries as anyone (i) occupying the positions of chief executive, supervisor, company secretary, chief operating officer or chief financial officer; (ii) performing managerial functions under the directors’ immediate authority; or (iii) referred to as senior management in publications on the website of HKEx or the company.

We expect several of these proposals to meet strong resistance, particularly the proposal to introduce secondary liability. The deadline for market responses is October 9, 2020.

## HKEx Published Chapter 37 Consultation Conclusions, Guidance on Disclosures in Listing Documents and Continuing Obligations Under Chapter 37

Following HKEx’s consultation paper on Chapter 37 of the Listing Rules (which was covered in [our Hong Kong Regulatory Update published on January 8, 2020](#)), HKEx issued its consultation conclusions with the amendments to the Listing Rules to take effect on November 1, 2020. HKEx adopted most of the proposals from its paper, including:

- increasing the minimum net assets required for a company to be eligible to conduct a listing of debt under Chapter 37 from HK\$100 million to HK\$1 billion;
- introducing a minimum issuance size of HK\$100 million;
- requiring companies to state on the front cover of listing documents that the intended investor market for the debt securities in Hong Kong is professional investors only;
- requiring listing documents to be published on HKEx’s website upon listing;
- implementing Listing Rules amendments to enhance regulatory oversight over companies and guarantors relating to their continuing obligations;
- replacing (i) requirements to submit copies of constitutional documents and resolutions with the requirement for the duly authorized representative of the company (or guarantor as applicable) to confirm in writing the company’s incorporation, capacity and authorization of the listing; and (ii) requirements to submit the published financial statements with the obligation to disclose them in the listing document; and
- removing the need to apply for the professional investor waiver by revising the definition of “professional investors” to encompass high-net-worth investors.

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HKEx has also published guidance on disclosure and continuing obligations relating to the issuance of debt securities.

## HKEx Published Consultation Conclusions on 'Codification of General Waivers and Principles Relating to IPOs and Listed Issuers and Minor Rule Amendments' and Guidance on Company Secretary Qualifications

Following HKEx's consultation on codification of general waivers and principles relating to IPOs and listed issuers and minor rule amendments (which was covered in our [Hong Kong Regulatory Update published in October 2019](#)), HKEx issued its consultation conclusions with the amendments to the Listing Rules to take effect on October 1, 2020. All the proposals outlined in the consultation were adopted except for the proposal to codify the factors assessed when granting a waiver regarding the experience and qualification requirements of a company secretary. The key updates include:

- codification of a number of waivers previously approved by SFC relating to (i) publication and distribution of annual results and reports, (ii) shareholder approval requirements for bonus or capitalization issuances by PRC-incorporated companies, (iii) calculation of the consideration ratio for PRC-incorporated companies dually listed on HKEx and a PRC exchange, and (iv) inclusion of stock code in documents;
- codification of general principles underpinning a number of waivers that have been granted to new applicants and/or listed companies relating to financial disclosure matters, acquisition of aircrafts by airline operators, incentive schemes, and working capital statements in the listing documents and transaction circulars of banking or insurance companies; and
- minor amendments to the Listing Rules to clarify interpretation and to codify a number of administrative matters that are currently provided in guidance letters or listing decisions.

HKEx has also issued new guidance letter GL108-20 to clarify and contextualize the policy rationale of Listing Rule 3.28, and the factors and conditions considered in granting a waiver regarding the experience and qualification requirements of a company secretary. The waiver condition is heightened in that the waiver will be revoked if the company breaches the Listing Rules in a material way.

## HKEx Issues Listing Decision (LD-129-2020) on Whether Granting Options to a Discretionary Trust Under a Share Option Scheme Would Meet

## Requirements Under Chapter 17 of the Listing Rules

A company applied to HKEx proposing to grant share options to a discretionary trust through a share option scheme, with the beneficiaries of the trust being company employees. Share options were to be granted to the trust for future allocations to beneficiaries as identified by the board of directors from time to time. However, HKEx ruled that "any discretionary object of a participant which is a discretionary trust" serving as a participant of a share option scheme does not meet the requirements of Chapter 17 of the Listing Rules.

Listing Rule 17.01(1) allows "any discretionary object of a participant which is a discretionary trust" to be a participant of a share option scheme provided the grant is for the benefit of specified participants (*e.g.*, directors or employees). In this case, the participants for the benefit of whom the options were granted were unspecified at the time of the grant. This could facilitate circumvention of Rule 17.03(9), which requires the exercise price to be set at the time of the grant and be no lower than the market price, and would breach Rule 17.03(17), which prohibits the transfer or assignment of options to other persons.

