



Hong Kong Regulatory Update

Contacts

Paloma Wang

Partner / Hong Kong
852.3740.6888
paloma.wang@skadden.com

Kai Sun

Partner / Hong Kong
852.3740.6820
kai.sun@skadden.com

Anthony Pang

Counsel / Hong Kong
852.3740.4831
anthony.pang@skadden.com

Martina To

Asia Pacific Counsel / Hong Kong
852.3740.4776
martina.to@skadden.com

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One Manhattan West
New York, NY 10001
212.735.3000

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

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 Publishes Results of Latest Review of Annual Report Disclosures

HKEx has published findings and recommendations from its review of issuers' annual reports for the 2020 financial year. These reports, published each year in advance of annual reporting season, can provide helpful guidance on issues for listed companies to consider as they prepare their annual reports. The latest report highlighted the following:

- **Disclosure about use of proceeds by newly listed issuers:** Companies should ensure that their use of IPO proceeds strictly adheres to the proposed use disclosed in their prospectuses. HKEx found that some newly listed issuers invested a material part of their IPO proceeds in private entities or wealth management products associated with professional parties involved in the initial listing or made payments for consultancy arrangements to these parties shortly after listing. These investments or arrangements were not disclosed in the prospectuses, were inconsistent with the issuers' business plans and lacked clear commercial rationale. The directors in these instances may have breached their fiduciary duties, and HKEx referred these cases to the SFC for investigation.
- **Audit issues:** Prior to auditing, audit committees should discuss areas of high risk and an approach, timetable and form of reporting for the audit. Companies should develop supportable estimates for valuations of major assets, extensively document the key judgments made and consider enlisting experts for asset valuations. Companies should also engage auditors early in the process to determine appropriate timing, form and approach for the assessment of these estimates. Audit committees should evaluate and challenge the reasonableness of management's assumptions and adopted valuation methods.
- **Material lending transactions:** Companies should implement appropriate internal controls to monitor lending, and directors should properly oversee such activities if they fall outside the company's ordinary course of business. HKEx recommends additional specific disclosures for companies in the money-lending business.

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- **Material intangible assets reported on financial statements:** Financial forecasts and key assumptions used in impairment tests should be reasonable and not overly optimistic, taking into account historical cash flows, available market information and future prospects. Companies should continuously review the clarity and transparency of their disclosure of impairment tests.

HKEx also reminded issuers to include the following commonly omitted disclosures in their annual reports:

- **Continuing connected transactions:** (i) a confirmation on whether the related party transactions in the accounts constituted connected transactions under the Listing Rules and (ii) findings from the auditors and independent nonexecutive directors that the transactions were conducted according to the agreements, were fair and reasonable to shareholders and complied with the rules governing connected transactions.
- **Share schemes:** (i) the number and percentage of securities available for issue under the share schemes; (ii) the identities of the grantees who are nonemployee participants and the rationale for such grants; (iii) consideration payable for the application or acceptance of options; and (iv) the period within which the securities must be traded under an option.
- **Pension schemes:** *For defined contribution plans:* (i) details about whether forfeited contributions may be used by the employer to reduce the existing level of contributions (where there are no such reduction arrangements, a negative statement should be included) and (ii) how the contributions or expenses were calculated. *For defined benefit plans:* (i) levels of funding expressed in percentage terms and (ii) commentary on material surplus or deficiency in funding.
- **Fundraisings through issuance of equity or convertible securities and subscription rights:** (i) a breakdown of the intended use and expected timeline for unutilized proceeds; (ii) a breakdown of the actual use of proceeds during the year; and (iii) whether proceeds were used or are proposed to be used as intended, and/or reasons for material changes or delay.
- **Significant investments:** (i) a discussion of investment strategy; (ii) the names and principal business of the underlying companies; (iii) the performance of each investment during the year; (iv) investment costs; and (v) the size of each investment relative to the issuer's total assets.
- **Material "other expenses/income":** additional breakdowns of material "other expenses" or "other income" in the notes to financial statements or explanations in the MD&A section.
- **Other annual report disclosure:** (i) remuneration of the company's five highest paid individuals; (ii) details of subsidiaries, including the principal countries of operation of the subsidiaries and the legal forms of subsidiaries established in the PRC; (iii) the percentages of revenue/purchases attributable to the largest customer/supplier, the percentages of revenue/purchases attributable to the five largest customers/suppliers combined, and the interests of any of the directors, their close associates or any 5% shareholder in the five largest customers/suppliers; (iv) reserves available for distribution; and (v) details of the ultimate parent company undertaking.

