Hong Kong Corporate Finance Regulation

2014 and 2015 – IPO Sponsor due diligence update

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Hong Kong Corporate Finance Regulation – 2014 Highlights and the Year Ahead

A year of firsts in many ways, 2014 saw Hong Kong markets continue to reap the benefits of their first-mover advantage created by Mainland China experimenting with policy changes in Hong Kong first, before rolling them out in other jurisdictions, and the development of more RMB-denominated investment products. In terms of regulation, 2014 saw continued efforts to ensure Hong Kong's regulatory framework keeps pace with market developments and changes in international regulation.

2014 TOP 10 REGULATORY HIGHLIGHTS

1. **China-Hong Kong Mutual Market Access**
   - **Shanghai-Hong Kong Stock Connect commenced November 2014**
   - **New Developments for Covered Short-selling of A Shares and Dealing with China's Pre-trade checking requirement**
   - **Shenzhen-Hong Kong Stock Connect expected in 2015**
   - **China-Hong Kong Mutual Recognition of Funds (MRF) Scheme in final stages**
2. **First RMB-denominated Commodities Contracts Commenced Trading on 1 December 2014**
3. **HKEx's Weighted Voting Rights Concept Paper**
4. **Improved Regulatory Regime for Funds**
   - **New Open-ended Fund Company Structure proposed for Investment Funds**
   - **Stamp Duty Waiver for all Hong Kong-listed ETFs which took effect on 13 February 2015**
   - **It's been proposed that the existing profits tax exemption for offshore funds should be extended to offshore private equity funds**
5. **Full Implementation of New Regulatory Regime for Hong Kong IPOs**
6. **SFC Drops Proposed Amendments to Sponsors' Statutory Liability for Prospectus Misstatements**
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8. **New Mandatory Reporting Obligations for OTC Derivatives expected in Q1 2015**
9. **Significant Disciplinary Decisions**
   - **Court Orders Ernst & Young (EY) to Produce Chinese Accounting Records to the SFC**
   - **IPO Sponsor Fined HK$12 million and has Licence Suspended**

- **SFC Disciplines Moody's for Red Flags Report on Chinese Companies**
- **SFC Starts Market Misconduct Proceedings over Alleged False Research Report**
- **SFC Disciplines Investment Banks for Regulatory Breaches**

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- **SFC Consults on Regulation of Alternative Liquidity Pools**
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- **Improvements to Hong Kong's Corporate Insolvency Law and Proposed New Statutory Corporate Rescue Procedure**
- **Introduction of 3 Days' Statutory Paternity Leave from 27 February 2015**

2015 – THE YEAR AHEAD – THE TOP 11

1. **New Measures for Shanghai-Hong Kong Stock Connect:**

   - **covered short-selling of eligible A Shares is allowed (with effect from 2 March 2015) and**
   - **institutional investors were allowed to sell A Shares without transfer to brokers' accounts one day prior to sale with effect from 30 March 2015.**

2. **Implementation of Shenzhen-Hong Kong Stock Connect.**

3. **New China-Hong Kong Mutual Recognition of Funds (MRF) scheme to be introduced to allow Hong Kong domiciled funds authorised by the SFC to be sold in China and CSRC-authorised funds to be sold in Hong Kong.**

4. **Publication of HKEx's conclusions on Weighted Voting Rights and decision on whether companies with dual class share structures and other WVRs should be allowed to list in Hong Kong.**

5. **The FSTB should publish its consultation conclusions on allowing open-ended investment funds in corporate form under amendments to the Securities and Futures Ordinance.**

6. **The waiver of stamp duty on all ETFs took effect on 13 February 2015 following the passing of the Stamp Duty (Amendment) Bill 2014 by Legco on 3 February.**

7. **It is proposed that the profits tax exemption for offshore funds should be extended to private equity funds.**

8. **New mandatory reporting obligations for OTC derivatives are expected to come into force in 2015 on implementation of the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules.**

9. **New fathers' statutory entitlement to 3 days' paid paternity leave took effect on 27 February 2015.**

10. **The Securities and Futures Appeal Tribunal will begin its review of the SFC's disciplinary decision against Moody's Investors Service in September 2015 in relation to publication of its Red Flags Report on 61 Chinese companies.**

11. **EY's appeal against the court order to produce documents held by its Mainland affiliate should be heard in 2015.**

2014: THE TOP 10 REGULATORY HIGHLIGHTS

1. China-Hong Kong Mutual Market Access

- **Shanghai-Hong Kong Stock Connect commenced November 2014**

Probably the key event of 2014, the much anticipated Shanghai-Hong Kong Stock Connect programme (**Stock Connect**) finally launched on 17 November. Allowing Mainland Chinese investors to trade Hong Kong listed stocks, and Hong Kong and international investors to trade Shanghai-listed stocks through Hong Kong, the programme represents a major step in the opening of Mainland China's capital markets and internationalisation of the RMB. It also cements Hong Kong's position as the gateway to China with Hong Kong brokers providing the door through which investors worldwide can trade Shanghai-listed stocks.

Certain restrictions currently apply:

- The stocks eligible for trading under the programme are limited to the constituent stocks of the Shanghai Stock Exchange 180 and 380 Indexes and the Hang Seng Composite LargeCap and MidCap Indexes. A and H shares not included in the specified indexes, but which have equivalent H or A shares listed on the other market, are also eligible for trading.

- Aggregate and daily quotas apply on a net-buy basis.

- Only Mainland "professional investors" (i.e. institutional investors and individuals with RMB 500,000 in cash and securities) can participate in the scheme.

The programme is however intended to be scalable in size, scope and markets and the above restrictions are expected to be relaxed in the future. There have been rumours recently that the requirement for Mainland investors to hold RMB500,000 in cash and securities may be removed.

- **New Developments for Covered Short-selling of A Shares and Dealing with China's Pre-trade checking requirement**

  With effect from 2 March 2015, Hong Kong and international investors are allowed to conduct covered short-selling of eligible A shares under Stock Connect's northbound trading link. The list of A shares eligible for short selling is available on the HK Exchange's website at http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Eligiblestock.htm. This is the first reform to the stock connect scheme since it was implemented in November. Short selling of eligible stocks is subject to limits: the number of shares which can be sold short as a percentage of the total number of those shares held by all Hong Kong investors is capped at 1% per day, and no more than 5% cumulatively over 10 consecutive trading days. The tick rule also applies so that the input price of a short selling order cannot be less than the most recent execution price of the Shanghai-listed security, or its previous closing price if no trades have been executed on a given day. Chinese investors have always been able to short sell Hong Kong-listed stocks under the scheme.

  HKEx also implemented a new system from 30 March 2015 which means that institutional investors who hold A shares through custodians no longer need to transfer their A shares to brokers the day before they want to sell in order to comply with China's pre-trade checking requirement. Many overseas fund managers were previously prevented from trading A shares through the Northbound link as their rules prevent compliance with this requirement which was also contrary to standard international practice which allows settlement within two days after sale, a practice commonly followed in Hong Kong and other leading markets. Under the new system, institutional investors holding shares through custodians can open Special Segregated Accounts with CCASS and are allocated a unique investor identification number. Pre-trade checking is then conducted on the basis of the A shares in Special Segregated Accounts before market open. When placing a sell order, the investor only needs to give its investor ID number to its selling Exchange Participant and its custodian can transfer the shares from the SPCA for settlement after execution of the trade. However, settlement must still take place on the same day the trade is executed.

  A major boost was given to trading of Hong Kong listed stocks by Mainland Chinese investors in March when the Chinese regulators gave the go-ahead for Chinese mutual funds to trade Hong Kong-listed shares through Stock Connect's southbound link with effect from 30 March 2015. Previously the southbound link had only been open to wealthy retail investors. Demand from Chinese investors through the southbound link was weak in the early months of Stock Connect's operation. The move led to April trading of Hong Kong listed shares by Mainland investors through the Southbound link reaching HK$235 billion – up 559% on the previous month. April also saw the Southbound daily quota used up for the first time since the launch of the scheme.

  The surge in Southbound trading also resulted in the market capitalisation of the Hong Kong exchange exceeding HK$31,000 billion (about US$4 trillion) for the first time on 27 April 2015.

