



Hong Kong

February 2020

SFC BULLETIN GIVES UPDATE ON SFC'S FRONT-LOADED REGULATORY APPROACH

On 7th February 2020, the Securities and Futures Commission (SFC) published its SFC Regulatory Bulletin (Issue No. 4)¹ to provide an update on its front-loaded approach to regulating market quality and corporate misconduct. The latest SFC Regulatory Bulletin includes case studies featuring the SFC's principal areas of concern and its recent regulatory actions in relation to initial public offering (IPO) applications and corporate transactions.

According to the SFC Regulatory Bulletin (Issue No. 4), undesirable market conduct including shell-related trading activities,² was the main cause of extreme price volatility of GEM and Main Board stocks in 2015 and 2016. Specific areas of focus include:

- dubious corporate transactions involving overvalued acquisitions and suspect valuations suggesting failure by directors to act in the best interests of shareholders and conflicts of interest in some cases;

- the need for sponsors to exercise professional scepticism in performing IPO due diligence; and
- extreme price volatility in the prices of GEM and Main Board stocks in 2015-2016 related to shell-related trading activities; and
- listed companies, particularly those with highly-concentrated shareholdings, acting in a manner which was prejudicial to the minority shareholders.

To combat market misconduct, the SFC established a cross-divisional working group in July 2016 which pools expertise from the SFC's Licensed Intermediaries, Corporate Finance and Enforcement divisions. Code-named ICE,³ the working group aims to implement a coherent consolidated regulatory approach to address a range of market quality and corporate conduct concerns. The main components of its multi-pronged approach include front-loaded regulatory intervention in listing matters, enhanced supervision of intermediaries and focused enforcement actions against senior management and persons with important gatekeeping roles.

1 [https://www.sfc.hk/web/EN/files/ER/images/20010153-SFC-Regulatory%20Bulletin\(e\).pdf](https://www.sfc.hk/web/EN/files/ER/images/20010153-SFC-Regulatory%20Bulletin(e).pdf)

2 In July 2019, the SFC released a [statement on the SFC's approach to backdoor listings and shell activities](#). According to the statement, Shell activities included: (1) listing businesses in order to monetise the premium attached to the listing status rather than to genuinely develop an underlying business; (2) disposing of all or substantially all of the listed company's original business in preparation for a subsequent change in control and injection of assets by the new controlling shareholders; and (3) pursuing new businesses with low entry barriers and little commercial substance (e.g. a money lending business with only a few customers) in an attempt to maintain the shell company's lasting status.

3 ICE is the short form of "Intermediaries, Corporate Finance, Enforcement", three of the seven divisions of the SFC. The ICE team consists of senior executives and officers to tackle corporate misconduct. See SFC, "SFC Annual Report 2018-2019". Available at: https://www.sfc.hk/web/EN/files/ER/PDF/Strategic_Priorities_EN.pdf

• **SFC Regulation of HKEx Listings and HKEx-Listed Issuers' Corporate Transactions**

Under section 6 of the Securities and Futures (Stock Market Listing) Rules, the SFC is entitled to object to a listing if it appears to the SFC that the listing application is misleading through the omission of a material fact, or that the listing of the securities would not be in the interest of the investing public or in the public interest. The SFC may also query or object to suspicious corporate transactions, for instance, if they do not appear to make commercial sense.

• **SFC Supervision of Intermediaries**

The SFC adopts a front-loaded and risk-based approach to the supervision of intermediaries and uses a variety of tools, including on-site thematic inspections and off-site monitoring, with a focus on firms' financial soundness and how they conduct business. The SFC also attaches considerable importance to the accountability of senior management under the Manger-In-Charge regime introduced by the SFC in 2017. According to the May 2018 issue of the SFC Compliance Bulletin: Intermediaries,⁴ the Manager-In-Charge regime was implemented to drive better ex ante decisions and proper behaviour at firms. For detailed information on the regime, please see Charltons' January 2017 newsletter.⁵