HKEx Publishes New and Revised Guidance Letters

In the first quarter of 2022, HKEx published a number of revised guidance letters relevant to IPO applicants and their advisers. The more notable include:

- **Revisions to Guidance Letter 55-13 on the documentary requirements and administrative matters for new listing applications.** Under the new arrangements, the check for the listing application fee from the listing applicant no longer needs to be physically delivered to HKEx. Rather, the check for the payment of initial listing fees should be deposited to HKEx's designated bank account in advance of submitting the listing application and the scanned copy of the check and the deposit slip should be uploaded to HKEX-ESS (the exchange's electronic submission system). HKEx will also now accept payment by direct transfer.
- **Amendments to Guidance Letter 94-18. "Grandfathered Greater China Issuers" and "Non-Greater China Issuers" have been permitted under Guidance Letter 94-18 to list with variable interest entity (VIE) arrangements that do not comply with HKEx's requirements.** Under new amendments to that guidance letter, this will be subject to an overall "suitability" test, with HKEx taking into account how far the company's VIE arrangements depart from HKEx's usual requirements, the materiality of the company's VIE businesses and reasons for the VIE arrangements.
- **New Guidance Letter 114-22, which provides guidance on the qualifications and obligations of the trustee or custodian for a special purpose acquisition company (SPAC) referred to in Listing Rule 18B.17.** In addition to the requirements to have an independent trustee or custodian based in Hong Kong, Guidance Letter 114-22 sets out a list of obligations applicable to the trustee or custodian regarding the operation of the SPAC escrow account, including but not limited to detailed requirements for handling and separating the property of a SPAC.

Takeovers Bulletin

The SFC issued its regular bulletin on the Codes on Takeovers, Mergers and Share Buybacks (**Takeovers Code**), which included the following highlights:

Schemes of arrangement and Rule 2.10 of the Takeovers Code

Where any person seeks to use a scheme of arrangement or capital reorganization to acquire or privatize a public company, Rule 2.10 requires: (i) approval of at least 75% of the votes attached to disinterested shares and (ii) that the number of votes cast against the resolution do not exceed 10% of votes

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attached to the disinterested shares. “Disinterested shares” means shares other than those that are owned by the offeror or persons acting in concert with the offeror. This ensures that the approval of a privatization is decided by truly “independent” shareholders and that the offeror and parties acting in concert with it should not be in a position to determine or have substantial influence over the outcome of the scheme of arrangement. In a recent Hong Kong court decision, *Re Chong Hing Bank Limited* (HMCP 968/2021, [2021] HKCFI 3091), the court reiterated that the offeror and his or her concert parties cannot vote at all.

Application of the Codes to a Grandfathered Greater China Issuer

Effective from January 1, 2022, HKEx amended the Listing Rules to streamline the listing regime for overseas issuers and extended the definition of “Grandfathered Greater China Issuer” to include an issuer with corporate weighted voting rights (WVR) and with a primary listing on a qualifying exchange between December 15, 2017, and October 30, 2020. The SFC reiterated that the Takeovers Code will not normally apply to a Grandfathered Greater China Issuer with a secondary listing until the issuer is treated by HKEx as having a dual-primary listing in Hong Kong or a primary listing in Hong Kong, which may arise as a result of trading migration, delisting from the overseas exchange or voluntary conversion on the part of the issuer.

Enforcement Matters

HKEx Criticizes Fantasia, Colour Life For Breaching Post-Spin-Off Noncompete and Delineation Agreements

In spin-off cases, the companies involved must establish adequate and effective internal controls to ensure the businesses retained by the parent and those to be spun off remain clearly delineated.