## Takeovers Bulletin

In June 2020, SFC issued a Takeovers Bulletin regarding issues relating to the Codes on Takeovers, Mergers and Share Buybacks (the **Takeovers Code**), with the following highlights:

### Restrictions on voting by connected EPTs under Rule 35.4 of the Takeovers Code

SFC consulted on the applicability of Rule 35.4 of the Takeovers Code in a privatization case, where the relevant shares were held by a connected exempted principal trader (**EPT**) as a simple custodian for and on behalf of nondiscretionary clients, and over which the EPT had no voting discretion. Rule 35.4 provides that securities owned by an EPT connected with an offeror or the offeree company must not be voted in the context of an offer. In this case, the EPT failed to disclose during the consultation that some of its underlying clients were concert parties of the offeror and were not entitled to vote on certain resolutions.

Going forward, where a connected EPT considers that Rule 35.4 does not apply to the relevant shares, SFC will require a written confirmation stating that:

- the connected EPT holds the relevant shares as a simple custodian for and on behalf of nondiscretionary clients;
- contractual arrangements between the connected EPT and its clients strictly prohibit the EPT from exercising any voting discretion over the relevant shares, and the client has



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- provided relevant instructions; and
- the connected EPT has conducted reasonable due diligence and made appropriate inquiries with its underlying clients on whose behalf it holds the relevant shares, and has confirmed that the underlying clients are entitled to vote in the context of the offer in question.

The voting results announcement should disclose that the connected EPT did not vote (other than those shares held by such EPT as a simple custodian for and on behalf of nondiscretionary clients who are entitled to vote and over which such EPT has no voting discretion) in the context of the offer.

SFC also noted that paragraph 7.3 of Practice Note 9 will be amended. Where a client of a group's corporate finance department is involved in an offer or a whitewash transaction, SFC will require the group to submit details of its aggregate holdings of relevant securities of the offeree company and, in the case of a securities exchange offer, the offeror, as at the close of business on the day the offer period commences or the whitewash transaction is announced. Details of securities held by an EPT as a simple custodian for and on behalf of nondiscretionary clients and over which the EPT have no voting discretion should also be included.

## Preserving confidentiality obligations under Rule 1.4 of the Takeovers Code

SFC noted that in some recent cases, inside information relating to the possibility of a Takeovers Code transaction might have been leaked to the media. SFC subsequently reminded parties and their advisers of the confidentiality obligations set out in Rule 1.4 of the Takeovers Code and the importance of preserving confidentiality prior to a firm intention announcement. SFC further highlighted the importance of keeping information confidential to prevent the need for a "talks" announcement when discussions are still preliminary or ongoing, and noted the undesirable impact of commencing an offer period during this stage. If the obligation to make a "talks" announcement does arise, SFC would expect the announcement to be relatively short and to disclose only that discussions are taking place.

## SFC's public criticism relating to dealing disclosure breaches

SFC publicly criticized an investment bank for breaching the dealing disclosure requirements under Rule 22 of the Takeovers Code as a result of the bank's late disclosure of dealings in the relevant securities. The disclosure obligations under Rule 22 are intentionally onerous to reflect the fact that timely and accurate disclosure of information related to dealings

by an offeree company's or an offeror company's associates (including EPTs) plays a fundamental role in ensuring that takeovers are conducted within an orderly framework and that the integrity of the markets is maintained.

## New online DoD submission platform

To streamline the submission process for documents required to be displayed (**DoD**) under Note 1 to Rule 8 of the Takeovers Code, SFC will move the process online to its web-based InteGrated Service (**WINGS**) portal. The procedure to prepare all documents in PDF format and the preparation of the DoD Submission Form remain largely the same, with the exception that CD or DVD submission is no longer required. Instead, applicants will submit documents online via WINGS. SFC has yet to announce the commencement date for the new procedure.

## Enforcement Matters

### HKEx censured State Energy Group and former executive director and CEO for breach of the Listing Rules

State Energy Group International Assets Holdings Limited (**State Energy Group**) was censured for breaching Listing Rule 2.12A for failing to provide HKEx with relevant information required to verify Listing Rules compliance. The case highlights that in their engagement with HKEx, listed issuers and directors have an obligation to provide complete, accurate and up-to-date information when making inquiries to the exchange or responding to requests from HKEx for information or explanation. Listed companies must provide any information reasonably considered to be appropriate to protect investors or to ensure the smooth operation of the market, as well as any information required to investigate a suspected breach or verify compliance with the Listing Rules.