- **Shenzhen-Hong Kong Stock Connect expected in 2015**

According to news reports, China's State Council has signed off on a stock-trading link between Shenzhen and Hong Kong sand is expected to be launched in the second half of 2015.[1]

The Shenzhen-Hong Kong link is expected to mimic the existing Shanghai link and to include shares listed on Shenzhen's ChiNext Board (its Nasdaq-style board for high-growth, high-tech companies). It is hoped that the Shenzhen link will offer more access to Chinese technology, consumer and health-care stocks, which make up almost half of Shenzhen's benchmark index, while the Shanghai stock exchange is dominated by state-backed banks and large industrial companies.

- **China-Hong Kong Mutual Recognition of Funds (MRF) Scheme in final stages**

Approvals for the China-Hong Kong MRF scheme, the "through train" for Chinese and Hong Kong funds and the first such scheme between the Mainland and a foreign market, were in the final stages in October 2014 according to a speech given by Alexa Lam, SFC Deputy Chief Executive Officer. The scheme will give Hong Kong funds access for the first time to the Mainland's 1.3 billion potential investors and is expected to promote growth in Hong Kong's fund management industry, since participation will require funds to have a Hong Kong domicile and be managed by an SFC-licensed asset management company. The scheme is expected to be launched in the second half of 2015.

When implemented, the scheme will allow:

- Hong Kong domiciled funds which are authorised by Hong Kong's Securities and Futures Commission (**SFC**) for retail offering to be sold in Mainland China; and
- Chinese funds authorised by the China Securities Regulatory Commission to be sold in Hong Kong.

It will be a condition of recognition under the scheme that fund managers must be licensed by their home regulator – the SFC for Hong Kong funds and the CSRC for Chinese funds. Funds recognized under the scheme will then benefit from a streamlined vetting procedure by the regulator of the market in which they will be offered – the CSRC for Hong Kong funds and the SFC for Chinese funds.

An article in the South China Morning Post on 26 February indicated that the SFC has identified about 600 Hong Kong and Mainland funds for participation in the mutual recognition scheme for funds.[2] It quoted deputy Chief Executive Alexa Lam as saying that about 100 of the 300 Hong Kong domiciled funds are qualified while there are about 500 Mainland-domiciled funds which would be eligible to trade in Hong Kong. The reason two-thirds of Hong Kong domiciled funds

[1] Bloomberg. *"China State Council Said to Approve Hong Kong-Shenzhen Link".* 8 May 2015 at http://www.bloomberg.com/news/articles/2015-05-08/china-s-state-council-said-to-approve-hong-kong-shenzhen-link .

[2] SCMP. *"SFC identifies 600 funds for cross-border scheme".* 26 February 2015 at http://www.scmp.com/business/banking-finance/article/1724492/sfc-identifies-600-funds-cross-border-scheme.

would not qualify is that the scheme will be restricted to simple bond and equity issues and will not allow the selling of hedge funds or derivatives funds. The scheme is expected to be launched in 2015.

Ultimately, the Hong Kong exchange hopes that mutual market access will be expanded to include a range of other investments including fixed income, commodities and ETFs.

2. First RMB-denominated Commodities Contracts commenced Trading on 1 December

Trading in RMB-denominated metal contracts in zinc, copper and aluminium started on the Hong Kong Futures Exchange on 1 December 2014, marking the Hong Kong Stock Exchange's (**HKEx's**) first step in increasing commodities trading on the exchange, following its acquisition of the London Metal Exchange in 2012.

The so-called London Metal Mini Futures are traded on the Hong Kong Futures Exchange and are cash-settled futures contracts. They are settled at the official settlement prices for the relevant metal published by the LME. Their aim is to match Chinese physical players' exposure to commodities contracts priced in RMB and to establish RMB pricing of metals in Asian trading hours.

3. HKEx's Weighted Voting Rights Concept Paper

HKEx retained its second place ranking (after the NYSE) among the world's top IPO fund-raising exchanges in 2014, raising HK$227.8 billion (US$29.3 billion) in 115 IPO[3] an increase of 33% on the HK$171.3 billion raised in 2013. The top IPO exchange was NYSE, for the third year in a row, with IPO funds raised of US$74.1 billion, up 62% on 2013, boosted by the world's largest IPO ever, of Chinese internet company, Alibaba Group, which raised US$25 billion in September 2014. Alibaba's first choice listing venue was however HKEx, but its management structure allowing the company's founders and senior management to nominate 50% of the board without holding an equivalent number of the company's shares, would have contravened HKEx's "one-share one-vote" (**OSOV**) principle.

In the wake of Alibaba choosing to list in the US rather than change its governance structure, HKEx published its Weighted Voting Rights Concept Paper1 in August 2014, seeking views on whether Hong Kong's Listing Rules should be amended to allow companies with dual class shares and other weighted voting rights (WVR) structures, like Alibaba, to list.

Those in favour are keen for Hong Kong to recover its competitive position as the international fund raising market of choice for Mainland Chinese companies, given the recent popularity of the NYSE and Nasdaq for listing Chinese tech stocks. Companies with WVR structures accounted for 86% by market capitalisation of the Mainland Chinese companies primary listed in the US at 31 October 2014. Technology was also the leading sector for IPOs worldwide in terms of capital raised in 2014, with the sector raising US$50.2 billion worldwide, driven by Alibaba's record

[3] Excluding transfers of listing to the Main Board from GEM.

breaking IPO.2 WVR structures are particularly common among tech companies and so HKEx's OSOV principle effectively prevents the Hong Kong listing of many Chinese tech companies which, like Alibaba, Baidu, JD.com Inc. and Weibo Corp., list in the US where WVR structures are not an obstacle to listing.

Arguments against listing companies with WVR structures focus on investor protection concerns, although these are allayed to a degree by HKEx's already comprehensive regulation of connected and related party transactions and the provisions of the Takeovers Code requiring equal treatment of shareholders in takeover situations.

Some commentators have argued that it is not appropriate to allow companies with WVR structures to list in Hong Kong, because Hong Kong does not have a class action regime or allow legal contingency fees. The US, whose stock exchanges permit the listing of such companies, has a class action regime and allows law firms to charge on a contingency basis which it is argued makes it easier for minority shareholders to take legal action. The class action regime argument is however a red herring in terms of the argument against allowing WVRs to list.

Investor Protection – Class Action

Stanford Law School and Cornerstone Research produce annual reports on US securities class actions which consistently show that these are used almost exclusively to bring claims for securities fraud, normally in relation to misleading financial disclosure. For example, their report "Securities Class Action Filings 2013 Year in Review"[4] indicates that:

- 84% of the claims made in 2013's 166 securities class action filings were claims under Rule 10b-5
- 97% of all claims involved allegations of misrepresentation in financial documents
- 54% of all claims involved allegations of false forward-looking statements
- 152 securities class action claims were filed against listed companies in 2013 (55 against NYSE listed companies and 97 against Nasdaq listed companies)
- in 2013, approximately one in 30 companies was the subject of a class action
- filings against foreign companies were most commonly against Chinese companies

The principal claim in a US securities class action suit is usually one of securities fraud under section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the SEC adopted under the Exchange Act. They are typically used in the US where investors suffer loss due to company fraud or misleading disclosure which triggers a drop in the company's share price. The US class action regime assists minority shareholders in these cases as they allow one shareholder to

[4] https://www.cornerstone.com/CMSPages/GetFile.aspx?guid=d88bd527-25b5-4c54-8d40-2b13da0d0779

bring a representative action against the company on behalf of the entire class of shareholders who each have the same direct claim against the company.

Class action suits are not however used to obtain a remedy for shareholders for the types of governance issues which are likely to arise in the case of companies with WVR structures. The types of wrongdoing most likely with this type of company are that the company's controllers breach their fiduciary duties to act in the best interests of the company and its shareholders as a whole; that the directors waste corporate assets or breach duties owed to shareholders as a result of mismanagement or self-dealing. In these cases the appropriate type of action is not a class action suit by shareholders to recover damages from the company but a derivative action which a shareholder brings on behalf of the company against the company's directors. In these actions the minority shareholders have no direct action against the company. Instead their action is derivative to the company's action against its directors.

In a derivative action, the court will typically order improvements in the company's corporate governance. If damages are awarded, they are awarded to the company, not the shareholders. The minority shareholders benefit indirectly from improvements to the company's governance and any consequential increase in the company's share price.