Fantasia Holdings Group Co., Limited (**Fantasia**) spun off Colour Life Services Group Co., Limited (**Colour Life**) and remained its controlling shareholder. The two companies engage in property management business and entered into a deed of noncompetition and a business delineation scheme to eliminate potential competition and provide a clear business delineation between the two companies. In particular, Fantasia undertook not to engage in any business involving property management focusing on “residential communities.” In addition, the companies promised to make annual declarations of their compliance with the deed and scheme.

HKEx found that the companies were in breach of the deed and scheme because (i) Fantasia participated in projects categorized as “pure residential communities/residential communities and ancillary facilities” but did not refer these projects to Colour Life for its evaluation and (ii) Colour Life managed “pure commercial properties” and did not dispose of such management contracts. This was a result of the companies’

failure to put in place adequate and effective internal controls to procure compliance with the deed and the scheme, which led to inaccurate disclosures in their annual reports where the companies declared that they were compliant with the scheme.

HKEx criticized Fantasia and Colour Life for failing to maintain adequate internal controls that resulted in their breaches and inaccurate disclosures. Directors of both companies, two of whom were also members of a management team responsible for ensuring the companies’ compliance with the deed and the scheme, were also criticized for breaching their directors’ duties in respect of the internal control deficiencies and were ordered to attend relevant legal and regulatory training.

HKEx Disciplinary Action Against Beijing Media Targets Internal Control Deficiencies

A breach of the Listing Rules by a listed company will often reveal underlying internal control deficiencies. A failure to maintain adequate and effective internal controls, including at the subsidiary level, and promptly identify and address any deficiencies is itself a breach of directors’ duties under the Listing Rules.

Beijing Media Corporation Limited (**Beijing Media**), through its subsidiaries, provided 13 loans to its controlling shareholder and seven loans to its associate, amounting to over RMB550 million in aggregate. Beijing Media did not comply with the announcement and shareholders’ approval requirements related to these loans, and some loans had no written agreements. The failure to comply with the relevant requirements also demonstrated that the directors had failed to ensure Beijing Media maintained adequate and effective internal controls.

Internal control deficiencies were found to include: (i) inadequate reporting procedures at the subsidiary level; (ii) personnel with insufficient knowledge of regulatory compliance, including staff at subsidiaries; (iii) no systems to monitor subsidiaries; (iv) no written procedures for identifying, reporting and executing notifiable transactions; (v) the failure of subsidiary-level staff to report connected transactions to the board; and (vi) the practice that board members and senior executives of subsidiaries and shareholders of connected parties were not required to declare business relationships and potential conflicts to the company.

HKEx censured Beijing Media and the directors who were aware of and involved in these loans and criticized the other directors. HKEx also issued statements designating some directors as prejudicial to investors’ interests.

HKEx Censures Zhejiang Prospect Over Connected Payments

Directors of listed companies in Hong Kong should pay close attention to unusual patterns of transactions, particularly those involving a substantial outflow of money and/or with questionable commercial rationale, and consider Listing Rules implications.

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Between 2017 and early 2018, Zhejiang Prospect Co Limited (**Zhejiang Prospect**) entered into 28 transactions involving an outflow of RMB365.4 million, purportedly for purchasing steel and/or bank acceptance bills by way of prepayments or deposits. Some of the counterparties were connected or related to the company. All the transactions were canceled within a month, and the prepayments/deposits were refunded to Zhejiang Prospect. This pattern of transactions was repeated monthly throughout 2017 and through February 2018. After Zhejiang Prospect was unable to announce its 2017 results, forensic accountants were engaged and concluded that the transactions lacked commercial rationale and that the overall effect of the transactions was analogous to the company providing revolving loans to the counterparties. Zhejiang Prospect failed to comply with the Listing Rules requirements for connected transactions in relation to these transactions.

HKEx ruled that the directors failed to discharge their duties regarding conflicts of interest and the effectiveness of the company's internal controls. This followed HKEx's publicly censuring Zhejiang Prospect and eight of the directors in 2012 for compliance failures. The supervisors involved in the current case also failed to cooperate with HKEx's investigations.