• **SFC Enforcement**

The SFC takes enforcement action by exercising its powers under the Securities and Futures Ordinance (SFO) to freeze unlawful proceeds, seek disqualification orders against irresponsible directors, discipline sponsors who have failed to discharge their duties and suspend the share trading of listed companies where broader investor interests are at risk. According to the May 2017 issue of the SFC *Enforcement Reporter*,⁶ the SFC commenced a number of proceedings under s. 214 of the Securities and Futures Ordinance to disqualify the senior management of the failed companies, for example, (1) disqualifying five directors of *Hanergy Thin Film Power Group Limited* on the grounds that they had failed to act in the company's best interests, and (2) disqualifying 10 former

executives and non-executive directors of *Freeman FinTech Corporation Limited* on the grounds that they failed to act in good faith and in the best interests of the company.

SFC key policy initiatives to preserve Hong Kong market quality and good corporate conduct

According to the SFC Regulatory Bulletin, the SFC's key policy initiatives to ensure market quality and address corporate risks since 2016 were as follows:

| | SFC Key initiatives against market quality and corporate risks since 2016 |
|-------------|---|
| 2016 | <ul style="list-style-type: none"> • Joint SFC-HKEx press release on highly dilutive rights issues (December) <p>The SFC and the Stock Exchange of Hong Kong Limited (HKEx) emphasised the importance of fair and equal treatment of all shareholders when conducting rights issues and open offers. The HKEx adopted a rigorous approach to vetting relevant draft announcements, while the SFC made enquiries into cases where the terms of proposed offers were highly dilutive.</p> |
| 2017 | <ul style="list-style-type: none"> • Guideline for intermediaries and joint SFC-HKEx statement on GEM stocks (January) • Statement on recent GEM listing applicants (March) <p>The SFC provided guidance to sponsors, underwriters and placing agents on the standards of conduct expected of them in the listing and placing of GEM IPOs.</p> <p>The SFC issued a guideline to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks and a joint statement with the HKEx regarding the price volatility of GEM stocks.</p> |

4 https://www.sfc.hk/web/EN/files/ER/PDF/SFC%20Compliance%20Bulletin/SFC%20Compliance%20Bulletin%20May%202018_Eng%20final.pdf

5 <https://www.charltonslaw.com/new-sfc-measures-to-increase-the-accountability-of-licensed-corporations-senior-management/>

6 https://www.sfc.hk/web/EN/files/ER/Reports/Enforcement%20Reporter/Enforcement%20Reporter_ENG_24%20May%202017_final.pdf

| | SFC Key initiatives against market quality and corporate risks since 2016 |
|-------------|--|
| 2017 | <ul style="list-style-type: none"> • Guidance on directors' duties and circular to financial advisers on valuations (May) <p>The SFC issued a guidance note on directors' duties and a circular to financial advisers regarding valuations in corporate transactions together with a statement on the liability of valuers for disclosure of false or misleading information. The guidance note reminds directors that they are the guardians of a listed company's assets and should ensure acquisition targets are properly considered and investigated.</p> |
| 2018 | <ul style="list-style-type: none"> • Circular on sponsor quality (March) <p>The <i>SFC Report on Thematic Review of Licensed Corporations Engaged in Sponsor Business</i> highlighted a number of deficiencies and instances of non-compliance with relevant provisions in the Code of Conduct for Persons Licensed by or Registered with the SFC, the Corporate Finance Adviser Code of Conduct and the Listing Rules in respect of due diligence practices and internal systems and controls. The SFC reminded licensed corporations of the need to comply with the expected standards in carrying out sponsor work.</p> <ul style="list-style-type: none"> • Circular on use of nominees and warehousing arrangements (October) <p>The SFC reminded intermediaries to be mindful of red flags indicating potential improper activities, make due follow-up enquiries with clients and report promptly to the SFC and other authorities where necessary.</p> <ul style="list-style-type: none"> • New requirements for capital raisings and delisting take effect <p>The HKEx implemented its proposals on the delisting of issuers, including (1) adding a separate delisting criterion to allow it to delist an issuer after its continuous suspension for a prescribed period (fixed period delisting criterion); and (2) allowing HKEx to publish a delisting notice and give the issuer a period of time to remedy the issues or be delisted (remedial period).</p> |