Hong Kong shareholders are already entitled to bring a derivative action on behalf of a company against a wrongdoer (e.g. a company director) under sections 731 to 738 of the Companies Ordinance (Cap. 622). There has been little shareholder litigation against HK listed companies. This is partly a cultural phenomenon, but also reflects the difficulty and cost of bringing a derivative action. Hong Kong does not allow lawyers to charge on a contingency basis, hence the best course of action for a minority shareholder is often to simply sell out.

In recent years the SFC has taken up the mantle of seeking legal remedies for public shareholders of Hong Kong listed companies using its powers under sections 212 to 214 of the Securities and Futures Ordinance. Hence:

- in June 2012, the Court of First Instance granted an order sought by the SFC under section 213 SFO for Hontex International Holdings Company Limited (**Hontex**) to make a repurchase offer to around 7,700 public shareholders who had subscribed for Hontex shares in its IPO or purchased Hontex shares in the secondary market. The order was made based on Hontex's admission that it had contravened Section 298 SFO (offence of disclosure of false or misleading information inducing transactions).

- The SFC has also started proceedings against Qunxing Paper Holdings Company Limited (Qunxing) alleging that materially false or misleading information was included in Qunxing's IPO prospectus for its 2007 listing and the announcements of its annual results for the years 2007 to 2011. The SFC is seeking orders for Qunxing's public shareholders and warrant holders to be restored to their positions before acquiring the shares and warrants.

- The SFC also commenced proceedings in both the Court of First Instance and the Market Misconduct Tribunal against CITIC Limited (CITIC) and five of its former executive directors in September 2014 based on market misconduct involving disclosure of false or misleading information on CITIC's financial position following huge losses incurred as a result of its investment in leveraged foreign exchange contracts in 2008.

The SFC is seeking restoration or compensation orders to restore or compensate up to 4,500 investors who purchased CITIC shares between the date on which the false or misleading information was allegedly announced and the date the true financial position was disclosed. The allegations relate to a 12 September 2008 circular issued by the company stating that the directors were not aware of any adverse material change in the group's financial or trading position since the end of 2007. Just over a month later, on 20 October 2008, the company issued a profit warning which disclosed huge realised and mark to market losses arising from leveraged foreign exchange contracts of which it became aware on 7 September 2007, just prior to the circular containing the statement of no material adverse change. CITIC incurred a loss of US$2 billion from the forex derivatives, also known as "accumulators".

Class Action Regime a Red-herring?

It seems that a US-style class action regime in HK would not assist minority shareholders in bringing derivative actions against WVR company controllers who breach fiduciary duties to the company since US class actions are only available where shareholders have **direct claims** against the wrongdoers. The appropriate action for shareholders to bring in the case of directors' breach of fiduciary obligations is a derivative action, which is available in Hong Kong. Class actions do not assist where a shareholder brings a derivative action.

The availability of class action suits in the US does not appear to be relevant to the question of whether or not it is appropriate to allow the listing of companies with WVR structures as would seem to be suggested by the Concept Paper.

The consultation closed at the end of November 2014. The Concept Paper said that if responses favoured allowing companies with WVR to list, the HKEx would publish consultation conclusions and a further consultation paper on the proposals. Comments made at an SFC media event last week by SFC CEO Ashley Alder and Chairman Carlson Wong suggested that the SFC is willing to allow the listing of companies with WVR structures provided that this is restricted to creative high-tech companies whose corporate values rely on their founders and restrictions such as sunset clauses are imposed for the protection of investors.

4. Improved Regulatory Regime for Funds

New Open-ended Fund Company Structure proposed for Investment Funds

As a step towards enhancing Hong Kong's legal and regulatory frameworks to strengthen its position as a major international asset management centre, the Government held a three-month public consultation on introducing a new open-ended fund company (**OFC**) structure for investment funds.

Open-ended investment funds require the flexibility to vary their capital to satisfy investor applications and redemptions. Currently, an open-ended investment fund can be established under Hong Kong law in the form of a unit trust, but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (Cap. 622). Internationally, however, the corporate fund structure is more popular than unit trusts and it is therefore proposed to allow an OFC structure under the Securities and Futures Ordinance (Cap. 571) to attract more mutual funds and private funds to domicile in Hong Kong. Continued growth in the number of Hong Kong-domiciled funds is also expected to be driven by the China-Hong Kong Mutual Recognition of Funds scheme which, when implemented, will only allow Hong Kong-domiciled funds to be sold in China under the scheme.

The Government has yet to publish its consultation conclusions, but these should be issued fairly soon given that the cut-off date for responding to the consultation was 19 June 2014.

- **Stamp Duty Waiver for all Hong Kong-listed ETFs from 13 February 2015**

Exchange Traded Funds (**ETFs**), one of the fastest growing products in the asset management industry, had a record year in Hong Kong in 2014 with turnover reaching a record high of HK$1.2 trillion. The number of Hong Kong-listed ETFs has risen significantly: there are currently 141 listed ETFs[3] compared with 69 at the end of 2010. Nevertheless, Hong Kong's position as a regional ETF hub is considered to face serious challenges from other exchanges in the Asia-Pacific region.

A further measure aimed at fostering Hong Kong's asset management industry is a stamp duty waiver for all exchange traded funds (**ETFs**) listed on HKEx, irrespective of the percentage of Hong Kong stocks in their portfolios. The previous waiver did not apply to ETFs comprising more than 40% Hong Kong-listed stocks which meant that 26 of Hong Kong-listed ETFs were previously subject to stamp duty. The waiver was implemented by the Stamp Duty (Amendment) Ordinance 2014 which took effect on 13 February 2015.

- **Extension of Profits Tax Exemption for Offshore Funds to Private Equity Funds Proposed**

A briefing paper was tabled before Legco in January 2015 setting out proposals to extend the exemption from profits tax which currently applies to offshore funds to offshore private equity funds. This will involve extending the exemption to transactions in private companies which are currently excluded from its scope. The paper also contains proposals to relax the current requirement that transactions must be conducted by or through SFC-licensed intermediaries and will allow the exemption where the fund is a "qualifying fund" since the managers of private equity funds may not be SFC-licensed.

5. Full Implementation of New Regulatory Regime for Hong Kong IPOs

1 October 2014 marked the first anniversary of a more stringent regulatory regime for Hong Kong IPOs, setting a higher bar for prospectus disclosure and the due diligence expected of IPO sponsors and other professionals involved in Hong Kong IPOs. The Hong Kong market is unique in that the overwhelming majority of its listed companies are incorporated offshore, primarily in Mainland China, which means that in the event of wrongdoing, the company and its directors are often beyond the reach of the Hong Kong courts.

Concerns that prospectus disclosure was sometimes falling short of the standard expected, led to a new requirement that issuers must publish the draft prospectus (the Application Proof) on the HKEx website on submitting their listing application, long before there is any certainty that listing approval will follow. An Application Proof which is found not to be "substantially complete", may be rejected by HKEx and the issuer and sponsor "named and shamed" by publication of the fact of the rejection on the HKEx website. Keen to avoid a box-ticking mentality, the SFC also imposed new sponsor due diligence obligations as broadly written duties rather than concrete steps, which has been criticised for effectively precluding any degree of certainty that "all reasonable" due diligence has been conducted.[4] The regime's various transitional arrangements, including HKEx's "Initial 3-Day Check" of Application Proofs, also fell away on 1 October 2014. Yet with HKEx retaining its second place ranking for IPO funds raised in 2014, the new regime does not appear to have damaged the attractiveness of HKEx.

6. SFC Drops Proposed Amendments to Sponsors' Statutory Liability for Prospectus Misstatements

The SFC however decided not to proceed with proposals to make explicit that sponsors may be subject to criminal and civil liability for deficiencies in IPO prospectuses under what is now the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32).[5] The SFC's Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability" published in August 2014, concluded that the legislative amendments were unnecessary as sponsors are already included in the existing category of "persons who authorise the issue of a prospectus" who are potentially liable for prospectus inaccuracies under the ordinance.

7. New Companies Ordinance implemented 3 March 2014

Hong Kong's updated and modernised Companies Ordinance (Cap. 622) (the **CO**) came into effect on 3 March 2014 after a seven-year rewrite aimed at enhancing Hong Kong's attractiveness as a leading international business and financial centre.

Some of the key improvements under the new legislation are:

- Allowing companies to dispense with AGMs by unanimous shareholders' consent.
- A new court-free procedure for reduction of capital based on a solvency test.
- Facilitating simplified financial reporting by small and medium enterprises.