HKEx censured Zhejiang Prospect and the directors and supervisors involved and issued a statement that the directors' retention of office would be prejudicial to the interests of investors.

HKEx Censures Enviro for Failing To Announce Prepayments

Listed companies need to carefully consider and scrutinize substantial prepayments to determine whether they are subject to any disclosure requirements under the Listing Rules. Directors should also note that they may be sanctioned for a disclosure violation even if they were not personally involved in the transactions related to prepayments and that directors must actively ensure the board's awareness of the Listing Rules implications of prepayments.

Enviro Energy International Holdings Limited (**Enviro**) made four prepayments to suppliers, each amounting to over 8% of the company's assets ratio, which constituted an advance to an entity under the Listing Rules. The prepayments lacked commercial substance or business rationale and were all refunded for various reasons, exposing Enviro and its shareholders to risk of significant losses. The payments were not announced in a timely manner and subsequent disclosures did not include all the relevant details of the advances to entities required under Listing Rule 13.15, including details concerning the balances, the nature of events or transactions giving rise to the amounts, the identity of the debtor group, the interest rate, repayment terms and collateral.

HKEx censured Enviro for failing to make timely announcements. Two executive directors and co-CEOs were censured

for failing to ensure the board's awareness of Listing Rules implications and were directed to attend 18 hours of training. Although one executive director and co-CEO had no personal involvement entering into the transactions, HKEx determined he should not have relied on the other director's verbal assurance that compliance requirements had been met.

HKEx Takes Disciplinary Action Against China Properties Over Repeated Listing Rules Breaches

Listed companies must be diligent about announcing their notifiable transactions, including discloseable transactions, as soon as possible in accordance with the Listing Rules. Directors of listed companies must respond appropriately and promptly when breaches or deficiencies have been discovered. A failure to do so will constitute a breach of directors' duties and can call into question the listed company's culture and attitude toward Listing Rules compliance. A company's repeated breach after HKEX has issued a warning or guidance is more likely to result in disciplinary action and public sanctions.

In 2019, China Properties Investment Holdings Limited (**China Properties**) entered into two share disposal transactions, both of which constituted discloseable transactions, but the company did not make any announcements (despite allowing similar breaches in 2018, which had prompted a warning from HKEx). After the incidents in 2018, China Properties had committed to measures including training and an internal controls review. Nevertheless, the company failed to make significant compliance improvements.

HKEx criticized China Properties and two of its executive directors for failing to meet announcement obligations in respect of both share disposals. HKEx further criticized those directors and three nonexecutive directors for failing to maintain an adequate and effective internal controls system to procure the company's Listing Rules compliance with respect to notifiable transactions. In addition, HKEx ordered the directors to complete training on legal and regulatory issues and a review of the company's internal controls.

HKEx Criticizes Samson and Its Executive Director for Failure To Comply With Major Transaction Requirements

As highlighted in some of the enforcement actions above, repeated breaches of the Listing Rules indicate a poor compliance environment within a listed company and bring an increased likelihood of disciplinary action and public sanction against a listed company and its directors. Receipt of a regulatory letter from HKEx should result in a proactive and meaningful response by a company's board, including any necessary remedial action. Listed companies must observe that shareholders are entitled to receive information about and, if applicable, to vote on material transactions carried out by listed companies.

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In 2018, Samson Holding Limited (**Samson**) failed to comply with the announcement, circular and shareholders' approval requirements under the Listing Rules when entering into a US\$150 million investment that constituted a major transaction, which omissions resulted a guidance letter from HKEx. Ms. Yi-Mei Liu, an executive director, failed to circulate HKEx's guidance letter to the board for consideration. In 2019, Samson disposed of the investment, which constituted another major transaction, and Samson again failed to comply with the same Listing Rules requirements.

Ms. Liu was responsible for both the investment and the disposal. HKEx criticized Ms. Liu for her failure to (i) bring the disposal to the board for its consideration, (ii) seek professional advice on compliance with the Listing Rules, (iii) circulate HKEx's guidance letter to the board and (iv) ensure the company had an adequate internal controls system. HKEx criticized Samson and directed the company to conduct a review of its internal controls.