| | SFC Key initiatives against market quality and corporate risks since 2016 |
|-------------|--|
| 2019 | <ul style="list-style-type: none"> • Statement on the conduct and duties of directors when considering corporate acquisitions and disposals (July) <p>The statement outlined recurring types of misconduct in relation to corporate acquisitions and disposals that have given rise to concerns and, in some cases, led to intervention by the SFC. Directors and their advisers were reminded to comply with their statutory and other legal duties when evaluating or approving the acquisition or disposal of a company or a business.</p> |
| 2019 | <ul style="list-style-type: none"> • Statement on backdoor listing and shell activities (July) <p>The SFC published a statement explaining its general approach to utilising its statutory powers under the Securities and Futures (Stock Market Listing) Rules and the Securities and Futures Ordinance to tackle backdoor listings and shell activities.</p> <ul style="list-style-type: none"> • Circular on dubious private fund and discretionary account arrangements (November) <p>The SFC published a circular to provide guidance to assist asset managers in (1) considering if a proposed private fund and discretionary account arrangement or transaction is dubious and (2) deciding if they should proceed with a proposed arrangement or transaction that has been considered dubious.</p> <ul style="list-style-type: none"> • Statement on disclosure of ultimate beneficial ownership of counterparties (November) <p>The SFC emphasises the importance for listed issuers of ensuring that announcements, statements, circulars and other documents made or issued by them, or on their behalf, do not include materially false, incomplete or misleading information regarding their counterparties in a transaction.</p> |

The SFC's thematic review of licensed corporations conducting sponsor work identified a number of deficiencies in IPO sponsors' due diligence practices and internal systems and controls. The SFC's Report on Thematic Review of Licensed

Corporations Engaged in Sponsor Business⁷ noted serious deficiencies and instances of non-compliance in sponsors' work on some GEM IPOs, and instances where some sponsors did not take reasonable steps to follow up on their due diligence despite obvious red flags. This indicated poor professional judgement and a lack of professional scepticism. The SFC therefore reminded IPO sponsors of their responsibilities and the SFC's expected standards.

- Hong Kong IPO Sponsor Due Diligence

The SFC noted that IPO sponsors have repeatedly failed to apply professional scepticism and turned a blind eye to obvious red flags uncovered by due diligence. The SFC therefore reminds IPO sponsors that they should assess listing applicants scrupulously and objectively with a questioning mind and be alert to information which contradicts or brings into question the reliability of the facts they are seeking to understand. Detailed records of due diligence should also be kept to demonstrate compliance with regulatory requirements.

- Third parties' work

The SFC identified the problem that IPO sponsors rely excessively on third party professionals such as lawyers and accountants. The SFC reminds IPO sponsors that they carry ultimate responsibility for the quality and substance of the due diligence conducted by agents. It notes in particular, sponsors' responsibility for supervising agents and ensuring that they sufficiently understand the depth and scope of the task. They should also be satisfied that the agents may reasonably be relied upon to do the work.

- Oversight of junior staff of IPO sponsors

Another problem identified by the SFC was ineffective or insufficient senior management oversight of junior staff. Sponsor firms have a duty to ensure that effective personnel and controls are in place and that every aspect of the sponsor function is properly performed. This includes making sure that at least one senior management staff member has the requisite experience, knowledge and skill to closely supervise each engagement at all times.

- SFC Disciplinary actions against IPO sponsor principals

The SFC investigations examined whether failures were attributable to the sponsor principals and whether their supervision of the transactions was adequate. The SFC has taken a number of disciplinary actions, including the following:

SFC disciplinary actions against IPO sponsor principals

- **SFC disciplinary actions against the former sponsor principal of Standard Chartered Securities (Hong Kong) Limited (July 2018)**

In 2018, the SFC banned a former responsible officer of Standard Chartered Securities (Hong Kong) Limited, from re-entering the industry for three years. The SFC found that he had failed to (1) exercise due skill, care and diligence in handling the listing application; (2) ensure the maintenance of appropriate standards of conduct and Standard Chartered Securities (Hong Kong) Ltd.'s adherence to proper procedures; and (3) diligently supervise his subordinates and the sponsor work undertaken by Standard Chartered Securities (Hong Kong) Limited.