- Abolition of par value for company shares.
- Abolition of the requirement for Hong Kong companies to have a memorandum of association.
- Requiring all private companies to have at least one director who is an individual.
- A new statutory duty of care, skill and diligence for directors,[6] subject to both a subjective and an objective test.
- A reduction in the shareholding requirement for demanding a poll to 5% (from 10%).
- Requiring public and large private companies and guarantee companies to prepare more comprehensive directors' reports including an analytical and forward-looking "business review". Private companies may opt out by special resolution.
- A new requirement for approval by disinterested shareholders where shareholders' approval is required for connected party transactions of directors of public companies and their subsidiaries.
- For schemes of compromise or arrangement, the court has a new discretion to dispense with the headcount test in appropriate circumstances.

8. New Mandatory Reporting Obligations for OTC Derivatives expected in 2015

Draft rules for reporting over-the-counter (**OTC**) derivatives transactions published by the SFC and Hong Kong Monetary Authority are to be submitted to Legco for negative vetting, and are expected to be implemented in 2015, according to the SFC/HKMA Consultation Conclusions and Further Consultation on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules[7] (**OTC Derivative Rules**) published in November 2014.

The OTC Derivative Reporting Rules will implement the first phase of a new regulatory regime for Hong Kong's OTC derivatives market, the framework for which is set out in the Securities and Futures (Amendment) Ordinance 2014 passed in March 2014. The detailed requirements for the new regime will be set out in subsidiary legislation of which the OTC Derivative Reporting Rules will be the first to be implemented.

The new regime will be introduced in phases; starting with mandatory reporting, followed by mandatory clearing and finally mandatory trading. The record keeping obligation will be implemented in phases at the time the relevant mandatory obligation takes effect (i.e. the record keeping obligation with respect to mandatory reporting will be introduced in the first phase with mandatory reporting).

9. Significant Disciplinary Actions

- **Court Orders Ernst & Young to Produce Chinese Accounting Records to the SFC**

In May 2014, the Court of First Instance ordered Ernst & Young (**EY**) to hand over to the SFC accounting records relating to its work as the reporting accountant and auditor on the failed listing application of Standard Water Limited. The Court rejected EY's argument that it was prevented from handing over the accounting records by PRC state secrecy laws. EY is appealing the court order to produce documents held by its Mainland affiliate, EY Hua Ming, having produced a disc of documents held by it in Hong Kong.[8]

- **IPO Sponsor fined HK$12 million and has licence suspended**

In January 2014, the Securities and Futures Appeal Tribunal affirmed the SFC's disciplinary decision against Sun Hung Kai International Limited for deficiencies in its sponsor work on the listing of Sino-Life Group Limited on HKEx's Growth Enterprise Market in 2009.[9]

- **SFC Disciplines Moody's for Red Flags Report on Chinese Companies**

Moody's Investors Service Hong Kong Limited (**Moody's**) was fined HK$23 million and publicly reprimanded for breach of provisions of the SFC's code of conduct for SFC-regulated entities involved in its publication of a report which identified red flags in terms of potential governance or accounting risks at 61 Chinese non-financial companies. The nature of the allegations against Moody's is not known as the SFC's decision notice of 3 November 2014 is not yet publicly available. Moody's is appealing the decision.

- **SFC Starts Market Misconduct Proceedings over Alleged False Research Report**

The SFC started proceedings before the Market Misconduct Tribunal against the head of a US-based research company in December 2014, alleging that information contained in a research report on Chinese property developer, Evergrande Real Estate Group Limited, was false or misleading. The proceedings under section 277 of the SFO relate to the disclosure of false or misleading information likely to induce dealings in securities where the person making the disclosure knows that the information is false or misleading, or is reckless or negligent as to whether that is the case.

- **SFC Disciplines Investment Banks for Regulatory Breaches**

The SFC reprimanded and fined ICBCI Capital and ICBCI Securities HK$12.5 million each for failing to ensure the independence of placees for the subscription of shares of Powerlong Real Estate Holdings Limited on its 2009 listing on HKEx. It also reprimanded and fined Deutsche Bank HK$1.6 million for regulatory breaches and internal control failings in relation to its failure to disclose changes to its percentage holdings of Up Energy Development Group Limited shares.

10. Other Regulatory Developments

A number of other Hong Kong regulatory initiatives in 2014 aim to ensure Hong Kong's continued success as Asia's leading financial centre by ensuring that its regulatory framework is on a par with those in other leading international markets. The following are among the key developments in 2014.

- **Hong Kong Lays Basis for Uncertificated Securities Market**

A bill[5] to allow investors to choose to hold and transfer securities without paper documents and register the securities kept in the CCASS in their own names, has been introduced to Legco for consideration. It is proposed that the regime will initially cover shares listed or to be listed on HKEx, while listed debentures and unit trusts will be covered at a later stage. If passed, the bill will amend the SFO and empower the SFC to make the necessary subsidiary legislation to provide for the operation and regulation of the uncertificated securities market.

- **FSTB Moves to Increase Independence of Regulatory Regime for Listed Entity Auditors**

The Financial Services and the Treasury Bureau published a consultation paper [10] in January 2014 on proposals that would make the Financial Reporting Council (**FRC)** the independent oversight body for auditors of Hong Kong listed entities. The FRC would also be given disciplinary and inspection powers to complement its existing investigatory powers. The proposals seek to ensure that Hong Kong qualifies for membership of the International Forum of Independent Audit Regulators, to which entry is restricted to regulators that are independent of the audit profession and professional bodies. Under the proposals, the Hong Kong Institute of Certified Public Accountants, the professional body, would perform various statutory functions such as registration, setting standards on professional ethics, auditing and assurance and stipulating common professional development requirements.

- **SFC Consults on Regulation of Alternative Liquidity Pools**

The SFC published a consultation paper[11] in February 2014 setting out proposals to regulate operators of alternative liquidity pools (**ALPs**), also known as "dark pools", on which trades are executed anonymously outside of "lit" markets. The SFC has proposed regulating ALPs' operations by imposing requirements under the SFC's code of conduct for regulated entities similar to the conditions currently imposed on the licences of ALP operators.

- **Hong Kong Government Consults on Resolution Regime for Failing Financial Institutions**

In response to the G20 consensus that member jurisdictions should establish a "resolution regime" giving authorities powers to deal with failing financial institutions while ensuring that the costs of failure are borne by shareholders and creditors rather than taxpayers. Hong Kong's regulatory authorities published proposals for the establishment of such a regime in Hong Kong in a consultation paper[12] published in March 2014.

- **Improvements to Hong Kong's Corporate Insolvency Law and Proposed New Statutory Corporate Rescue Procedure**

The FSTB published consultation conclusions on its proposals to modernise and streamline Hong Kong's corporate insolvency provisions in May 2014 and plans to introduce an amendment bill to Legco in 2015. The aims of the amendments to relevant provisions of the Companies (Winding Up and Miscellaneous Provisions) Ordinance are to facilitate more efficient administration of the winding-up process and increase protection for creditors.

- **Introduction of 3 Days' Statutory Paternity Leave from 27 February 2015**

[5] The Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014.

From 27 February 2015, male employees will be entitled to 3 days' statutory paternity leave at 80% of their average daily wages under recent amendments to the Employment Ordinance. The entitlement is subject to the condition that the employee must have been employed for at least 40 weeks under a continuous contract. Employers who fail to grant paternity leave or pay eligible employees for paternity leave are liable to prosecution and may be fined HK$50,000.

2015 – THE YEAR AHEAD – THE TOP 11

The Top 11 regulatory developments in 2015 should include the following:

1. New Measures for **Shanghai-Hong Kong Stock Connect**:

    - covered short-selling of eligible A Shares is allowed (with effect from 2 March 2015
    - institutional investors will be able to sell A Shares held through custodians without having to transfer them to brokers' accounts one day prior to sale from 30 March 2015
    - Chinese mutual funds have been allowed to trade Hong Kong-listed shares through Stock Connect since 30 March 2015. This has significantly boosted trading in Hong Kong listed shares through the southbound link.

2. Implementation of **Shenzhen-Hong Kong Stock Connect**.

3. New **China-Hong Kong Mutual Recognition of Funds (MRF)** scheme to be introduced to allow Hong Kong domiciled funds authorised by the SFC to be sold in China and CSRC-authorised funds to be sold in Hong Kong.