HKEx Censures Yihua Over Listed Debt Disclosures

While issuers of listed debt to professional investors under Chapter 37 of the Listing Rules are subject to less onerous compliance obligations than companies with shares listed on HKEx are, HKEx has reminded debt issuers that they must announce sufficient information as required under the Listing Rules to avoid creating a false market. If it is not possible to make any required disclosures promptly upon issuance, the debt issuer must apply for a trading halt or suspension.

In 2017, Yihua Overseas Investment Limited (**Yihua**) issued debt to professional investors under Chapter 37 of the Listing Rules. Pursuant to the offering memorandum, interest payments were due on April 23 and October 23 of each year until the debt's maturity. If Yihua failed to pay interest on the due date or within 30 days thereafter, an event of default would occur. Yihua failed to pay interest due between April 23, 2020, to May 23, 2020, and defaulted on the debt. HKEx commenced investigations and directed a trading suspension of the debt from August 4, 2020, which lasted until the debt was delisted upon maturity on October 23, 2020. Yihua, through its authorized representative, did not respond to HKEx's investigation for several months.

In the days preceding the interest due date, Yihua knew of its inability to meet payment obligations but did not announce that information until November 20, 2020, which was after: (i) the debt had been delisted upon maturity and (ii) the commencement of HKEx's investigation. In addition, Yihua did not apply for a halt to trading as required by the Listing Rules when discloseable information cannot be announced promptly.

HKEx censured Yihua for its delayed announcement and failure to apply for a trading halt and further censured Yihua and its authorized representative for failing to respond to HKEx's requests for information in a timely manner.

HKEx Censures Former Directors of National Investments for Inappropriate Acquisitions

National Investments Fund Limited (**National Investments**) is an investment company listed under Chapter 21 of the Listing Rules. Its primary investment objective has been to achieve short- to medium-term capital appreciation by investing in listed and unlisted companies, mainly in Hong Kong and the PRC. The company's board was responsible for approving investment decisions and supervising the investment manager. From 2011 to 2015, at least HK\$61 million of its money was used in an unchecked spending spree to acquire various luxury assets, including a yacht (HK\$24.5 million), a diamond (HK\$20 million), furniture (over HK\$3.8 million), seven cars (over HK\$8.48 million), a club membership (HK\$1.8 million), a diamond ring (HK\$230,200) and 57 paintings (HK\$2.2 million). These acquisitions were not in accordance with National Investments' investment objectives and were made during a period in which its financial position was significantly deteriorating and the company was recording losses and incurring net operating and investing cash outflows.

Mr. Danny Wong, the company's executive director, solely approved at least some of the acquisitions. He failed to address his assessment of the suitability, necessity and benefits of the acquired assets for National Investments. The other directors approved monthly announcements of the value of National Investments' net assets per share. Notwithstanding the company's deteriorating financial position and the significant expenditure of monies on the above assets, the other directors failed to take an active interest in National Investments' affairs and scrutinize any unfavorable information that came to their attention regarding the acquisitions. HKEx censured four directors, ordered two directors to attend training and issued a statement that retention of two of the directors on the board would have been prejudicial to the interest of the investors.

Court Convicts Wai Chun and Its Director of Offenses Related to Disclosure of Interests

The Eastern Magistrates' Court convicted Wai Chun Holdings Group Limited (**Wai Chun**) and its director, Mr. Ching Kui Lam, for disclosure of interests-related offenses in prosecutions brought by the SFC. The case highlights for directors and their companies the consequences, including criminal convictions, of neglecting their disclosure obligations under Part XV of the Securities and Futures Ordinance.

Mr. Lam, through Wai Chun, acquired certain shares in Chinese Strategic Holdings Limited (**Chinese Strategic**) which gave rise to an obligation to disclose his interests within three business days. Mr. Lam was aware of this obligation and delegated the task, but ultimately failed to disclose his interests until almost three years later. Mr. Lam and Wai Chun were fined a total of HK\$20,000 and ordered to pay the SFC's investigation costs.