- **SFC disciplinary actions against the former sponsor principal of China Merchants Securities (Hong Kong) Co., Limited (February 2018)**

The SFC suspended the licence of a former responsible officer of China Merchants Securities (Hong Kong) Co., Limited, for 18 months for breaching the SFC Code of Conduct and the Sponsor Guidelines. The SFC found that he failed to (1) exercise due skill, care and diligence in handling the listing application; (2) ensure the maintenance of appropriate standards of conduct and adherence to proper procedures by China Merchants Securities (Hong Kong) Co., Limited; (3) diligently supervise his subordinates and the sponsor work undertaken by China Merchants Securities (Hong Kong) Co., Limited.

⁷ <https://www.sfc.hk/web/EN/files/ER/Reports/Report%20on%20the%20Thematic%20Review%20of%20Licensed%20Corporations%20Engaged%20in%20Sponsor%20Business.PDF>

SFC disciplinary actions against IPO sponsor principals

- **SFC disciplinary actions against the former sponsor principal of Sun Hung Kai International Limited (September 2014)**

The SFC suspended a representative in all regulated activities and withdrew approval for him to act as a responsible officer for three years. The SFC found that he failed to (1) assess the accuracy and the completeness of the information submitted by Sino-Life to demonstrate that it satisfied the financial requirements to list on GEM; (2) ascertain the existence of various encumbrances on the title of a major business deal of Sino-Life in Taiwan; (3) properly assess the business of Sino-Life's wholly-owned subsidiary in Taiwan; (4) ensure true, accurate and complete disclosure was made to HKEx and in Sino-Life's prospectus and breached the sponsor undertaking to HKEx by filing untrue statements in the sponsor declaration; and (5) keep proper books and records in relation to the sponsor work conducted.

- **SFC disciplinary actions against the former sponsor principal of UBS AG (March 2019)**

The SFC suspended the licence of Mr. Cen Tian for two years for failing to discharge his supervisory duties as a sponsor principal in charge of supervision of the execution of China Forestry and Tianhe.

IPO Due Diligence Case studies

- Design and execution of IPO due diligence plans

The SFC details a case of a sponsor who failed to adhere to the final due diligence plan prepared by its lawyers and did not document the reasons for not completing such work. The SFC also noted that the sponsor's due diligence focused on the listing applicant's production figures and failed to adequately verify sales figures. The SFC therefore advised sponsors to design their own customised due diligence plan for each listing applicant and adhere to it, and to properly document any deviations or updates and give reasons for them. It cautioned sponsors against a "box ticking" approach.

- Due diligence on financial information

The SFC notes a case of a sponsor who could not provide sufficient evidence and explanations to clarify anomalies in the listing applicant's financial information. In this case, a number of individuals spent unusually large amounts on certain days during the track record period. The SFC expressed concerns but the applicant did not respond and the application subsequently lapsed. The SFC therefore reminded sponsors to thoroughly understand a listing applicant's business model, industry environment and associated risks. Sponsors should also verify the key business assets of listing applicants, including their physical existence and legal entitlements. The SFC also reminded sponsors to seek the assistance of qualified and reliable experts when required.

- Customer due diligence

The SFC provided a number of cases of unsatisfactory practices of customer due diligence performed by firms. One sponsor changed its interview plans due to pressure from the listing applicant. Other interviews were arranged by the applicant or conducted in the presence of the applicant's representatives. In some cases, the sponsors failed to independently verify customers' identities, enquire into key areas such as transactions and sales, or follow up on discrepancies. The SFC therefore reminded sponsors to independently arrange due diligence interviews which are free from interference. It noted that interviews should be conducted at the interviewees' business premises, and their identities and authority must be verified by multiple items of proof. Sponsors are also responsible for asking unequivocal questions during interviews and keeping complete and accurate notes.