State Energy Group failed to disclose relevant information about a material change in its exporting business when seeking confirmation from HKEx that its proposed acquisition of a hotel in the Czech Republic was not a reverse takeover (**RTO**) for the purposes of Chapter 14 of the Listing Rules. State Energy Group's turnover for the three years prior to the RTO inquiry was primarily attributable to its exporting business. Responding to concerns about whether the exporting business would become immaterial after the acquisition, State Energy Group provided HKEx with reassurance that the proposed acquisition would not cause a fundamental change to existing businesses. Consequently, HKEx determined on November 10, 2017, that the proposed acquisition would not constitute an RTO under Rule 14.06(6). The results for the six months ending September 30, 2017, contrarily uncovered that revenue from the export business decreased 99.6% from the

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previous corresponding period, and the RTO determination was retracted after further inquiries. HKEx determined that State Energy Group was or should have been aware of the significantly lower performance of the export business and that Guidance Letter HKEX-GL78-14 evidently indicated that such a substantial drop in performance would likely affect the outcome of the RTO decision.

The former executive director and CEO of State Energy Group who was responsible for the proposed acquisition and approving the submissions relating to the RTO inquiry was censured for:

- breaching Listing Rule 3.08(f), which requires directors to fulfil fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard of Hong Kong law, including to apply a degree of skill, care and diligence reasonably expected of persons of their knowledge and experience and holding their office;
- breaching his obligation under his Form 5B undertaking to HKEx to provide complete, accurate and up-to-date information to HKEx; and
- breaching his obligation under the undertaking to use his best efforts to procure compliance with Listing Rules.

## **HKEx censured Zhongtian and its former and current directors for breach of the Listing Rules**

Zhongtian International Limited (**Zhongtian**) was censured for failing to (i) comply with the announcement, circular and shareholders' approval requirements for an advance to an entity and a major transaction and (ii) implement and maintain an effective internal control system.

A subsidiary of Zhongtian entered into an arrangement with Qingdao Ruiding Energy Co., Ltd (**Ruiding**), whereby Ruiding appointed the subsidiary as the exclusive provider of construction materials and equipment, and the subsidiary would procure materials from a supplier. The subsidiary obtained a loan of RMB600 million by pledging land as security and entered into an agreement with Ruiding and the supplier, providing RMB600 million to the supplier. Mr. Chen, a director of Zhongtian, approved the agreement, and his son, a director of both the subsidiary and Ruiding, executed it for and on behalf of the subsidiary, and then announced the arrangement over eight months later. Zhongtian did not issue a circular or obtain shareholder approval for the transaction.

HKEx ruled that Zhongtian breached (i) Listing Rule 13.13 for failing to announce the details of an advance to an entity that exceeded 8% under the assets ratio; and (ii) Listing Rules 14.34, 14.38A and 14.40 for failing to announce, issue a circular and obtain shareholders' approval for major transactions (in this case, providing financial assistance).

HKEx also criticized Zhongtian's material internal control deficiencies (specifically, lack of a clear system governing the matters required to be approved by the board, failure to monitor compliance with Listing Rules and failure to provide regular management accounts to directors). These deficiencies resulted in all relevant directors breaching their undertakings to HKEx to comply with the Listing Rules to the best of their abilities and to use their best efforts to procure Listing Rules compliance (as a result of failing to monitor the financial position of the group). In particular, HKEx determined that Mr. Chen knew or should have reasonably known that the financial exposure and risk to the group was significantly high, and he breached his director duties by failing to (i) conduct adequate due diligence of Ruiding and the supplier, (ii) assess the risk of default, (iii) inform the directors of the agreement and the related transactions and (iv) obtain professional advice on Listing Rules implications. Mr. Chen's son breached his director duties due to his (a) conflicting position as sole director and legal representative of Ruiding; (b) failure to raise the matter with other directors; and (c) approval of payment to the supplier without exercising the requisite degree of skill, care and diligence.

HKEx ruled that Mr. Chen's retention on the board would have been prejudicial to the interests of investors and directed that (i) an internal control review be conducted, (ii) an independent compliance adviser be appointed, and (iii) requisite training be completed by all current and future directors.

## **HKEx censured Sanai and criticized its former and current directors for breach of the Listing Rules**

HKEx censured Sanai Health Industry Group Company Limited (**Sanai**) for its failure to publish its preliminary financial results for 2017 within three months after the end of the financial year. Similar failures occurred in Sanai's reporting in 2015 and 2016, resulting in suspensions of trade in the company's shares on each occasion and warning letters from HKEx. Regarding the delay in publishing the 2017 results, Sanai claimed that further time was required to resolve nonrecurring and unpredictable audit issues. However, HKEx found that these audit issues were predictable if directors had monitored the company's financial position and audit progress, made earlier inquiries about financial information and liaised with auditors.