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SFC Imposes Cold-Shoulder Order Under ‘Chain Principle’

The “chain principle” set out in Note 8 to Rule 26.1 of the Takeovers Code provides that a person or its concert parties acquiring statutory control of a company may as a result acquire control of that company’s subsidiaries, including any that are listed companies subject to the Takeovers Code. This may trigger an obligation to make a mandatory general offer for such listed company subsidiary if, in the view of the SFC, (i) the holding in the subsidiary is “significant” in relation to the first company or (ii) one of the main purposes of acquiring control of the first company was to secure control of the subsidiary.

Mr. Chu Hing Tsung acquired shares in Rong De Investments Limited (**Rong De**) and, together with his brother, obtained statutory control of Rong De by holding more than 50% of the voting rights in Rong De in 2012, which in turn held a 59.87% interest in Zhuguang Holdings Group Limited (**Zhuguang**), a listed company. Given that Rong De’s holding of a 59.87% interest in Zhuguang was significant to Rong De, this triggered a mandatory general offer for the shares under the chain principle. However, no general offer was made at that time.

The SFC censured and imposed a 12-month cold-shoulder order against Mr. Chu, which prohibits a person from dealing, whether directly or indirectly, in Hong Kong’s financial markets for the duration of the order. The SFC noted that the breach took place nine years ago and was inadvertent, given that Mr. Chu had sought legal advice for the transaction but was not advised of the Takeovers Code implications of his acquisition. The SFC emphasized that parties who wish to take advantage of the securities markets in Hong Kong should conduct themselves in accordance with the Takeovers Code. This includes seeking professional advice as needed. Parties should consult the SFC at the earliest opportunity if any doubt arises about the application of the Takeovers Code.

Court Orders Insider Dealers To Compensate Investors

A recent case serves as a reminder that insider dealers may be required to pay compensation to investors who suffered losses as a result of insider wrongdoing.

An SFC investigation found that from late February 2016 to April 12, 2016, Ms. Fong Yik obtained information about a proposed takeover of TeleEye Holdings Limited (**TeleEye**) when she acted as the representative of the controlling share-

holder of TeleEye to negotiate with the offeror. Before the takeover was announced on April 14, 2016, Ms. Yik bought TeleEye shares through three brokerage accounts and later sold the shares for a total profit of HK\$12.9 million.

The Court of First Instance found that Ms. Yik and her two associates engaged in insider dealing and ordered that the profits of HK\$12.9 million be paid to 63 investors who transacted with the three of them in order to restore those investors to their pre-transaction positions to the extent possible. The court determined that had these investors known that they were dealing with an insider, they would not have sold their shares at that price. This case sends a clear message that wrongdoers, not innocent investors or the market, will be expected to bear the consequences of the wrongdoing, including the costs of restoration or remediation.

Former Directors of DBA Disqualified for Publishing Results Announcement Without Auditor Sign-off

The SFC has obtained disqualification orders in the Court of First Instance against the former executive director and former independent nonexecutive director of DBA Telecommunication (Asia) Holdings Limited’s (**DBA**). The two were disqualified from serving as a director or being involved in the management of any listed or unlisted corporation in Hong Kong for a period of six years and 18 months, respectively, and were ordered to pay SFC’s investigation costs.

On March 28, 2013, DBA had published its results announcement for the year ended December 31, 2012. The SFC’s investigation revealed that DBA’s financial statements had not been approved by the auditors, as required under the Listing Rules, and were therefore false or misleading in a material detail. The former executive director (who was also the chief financial officer and company secretary) was involved in preparing and publishing the announcement and knew that audit work was outstanding and that the financial statements had not been approved by the auditors. Both directors allowed DBA to continue to perpetrate the misrepresentation for almost three months, and failed to cause DBA to timely correct or clarify the matter, despite DBA having made three more public announcements during that period.

In April 2019, the SFC secured the conviction of the former executive director for his role in making a false and misleading statement in relation to the results announcement for DBA for the year ended December 31, 2012. Earlier in June 2018, DBA had pleaded guilty to the same charge.