- Relying on experts

The SFC noted one particularly serious case that fell short of the standard expected of IPO sponsors. A sponsor relied on Mainland lawyers to verify certificates of legal title to the listing applicant's assets on the Mainland and made no attempt to understand the reasonableness of the steps taken to verify actual ownership. The law firm only performed a desktop review of the certificates without independently verifying their authenticity or the actual existence of the assets. The SFC therefore reminded sponsors to supervise and assess the work of third parties to ensure that the due diligence is reasonable and that any concerns have been addressed to their satisfaction.

- Red flags in IPO due diligence

The SFC provided an example of one sponsor who failed to provide satisfactory explanations upon the SFC's request. The SFC noted that both the listing applicant and the sponsor could not explain a decrease in the listing applicant's cost of inventories and an increase in its revenue after years of accumulated losses. The SFC wrote to the applicant to express its concerns and requested an explanation of the sponsor's independent due diligence. The applicant subsequently terminated the sponsor engagement and did not proceed with the application. In a separate case, a sponsor failed to conduct reasonable due diligence on short-term loans to customers which were guaranteed by connected persons including its chief executive officer and a company controlled by its second-largest shareholder. The sponsor did not initially disclose these guarantees, and only did so after several queries from the SFC.

In another case, a sponsor failed to look into third-party payment arrangements between the listing applicant and its customers despite clear red flags which cast doubt on the authenticity of the signatures on the agreements. The SFC therefore reminded and advised sponsors to review the information collected during the due diligence process with a sense of professional scepticism and to thoroughly follow up on any red flags.

- Supervision of junior staff of IPO sponsors

The SFC cited one case of a sponsor principal who acted as a "signing responsible officer" for a listing application and was involved neither in the due diligence nor the correspondence with the HKEx. The SFC further noted that the sponsor principal did not provide any guidance to the junior members of the deal team who conducted the customer interviews. The team was supervised by a managing director who was not a sponsor principal but was involved in the due diligence on the listing applicant's assets and operations.

The SFC reminded sponsors that the job of sponsor principal involves onerous duties and demands a high degree of professional judgement and a considerable investment of time. For each transaction team, there should at least be one qualified sponsor principal who can properly and adequately supervise the team. In relation to the requirements of a fit and proper sponsor principal, there are circumstances where the sponsor's capability to discharge its responsibilities is in doubt. In circumstances where a sponsor has a history of

returned or rejected listing applications or serious deficiencies and instances of non-compliance, frequent inspection visits and supervisory actions would be implemented.

SFC enforcement actions against IPO sponsor firms

Under the new sponsor regime implemented in October 2013, the disciplinary actions against sponsor due diligence failure are summarised as follows (against 11 firms resulting in fines totalling HK\$922.5 million):

| | Sponsor firms and action taken by the SFC | Listing applicant |
|-------------------|---|---|
| May 2019 | <ul style="list-style-type: none"> • China Merchants Securities (HK) Co., Limited <p>The SFC reprimanded and fined the sponsor firm HK\$27 million</p> | <ul style="list-style-type: none"> • China Metal Recycling (Holdings) Limited (China Metal) |
| March 2019 | <ul style="list-style-type: none"> • UBS AG and UBS Securities Hong Kong Limited <p>The SFC reprimanded and fined the sponsor firms a total of HK\$375 million; UBS Securities Hong Kong was suspended from acting as an IPO sponsor for one year</p> | <ul style="list-style-type: none"> • China Forestry Holdings; • Tianhe Chemicals Group Limited; • China Metal Recycling (Holdings) Limited |
| May 2019 | <ul style="list-style-type: none"> • Merrill Lynch Far East Limited <p>The SFC reprimanded and fined the sponsor firm HK\$128 million</p> | <ul style="list-style-type: none"> • Tianhe Chemicals Group Limited |