4. Publication of HKEx's conclusions on **Weighted Voting Rights Concept Paper** and a decision on whether its Listing Rules should be amended to allow companies with dual class share structures and other WVR structures to list. If WVRs are to be allowed to list, HKEx has said it will publish a further consultation paper on the rule changes. Publication of the conclusions on the concept paper and a further consultation paper on the scope of the regime for listing WVR companies are expected soon.

5. The FSTB should publish its consultation conclusions on allowing **open-ended investment funds in corporate form** under amendments to the Securities and Futures Ordinance.

6. Stamp duty on all Hong Kong-listed ETFs was waived with effect from 13 February 2015.

7. The current profits tax exemption for offshore funds will be extended to offshore private equity funds.

8. New **mandatory reporting obligations for OTC derivatives** are expected to come into force in Q1 2015 on implementation of the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules.

9. New fathers' statutory entitlement to **3 days' paid paternity leave** took effect on 27 February 2015.

10. The Securities and Futures Appeal Tribunal will begin its review of the SFC's disciplinary decision against **Moody's Investors Service** on 10 September 2015.

11. **EY's appeal** against the court order to produce documents held by its Mainland affiliate should be heard in 2015.

Due Diligence Update

The New IPO Regime: A Recap of Sponsors' Due Diligence Obligations

The new sponsor regime was implemented on 1 Oct 2013 under Paragraph 17 of the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (**Paragraph 17**) and amendments to the Listing Rules. As I mentioned earlier, the key changes were the requirement to publish a "substantially complete" Application Proof on the Exchange's website at the time of submitting the listing application. This meant that the due diligence process has to be front loaded so that it is completed before the A1 filing. The new regime also imposed a number of new diligence obligations which apply on top of the requirements already spelt out in Practice Note 21. Some of these were reactions to things that had gone wrong on specific IPOs – for example the specific requirements for interviews of suppliers, customers and franchisees stem from the Hontex/Mega Capital case, which I'll talk about later. Another key change related to sponsors' ability to rely on third parties – e.g. lawyers and reporting accountants – with new requirements for sponsors to assess whether it is reasonable to rely on experts' reports and prevent them from being taken at face value as happened in both the Hontex and SinoLife/Sun Hung Kai cases.

Reasonable Due Diligence Requirement

The requirement to front load due diligence was introduced in new Paragraph 17.4(a) of the Code of Conduct which requires that:

> "*Before submitting an application on behalf of a listing applicant to the Stock Exchange a sponsor should have performed <u>all reasonable</u> due diligence on the listing applicant except in relation to matters that by their nature can only be dealt with at a later date, and ensure that all material information as a result of due diligence has been included in the Application Proof.*"

Obligation to Identify Material Issues

The new regime also introduced a new obligation for sponsors to notify issues that are material to the listing applicant's suitability for listing to the Exchange. Paragraph 17.4(d) of the Code of Conduct requires that:

"*When submitting an application on behalf of a listing applicant to the Stock Exchange, a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of:*

i. *whether the listing applicant is suitable for listing; and*

ii. *whether the listing of the applicant's securities is contrary to the interest of the investing public or to the public interest,*

are disclosed in writing to the Stock Exchange."

Deficiencies in Returned Application Proofs

For the first year of the new regime, the HKEx carried out an "Initial 3-Day Check" of Application Proofs. In the first 6 months of the new regime, the fact that an Application Proof was returned to the issuer and its sponsor for failing the Initial 3-Day Check or the Exchange's subsequent qualitative assessment was not published on the HKEx website. According to the Exchange, in the first 4 months of the regime (to 31 Jan 2014), 4 out of 18 new listing applications were returned for failing the Initial 3-Day Check. The deficiencies noted by the Exchange were as follows:

In one case, the listing applicant had failed to follow Guidance letter HKEx GL6-09A in that the listing application was filed before the end of the 3-year trading record period but did not provide 9-month financials for the latest financial year end.

Paragraph 4.2(b)(ii) of the Guidance Letter requires an applicant that is unable to include financial information for the most recent financial year in an audited or advanced form in its Application Proof, to include with its listing application financial information for a stub period of at least 9 months and comparative information and the related Management Discussion and Analysis.

Paragraph 5.2 further provides that the earliest time a listing application can be filed is **after** the end of the 3-year trading record period.

In another case, insufficient information was submitted for assessment of whether the applicant satisfied the ownership continuity and control requirement under Main Board LR 8.05(1)(c). In a further case, insufficient information was submitted to assess whether the applicant satisfied the minimum profit requirement under Main Board LR 8.05(1)(a).

Other deficiencies in the information disclosed in Application Proofs included that:

- one applicant failed to submit a reply to the outstanding comments on the applicant's compliance with the minimum cash flow requirement under GEM LR 11.12(1) which had been raised by the Exchange during a previous application;
- another applicant failed to provide Liquidity Disclosure as defined in Guidance Letter HKEx-GL38-12 to a date no more than 2 months before the date of the Application Proof;
- There was one case where a controlling shareholder's conviction was not disclosed;

- In another case there was insufficient disclosure on the proposed issuance of corporate bonds on which guidance had previously been provided in a pre-IPO enquiry; and
- There was one case which lacked sufficient information on the performance of the listing applicant's business

Deficiencies noted in qualitative assessment

Two other cases that passed the Initial 3-day Check in the first 4 months of the new regime failed the subsequent qualitative assessment. The Application Proofs were returned because the information disclosed was not substantially complete in all material respects.

The following deficiencies were noted:

- Insufficient disclosure on the applicant's business model, non-compliance incidents, use of proceeds and hedging policy;
- Insufficient information to enable investors to assess the extent of the applicant's reliance on a major customer;
- Insufficient information to enable investors to assess the impact of certain disputes and complaints, suitability of directors and sustainability of the applicant's business; and
- Insufficient information to assess whether the applicant satisfied the management continuity requirement under GEM Listing Rule 11.12A(3).

No Application Proofs have been returned since the Exchange's ability to name and shame the issuer and sponsor by publishing the fact of return became effective on 1 April 2014. Sponsors have made huge efforts to make sure that theirs is not the first Application Proof to be rejected and thus, to that extent, the new regime may have achieved its aim of improving the standard of due diligence, or at least improving the quality of draft prospectuses submitted with listing applications.

Disciplinary Decisions to Date under Old IPO Regime

The disciplinary decisions relating to IPO sponsors were made under the previous IPO Regime. So far there have only been 2 disciplinary actions brought against sponsors, and both involved sole sponsors: Mega Capital (Asia) Company Limited **(**Mega Capital) for its work on the IPO of garment manufacturer Hontex International Holdings Company Limited and Sun Hung Kai International Limited for its work on the IPO of Chinese funeral company, Sinolife.

Mega Capital (Asia) Company Limited (Mega Capital)

The SFC revoked Mega Capital's corporate finance adviser licence and fined it HK$42 million for inadequate and sub-standard due diligence work on Hontex's 2009 IPO. The findings against Mega Capital related firstly to **inadequate and sub-standard due diligence work.**

The principal businesses of Hontex group were fabric sales and garment manufacturing (on an Original Equipment Manufacturing (OEM) basis for apparel owners and for Hontex's franchisees). The SFC considered that due diligence on the group's customers, suppliers and franchisees was necessary to assess the authenticity of the group's business performance.

The SFC reached the conclusion that Mega Capital's due diligence work was inadequate and sub-standard on the basis that:

Firstly, material information (such as transaction figures with the group) was missing from questionnaires that Mega Capital completed with suppliers and customers. Mega Capital then failed to follow up on the missing information.

In addition, a number of interviews with suppliers and customers were conducted on the phone in haste on the same day Hontex filed its listing application.

The SFC also found that franchisees' information provided by Hontex (e.g. name, address and turnover of each franchisee) was not properly verified and that transaction records between franchisees and the group were not obtained.

The second failing identified was that Mega Capital **failed to act independently and impartially.**

The SFC found that Mega Capital relied on Hontex inappropriately without performing independent scrutiny and verification when sourcing important aspects of its due diligence work in relation to Hontex's suppliers, customers and franchisees. The examples given by the SFC of inappropriate reliance included that Mega Capital complied with Hontex's request not to approach the group's suppliers, customers and franchisees directly. As a result, Hontex arranged all the interviews which were also attended by representatives of Hontex.