HKEx determined that Sanai exhibited the following material deficiencies in internal controls:

- maintaining an overly general manual relating to finance and accounting that failed to provide guidance for personnel in the preparation of information for the annual audit;
- failing to revise the manual after learning of its deficiencies (the last revision occurred on January 1, 2015, before the

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first failure to publish the 2015 results);

- failing to implement a system that would ensure directors and senior management received alerts about matters raised by auditors;
- failing to ensure that delays in the audit process were reported to the audit committee; and
- failing to provide directors with monthly or regular management accounts from subsidiaries.

Despite conducting a review on the risk management and internal control systems of subsidiaries for 2016 and 2017 with an external professional consultant, Sanai did not rectify the related issues. HKEx regarded Sanai's breach as serious, given that the reporting delay prejudiced interests of investors, who received limited information to enable informed decision-making, and that the resulting suspension in trading prevented the market from functioning effectively.

HKEx also criticized certain current and former executive directors, independent nonexecutive directors and members of the audit committee for failing to use their best efforts to procure compliance with the Listing Rules. HKEx further ordered that an internal control review be conducted and director training for the directors in question.

## **SFC commenced proceedings against Tianhe and its executive director for a defective prospectus**

SFC commenced proceedings in the Market Misconduct Tribunal against Tianhe Chemicals Group Limited (**Tianhe**) and its executive director under section 277 of the Securities and Futures Ordinance (**SFO**) for allegedly overstating the revenue of the company by over RMB6.7 billion in the prospectus issued in 2014. The exaggerated figure amounted to 53% of the total track-record-period revenue of RMB12.6 billion disclosed in the prospectus. SFC claimed that the prospectus contained materially false or misleading information regarding revenue and profits for the track record years of 2011 to 2013, which would have likely induced subscriptions for or purchases of the shares and/or would have increased the share price of Tianhe.

Compensation orders are being sought against Tianhe and its executive director in the Court of First Instance under section 213 of the SFO to restore public shareholders to their position prior to purchase or subscription of shares through restitution payments, share repurchasing or damages payments. SFC suspended trading of Tianhe shares on May 25, 2017, and the shares were delisted by HKEx effective from June 11, 2020.

## **Court of Appeal ruling on the disclosure of inside information**

The Court of Appeal recently clarified the interpretation of inside information disclosure requirements under Part XIVA of the SFO in the case of *Chan Lai Yin Tommy v. Securities and Futures Commission*. The case concerned a listed company that was suspended from trading between November 22, 2011, and January 5, 2012, after its shares had fallen significantly in 2011. On January 5, 2012, the company announced the disposal of its subsidiary that undertook the principal business of the company and trading was again suspended, after only one day of trading. Post-suspension, the company made announcements revealing that (i) litigation had commenced against counterparties for a project that the company was seeking to rescind; (ii) its original auditors had resigned; (iii) the company and two officers were facing litigation by lenders with respect to loan repayments; (iv) a nonexecutive director had resigned due to "strong disagreement with the board;" and (v) subsequently the company's new auditors had resigned.

SFC commenced proceedings against the company and its directors for alleged breaches of inside information disclosure requirements due to:

- the delay (of nearly one month) in announcing the resignation of its new auditors;
- the failure to disclose unresolved accounting issues relating to a qualified audit report by the new auditors; and
- the failure to disclose circumstances around prepayments of the company's subsidiary.

The case affirmed that section 307A(3) of the SFO provides that a listed company does not stop being a "listed" company simply because trading is suspended in that Part XIVA continues to apply where dealing in its shares is suspended. This rule does not, however, indicate that a listed company should be regarded to be continuously dealing at the pre-suspension price, meaning the company is still required to assess materiality on the false factual premise of trading. In determining whether information has a "material" effect on share price under section 307A(1), the individual circumstances of the company when the information is made available to the company and its directors are relevant. Section 307A(1) of the SFO defines "inside information" as information not generally known to persons likely to deal in the securities, but likely to materially affect the price if known. The assessment of materiality should therefore not be limited to evaluation of the impact on the pre-suspension price, but should involve consideration of events that could affect share price when the information

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was available, including post-suspension events.

The matter was remitted to the Market Misconduct Tribunal for determination on whether the information would likely materially affect the price, contemplating post-suspension events.