Mega Capital also accepted Hontex's representation that some suppliers/customers refused face-to-face interviews with Mega Capital without inquiring further. It agreed to have telephone interviews with suppliers and customers arranged by Hontex and allowed Hontex to collect written confirmations from franchisees confirming their independence from Hontex.

The third failing identified by the SFC was that Mega Capital's **audit trail of its due diligence work was inadequate**.

The SFC found that Mega Capital did not maintain adequate documentation of its due diligence planning and significant aspects of its due diligence work. For instance, Mega Capital kept no records showing what background or other due diligence searches were conducted on the group's suppliers, customers and franchisees.

Finally, the SFC complained about Mega Capital's **inadequate supervision of its staff.**

Most of the due diligence work was handled by junior and inexperienced staff of Mega Capital without adequate supervision. The two Responsible Officers both claimed that the other was responsible for supervision of the due diligence on the Hontex IPO.

<u>Breach of sponsor's undertaking and filing untrue declaration with HKEx</u>

In view of the failures identified, the SFC considered that Mega Capital had breached its undertaking and declaration to the Stock Exchange confirming performance of reasonable due diligence inquiries and that all information provided to the Exchange during the listing application process, including information in the IPO prospectus, was true in all material respects and no material information was omitted.

The SFC found that Mega Capital had failed to use reasonable endeavours to ensure that all information provided to HKEx during the listing application did not omit any material information and its declaration that it had made all reasonable due diligence inquiries also appeared to be untrue.

However, the SFC found no evidence that Mega Capital was involved in any fraud and it denied all allegations of wrongdoing.

Separately, Hontex was ordered to buy back its shares from around 7,700 eligible shareholders based on its admission of disclosure of false or misleading information.

The inadequacies identified in the Mega Capital/Hontex case led to the introduction of new requirements for sponsors under Paragraph 17 of the Code of Conduct. In particular, new Paragraph 17.6(f) introduced specific requirements for the conduct of interviews of major business stakeholders such as customers, suppliers, creditors and bankers. These include obligations on a sponsor to:

- Ensure that interview records are reasonably accurate, complete and reliable in all material respects;
- Select interviewees independently based on objective and proportionate criteria; and
- Carry out the interview directly with the person or entity selected for interview with minimal involvement of the listing applicant.

To address the issue of inadequate records being kept of sponsor due diligence work, Paragraph 17.10 of the Code of Conduct introduced a requirement for sponsors to maintain adequate records so as to demonstrate to the SFC its compliance with the Code and in particular compliance with the requirements of Paragraph 17 of the Code of Conduct. As well as specific requirements to document due diligence planning and changes to plans and the conduct of due diligence, Paragraph 17 further requires sponsors to document all significant matters arising in the course of the listing process, including internal discussions and actions taken, regardless of whether or not the relevant matters are disclosed in the final listing document.

Sun Hung Kai International Limited (Sun Hung Kai)

Another landmark disciplinary proceeding pursued by the SFC concerned the boutique bank Sun Hung Kai in relation to its work as sponsor on the IPO of Chinese funeral company, Sino-Life.

In Jan 2014, the Securities and Futures Appeals Tribunal (SFAT) upheld the SFC's disciplinary decision against Sun Hung Kai. The bank was fined HK$12 million and had its licence suspended for a year for due diligence failures as the sole sponsor of Sino-Life Group Limited (**Sino-Life**)'s IPO.

The timeline of events, in summary, was as follows:

- Sun Hung Kai was appointed by Sino-Life to manage its listing application on GEM in October 2007.
- A change in the GEM Listing Rules in May 2008 required listing applicants to demonstrate a positive cash flow of not less than HK$20 million in the preceding 2 financial years.
- The draft audit report obtained revealed a positive cash flow of less than HK$20 million.
- Sun Hung Kai requested a waiver of the new cash flow requirement but this was refused by the Exchange and the listing application was not filed.
- In October 2008, Sino-Life revived its listing application and appointed Sun Hung Kai as the sole sponsor.
- A new accounting firm was employed and the audit report submitted to the Exchange demonstrated an operating cash flow that met the HK$20 million requirement.
- A material difference was later found in the cash flow figure for the financial year ended 2007 used in the original and new audit reports.
- According to the original audit report, the cash flow for the year ended 2007 was RMB 7.007 million
- However, the new audit report stated the cash flow for the same period to be RMB 10.230 million - a difference of RMB 3.223 million.

The SFC commenced a 3-and-a-half-year long investigation after Sino-Life's listing and found that Sun Hung Kai had failed to carry out proper due diligence in relation to 5 matters:

(i) assessing the accuracy and the completeness of the information submitted by Sino-Life to demonstrate that it satisfied the financial requirements to list on GEM;

(ii) ascertaining the existence of various encumbrances on the title of a major business deal of Sino-Life in Taiwan;

(iii) properly assessing the business of Sino-Life's wholly-owned subsidiary in Taiwan;

(iv) ensuring true, accurate and complete disclosure was made to the Exchange and in Sino-Life's prospectus and breach of the sponsor undertaking to the Exchange by filing untrue statements in the sponsor declaration; and

(v) keeping proper books and records in relation to the sponsor work conducted.

The SFC considered that Sun Hung Kai had been selective in its disclosure to the Exchange during the listing application process.

On appeal, the SFAT confirmed most of the SFC's findings and considered that Sun Hung Kai's breaches were not the result of negligence. The SFAT identified the following failings by Sun Hung Kai as sponsor:

Failure to disclose and explain difference in 2007 cash flow figures

- The SFAT believed that Sun Hung Kai's team working on Sino Life's listing application was aware of the 45% discrepancy in the cash flow figures between the original draft audit report and the report submitted with the listing application and was well aware of its importance to the listing application. It considered that the team chose to ignore the difference and not to reveal it to the Exchange even upon subsequent inquiries.

- The omission was a clear breach of GEM LRs 6A.04 and 6A.15 which set out a sponsor's obligation to exercise reasonable due diligence in ensuring that any opinions or forward-looking statements of the directors of the applicant have been made on fair and reasonable bases and assumptions and that all information is true in all material respects and does not omit material information.

Failure to ascertain and disclose encumbrances on title of a major business deal

- Sino-Life disclosed in its IPO prospectus its intention to invest HK$13.1 million raised from the IPO to furnish a columbarium in Taiwan, to which it didn't have title or any rights.

Failure to ascertain and disclose encumbrances on title of a major business deal

- A Sun Hung Kai employee conducted an internet search and discovered that an auction against the columbarium had been halted, which hinted at the potential financial instability of the title owner of the columbarium.

- The discovery prompted Sun Hung Kai to seek an opinion from a Taiwanese lawyer.

- From evidence the SFC collected, Sun Hung Kai did urge Sino-Life to disclose relevant risks in their prospectus, but the issue was not taken further and not mentioned in the prospectus.

- The SFAT found that Sun Hung Kai should not have accepted the advice of the Taiwanese lawyer which appeared to be inadequate. The Tribunal was convinced that Sun Hung Kai had failed to pursue irregularities discovered and had breached Paragraph 2.3 of the Corporate Finance Adviser Code of Conduct. Paragraph 2.3 CFA requires a corporate finance adviser to provide a proper trail of work done upon request by the SFC.

The main due diligence issue was the ability of the sponsor to rely on an expert's opinion without further enquiry. The new regime under Paragraph 17 of the Code of Conduct imposes new obligations which sponsors must follow in order to be able to rely on an expert's report. In addition to satisfying themselves as to the qualifications etc. of the expert, a sponsor is required under new Paragraph 17.7 to:

- critically review the expert's opinion and the rest of the information in its report against the totality of all other information known to the sponsor about the listing applicant through due diligence and the sponsor's knowledge of the listing applicant; and
- corroborate the information in the expert report with the information disclosed in non-expert sections of the prospectus and the sponsor's knowledge of the listing applicant.

Guidance Letters Updates

Since the new regime came into effect in October 2013, the Exchange has published a number of updates to its disclosure requirements for IPO listing documents in new and updated guidance letters, all of which are available on the Exchange's website. If the requirements set out in the guidance letters are not complied with, the Exchange may treat an Application Proof as not substantially complete as required by the Listing Rules, and return it to the sponsor. On return, the issuer's and sponsor's name and the date of return will be published on the Exchange's website and a new application cannot be submitted for a further eight weeks.

The principal changes in disclosure requirements since October 2013 are set out below:

1) **GL41-12 (updated) & GL 27-12 (updated)**

   The Exchange updated 2 Guidance Letters (GL41-12 and GL27-12) in January to deal with IPO prospectus disclosure of material changes in the group's financial, operational and/or trading position since the end of the trading record period as required by paragraph 38 of Appendix 1A to the Listing Rules.

   GL41-12 Disclosure Requirements for IPO Cases – Disclosure of Material Changes in Financial, Operational and/or Trading Position after Trading Record Period

   GL41 sets out non-exhaustive examples of adverse changes which would require disclosure if material in relation in the technological, market, economic, legal or operating environment in which an applicant operates.

   The Exchange updated 2 paragraphs of GL41:

   - Paragraph 4.3 now requires inclusion in the "Summary" section of the listing document of either qualitative or quantitative disclosure with commentary on how the adverse changes affect the financial, operational and/ or trading position after the trading record period. Previously there was no indication of where in the listing document that information should be disclosed. Paragraph 4.3 now also specifies that such disclosure must enable investors to have a sense of the materiality of the adverse changes.

- Paragraph 4.3 already provides that where an applicant discloses quantitative information relating to its financial performance after the track record period other than net profit/loss (e.g. revenue, gross profit, etc.), this non-profit forecast financial information should be reviewed by the reporting accountants, and a statement must be included in the listing document that this information has been reviewed by the reporting accountants.

- Paragraph 4.3 has been amended to provide that the disclosure of the comparative financial information to the non-profit forecast financial information is not compulsory. However, if an applicant chooses to disclose such information in its listing document, this should at least be reviewed by the applicant's sponsor.

- Paragraph 4.4 has been revised to require that any material adverse changes are also highlighted in the "Risk Factors" and "Financial Information" sections of listing documents. These changes must be disclosed notwithstanding any mitigating factors which may reduce the potential impact of financial or operational loss to the applicant.

GL27-12: Simplification Series – Disclosure in Listing Documents for IPO Cases – the "Summary and Highlights" section

Attachment 1 to GL27 provides guidance on the information which is typically expected to be included in the "Summary and Highlights" section of listing documents. Attachment 1 has been revised to make it consistent with the new requirements under GL41 in relation to the disclosure of material adverse changes since the end of the track record period in the "Summary and Highlights" section.

A further change is a requirement to include underwriting commission in the total amount of listing expenses relating to an offer as stated in the "Summary and Highlights" section.

2) GL65-13 (updated)

GL65-13 provides guidance on the information to be included in property valuation reports and market reports included in IPO listing documents and was updated in January 2015. The updated guidance requires property valuation reports to make "clear reference to tenure and other specific factors such as title defects and special requirements imposed on the properties by the land grant contracts, and the associated value implications, if material".

3) **GL32-12 (updated)**

Guidance Letter 32-12 provides guidance on the accounting and disclosure requirements for (A) acquisitions of subsidiaries and businesses conducted during or after the trading record period and (B) stub period comparatives and was revised in October 2014.

Applicability

The updated guidance letter clarified the scope of Main Board Listing Rules 4.04(2) & (4) which require a listing applicant to include in its accountants' the results and balance sheets of any subsidiary or business acquired or proposed to be acquired since the date to which its latest audited accounts have been made up for the three financial years (two financial years for GEM applicants) preceding the issue of the listing document, or since the incorporation of such target entity or the commencement of such business, if this occurred less than three years (or two years for GEM applicants) prior to issue of the listing document.

The updated Guidance Letter clarified that Main Board Listing Rule 4.05A applies to acquisitions of a material subsidiary or business during an applicant's trading record period. Rule 4.05A requires listing document disclosure of pre-acquisition financial information on a material subsidiary or business acquired during the trading record period, which would be classified as a major transaction or a very substantial transaction (i.e. 25% or more).

In calculating the relevant ratios, the total assets, profits and revenue for the most recent financial year of the trading record period of the subsidiary or business being acquired should be compared to those of the applicant for the same financial year. If the financial year of the subsidiary or business to be acquired is not coterminous with that of the applicant, the total assets, profit or revenue for the most recent financial year of the subsidiary or business being acquired should be compared to those of the applicant for the most recent financial year of its trading record period.

Main Board Listing Rule 4.28 requires listing document disclosure of pro forma financial information in relation to a business or company which is acquired or proposed to be acquired after the trading record period (including those where an applicant has entered into an acquisition agreement after the trading record period which will not be completed at listing and where there is an intention to acquire a specific subsidiary or business, even where there is no binding agreement) which would be classified as a major subsidiary at the date of the listing application or any later day of acquisition before listing. New Paragraph 4.6A of GL32-12 requires that all acquisitions or proposed acquisitions of businesses or companies since the end of the trading record period should be aggregated. If the aggregate total assets, profits or revenue exceeds 5% under any of the percentage ratios, such acquisitions will be regarded as an acquisition of a major subsidiary and require disclosure of pro forma financial information in respect of the enlarged group. The entire amount of the major subsidiary's total assets, profits and revenue for the most recent financial year should be compared to those for the applicant's latest financial year of its trading record period.

Accounting / Disclosure Requirements

Requirements under paragraphs 32 and 33 of the Third Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance (C(WUMP)O) apply to an acquisition subject to Rules 4.04(2) and (4) if part of the listing proceeds is to be applied directly or indirectly to purchase any business or subsidiary. In this case, the Financial Information for the acquisition must be disclosed in a separate accountants' report.

The Guidance Letter amendments additionally require that pro forma financial information required to be disclosed under Rule 4.28 must be disclosed as an appendix to the listing document, which must be covered by an accountants' report as required by Main Board Rule 4.29 (GEM Rule 7.31).

Conditions for waiver

The updated Letter specifies the conditions for granting waivers under Rules 4.04(2) and (4):

1. Acquisitions of equity securities in the ordinary and usual course of business of the applicant

   The Exchange will ordinarily grant a waiver of Rules 4.04(2) and (4) provided that:

   (a) the percentage ratios of each acquisition are less than 5% by reference to the most recent financial year of the applicant's trading record period;

   (b) the applicant cannot exercise any control or significant influence over the underlying company or business; and

   (c) the listing document includes the reasons for the acquisitions and confirmation that the counterparties and their ultimate beneficial owners are independent third parties of the applicant and its connected persons.

2. Acquisitions of a business or subsidiary

   The Exchange will ordinarily grant a waiver of Rules 4.04(2) and (4) provided that:

   (a) the percentage ratios of the acquired or to be acquired business or subsidiary are all less than 5% by reference to the most recent financial year of the applicant's trading record period;

   (b) the historical financial information of the acquired or to be acquired business or subsidiary is not available or would be unduly burdensome to obtain or prepare; and

   (c) the listing document includes at least the information required for a discloseable transaction under Chapter 14 of the Main Board Rules (Chapter 19 of the GEM Rules).

The Exchange may modify these conditions if it considers it necessary.

In cases where the requirements of the Third Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance apply, an exemption of the relevant requirements is granted by the SFC.

4) GL6-09A (updated)

This guidance letter sets out the financial information required to be included for the trading record period in the Application Proof. It was last updated in May 2014 to make it consistent with GL32(12) (which I've just talked about) regarding the financial information required to be disclosed under Main Board Listing Rules 4.04(2) & (4) and 4.28 in respect of companies or businesses acquired or to be acquired after the latest audited financial year / period end (the **Acquisition**).

Accordingly GL-09A requires that where an Applicant has acquired or intends to acquire a company or business since the latest audited (or advanced draft) accounts were made up, the Application Proof must include:

(a) financial information of the company or business as required by Rules 4.04(2) & (4)(a); and

(b) where the Acquisition falls under Main Board Rule 4.28 (GEM Rule 7.30), pro forma financial information of the enlarged group under Main Board Rule 4.29 (GEM Rule 7.31).

The May amendments to the guidance letter provide that such information needs not be included in the Application Proof if the applicant's financial information in its subsequent draft listing document will be updated to cover a later period which includes the Acquisition. However, pre-acquisition financial information for acquisitions made during the trading record period and any stub period must be included in the Application Proof.

5) GL72-14 (new)

In January 2014, the Exchange published new guidance letter 72-14 setting out guidance on disclosure in the "Applicable Laws and Regulations" section of listing documents. The primary requirement is that the description of the rules and regulations that are material to the applicant's current and/ or future business should be succinct and easy to read. While current practice is generally to include this information in a standalone section of the listing document, the guidance letter suggests that including the information elsewhere in the listing document instead of in a standalone section might assist investors' understanding.

The following guidance is provided:

a) Avoid Use of Legalistic Language

Legalistic language and long complex descriptions should not be used. Applicants are recommended to give concise definitions of titles of laws and regulations to make the section easy to read.

b) Key Laws and Regulations of Relevant Jurisdictions

Disclosure should be made of laws and regulations that are specific to, and have a material impact on an applicant's business (e.g. rules and regulations governing the applicant's key licences for operations). Boiler plate disclosure of laws and regulations that do not materially impact the applicant's business should be avoided.

Where an applicant has or plans to have material businesses (in terms of its operations and sales) in a number of jurisdictions, disclosure should be made of the laws and regulations that have a material impact on the applicant's businesses in each such jurisdiction. Such description should be proportionate to their importance to the applicant.

c) Key Changes in the Laws and Regulations

Listing documents should disclose changes in laws or regulations that are expected to have a material impact on the applicant's business. Cross references should be included to the "Business" and "Risk Factor" sections to describe the impact of the laws and regulations on the applicant and its plans and procedures implemented or to be implemented to deal with them.

Where changes in laws and regulations occur during or prior to the track record period, these do not need to be disclosed unless:

(i) the applicant is subject to grandfathering provisions; or

(ii) the changes in laws and regulations have had a material impact on the business, which may be disclosed elsewhere in the listing document (e.g. in the "Business" or "Financial Information" section which should be cross-referenced within the "Applicable Laws and Regulations" section.

d) Relevance to the Applicant

As opposed to abstract summaries, this section should disclose clearly how each law and regulation is relevant to the applicant, unless it would be obvious to an average investor. If there is a risk that the applicant's business may breach a law or regulation, the steps that the applicant has taken and plans to take to ensure compliance should be disclosed in either the "Applicable Laws and Regulations" or the "Business" section, and it may be appropriate to include a legal opinion as to the likelihood of breach and the maximum liability of the applicant.

e) Highly Regulated Industries

Applicants engaged in highly regulated industries (including but not limited to banking, insurance and gambling) should ensure that the "Applicable Laws and Regulations" section focuses not only on local statutory laws governing the industries (e.g. banking laws, laws governing insurance companies and gambling laws), but also other internationally implemented industry specific rules and regulations (e.g. anti-money laundering).

f) Laws of the Issuer's Jurisdiction of Incorporation

The Guidance Letter refers to the Joint Policy Statement released on 27 September 2013 regarding the listing of overseas companies. The disclosure of regulatory provisions (as required by Main Board Rules 19.10(2) and (3) and specific disclosure items in paragraphs 63-66 of the Joint Policy Statement) in relation to an applicant's jurisdiction of incorporation should be set out in a section of the listing document separate from the "Applicable Laws and Regulations" section.

6) **GL68-13 (new)**

The Exchange published new Guidance Letter 68-13 in December 2013 setting out a non-exhaustive list of factors that may affect suitability of a listing applicant.

a) Suitability of director and controlling shareholders

There may be concern over the applicant's suitability if a person likely to exercise substantial influence on the applicant after listing has a past non-compliance or conviction record that raises serious concern as to the person's integrity.

b) Non-compliance

Systematic, intentional, and/or repeated breaches of laws and regulations may affect an applicant's suitability for listing. The Exchange will take into account the nature, extent and seriousness of the breaches, the reasons for them (i.e. whether they were intentional, fraudulent or negligent), their impact on the applicant's business and financial performance, the rectification measures adopted and precautionary measures to avoid future breaches.

c) Deteriorating financial performance

Even where an applicant satisfies the relevant requirements of Rule 8.05 during the track record period, any deteriorating financial performance after the track record period may be indicative of a fundamental deterioration of commercial or operational viability, which raises serious concerns as to its sustainability and suitability.

d) Excessive reliance on parent group / connected persons / major customer

If an applicant demonstrates heavy reliance on certain parties or model, the Exchange may have concerns as to its suitability for listing. Examples of reliance causing concern as to suitability for listing are:

i) Reliance on a parent group for important functions such as sales and procurement functions or financial and operational reliance on the applicant's parent;

ii) Reliance on a parent where there are overlapping directors, the applicant and parent are in the same industry sector, and the arrangements for managing potential conflicts of interest and delineation of businesses are inadequate;

iii) Where a significant portion of the applicant's turnover and net profit is derived from transactions with connected persons and other closely related parties;

iv) Extreme reliance on a single major customer may cause concern as to the applicant's suitability for listing. The Exchange will take into account the applicant's ability to find replacement customers, likelihood of reduced reliance in the future, the industry landscape, whether the reliance is mutual and complimentary, the existence of long-term contractual arrangements and the applicant's ability to sustain its revenue and profitability in the long-term.

v) A captive business model (meaning the sourcing of the listing applicant's principal raw materials and its principal customer channel are dominated by the same party) – If the applicant cannot operate independently of such party, this will raise concerns as to its listing suitability.

e) Gambling

Listing applicants are not suitable for listing unless they satisfy the requirements stated in the Exchange's announcement entitled "Gambling Activities Undertaken by Listing Applicants and/or Listed Issuers" and Listing Committee Report 2006.

f) Contractual Arrangements (VIEs)

Applicants that are VIEs must satisfy the conditions specified in Listing Decision "HKEx-LD43-3" to establish their suitability for listing.

g) Reliance on unrealized fair value gains to meet profit requirement

If the applicant cannot satisfy the profit requirement after excluding unrealised fair value gains of its investment properties and it did not have a substantive business during its track record period, it must demonstrate that it has a sustainable business in order for the Exchange to consider it suitable for listing. A sustainable business may be demonstrated by the existence of property projects under development or significant recurring income).

7. GL63-13 (updated)

Guidance Letter 63-13 which deals with disclosure of material non-compliance incidents was updated in May 2014 to put incidents into three categories:

(i) ***Material Impact Non-compliance Incidents***

Non-compliance incidents which, individually or in aggregate, have had or may have a material financial or operational impact on the listing document (e.g. those giving rise to significant financial penalties or which may result in the closure of material operating facilities;

(ii) ***Systemic Non-compliance Incidents***

Non-compliance incidents which are not Material Impact Non-compliance Incidents, but which reflect negatively on the applicant's or its directors'/senior management's ability to operate in a compliant manner, such as repeated and/or continuous breaches of laws;

(iii) ***Immaterial Non-compliance Incidents***

Non-compliance incidents not within the above two categories.

The guidance letter provides that where there are serious non-compliance incidents (e.g. involving director fraud, systemic failure of an applicant's internal controls and/or matters having a significant financial impact on the applicant), this may raise questions as to the suitability of the applicant's directors and/or the applicant's suitability for listing. The May amendment added that such serious non-compliance incidents may result in:

(a) the application being rejected; or

(b) the Exchange requesting a demonstration period of compliance from the cessation of the non-compliance incident(s) to show that rectification measures and enhanced internal controls put in place are effective and that there is no financial impact on the applicant. The demonstration period would normally be an audited period.

Where non-compliance incidents do not cause the applicant to be considered to be unsuitable for listing, the Exchange requires that:

- ***Material Impact Non-compliance Incidents*** should be highlighted in the "Summary and Highlights" section of listing documents and disclosure of the information set out in paragraph 3.4 of the guidance letter.

- ***Systemic Non-compliance Incidents*** should also be highlighted in the "Summary and Highlights" section of listing documents and the listing document disclosure should include the views of the directors and the sponsor(s) on the adequacy and effectiveness of the applicant's internal controls, the suitability of its directors and the applicant's suitability for listing the information.

Disclosure of major customers' identities

The Securities and Futures Commission's (the SFC's) latest Corporate Regulation Newsletter (Issue No. 2 of April 2015) sets out its recommendation that listing applicants should disclose the identities of their major customers in their listing documents, especially if a few customers only are responsible for a large part of the company's revenues. If a listing applicant does not disclose customer identities in its listing document, the listing applicant and its sponsor must take reasonable steps to ensure that this information is not included in any marketing communication provided to analysts or investors.

May 2015

This note is provided for information purposes only and does not constitute legal advice. Specific advice should be sought in relation to any particular situation. This note has been prepared based on the laws and regulations in force at the date of this note which may be subsequently amended, modified, re-enacted, restated or replaced.