| | Sponsor firms and action taken by the SFC | Listing applicant |
|-------------|--|---|
| March 2019 | <ul style="list-style-type: none"> Morgan Stanley Asia Limited <p>The SFC reprimanded and fined the sponsor firm HK\$224 million</p> | <ul style="list-style-type: none"> Tianhe Chemicals Group Limited |
| March 2019 | <ul style="list-style-type: none"> Standard Chartered Securities (Hong Kong) Limited <p>The SFC reprimanded and fined the sponsor firm HK\$59.7 million</p> | <ul style="list-style-type: none"> China Forestry Holdings Company Limited |
| July 2018 | <ul style="list-style-type: none"> CCB International Capital Limited <p>The SFC reprimanded and fined the sponsor firm HK\$24 million</p> | <ul style="list-style-type: none"> Fujian Dongya Aquatic Products Co., Limited |
| May 2018 | <ul style="list-style-type: none"> Citigroup Global Markets Asia Limited <p>The SFC reprimanded and fined the sponsor firm HK\$57 million</p> | <ul style="list-style-type: none"> Real Gold Mining Limited |
| March 2017 | <ul style="list-style-type: none"> COCOM International (Asia) Limited <p>The SFC reprimanded and fined the sponsor firm HK\$15 million</p> | <ul style="list-style-type: none"> China Huinong Capital Group Company Limited |
| August 2016 | <ul style="list-style-type: none"> Quam Capital Limited <p>The SFC fined the sponsor firm HK\$800,000</p> | <ul style="list-style-type: none"> Gayety Holdings Limited |

| | Sponsor firms and action taken by the SFC | Listing applicant |
|--------------|--|---|
| January 2014 | <ul style="list-style-type: none"> Sun Hung Kai International Limited <p>The SFC reprimanded and fined the sponsor firm HK\$12 million, and suspended its sponsor licence to provide corporate finance advisory services for one year</p> | <ul style="list-style-type: none"> Sino-life Group Limited |

HKEx Listed Companies' Corporate transactions

The SFC adopted a front-loaded, multi-pronged approach to tackle misconduct by listed companies, including suspending the trading of a company's listed securities.

- Concealed share ownership and control

The SFC noted that concealed share ownership and control often appears as a component of shell-related activities, networks of companies, shareholders' vote rigging and "pump and dump" schemes. Some corporate transactions appear to be part of schemes to transfer control without disclosing the identities of the incoming controllers. In other cases, nominee accounts, margin financing, third-party financing arrangements and alternate forms of investment vehicles such as private funds have been used to conceal ownership.

- Suspect Valuations by HKEx Listed Companies

Valuation activities are currently unregulated in Hong Kong. Boards are free to appoint persons who they consider appropriate and qualified to act as valuers. Listed companies, directors and other professional parties relying on the valuation report may often allow the appointed valuers to override their own professional judgements. The SFC thus issued a statement⁸ in 2017 reminding listed company directors of their fiduciary duties in the valuation of corporate transactions. The SFC also issued a circular to remind intermediaries of the duties and standards of care due from financial advisers.

⁸ <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/statement-on-the-liability-of-valuers-for-disclosure-of-false-or-misleading-information/statement-on-the-liability-of-valuers-for-disclosure-of-false-or-misleading-information.pdf>

Another statement⁹ in July 2019 set out common scenarios in corporate transactions involving serious misconduct or lapses by directors or valuers.

- Warehousing of Shares and Nominee Arrangements

The SFC closely monitors the arrangements used for warehousing of shares, where actual control is disguised through the use of nominees, and where nominee arrangements are used for vote rigging and market manipulation. The SFC issued a circular¹⁰ in October 2018 reminding intermediaries to be vigilant in identifying potential red flags which may suggest the use of these arrangements for illegitimate purposes, make follow-up enquiries with clients and report suspicious transactions promptly.

- Highly Dilutive Rights Issues by HKEx Listed Companies

The SFC has seen highly dilutive rights issues and open offers structured or conducted in a manner which appeared to go against the interest of minority shareholders in recent years. The HKEx, after discussions with the SFC, introduced a series of measures to address this. Together with the SFC's front-loaded approach, the result was a substantial drop in the number of these transactions. There were also fewer deeply-discounted share placements, an area where the SFC often directly intervened.

Case studies

- Overvalued acquisitions by HKEx Listed Companies

The SFC cites two cases of overvalued acquisitions, where the companies were not able to provide satisfactory responses to inquiries from the SFC. The first case involved a company which proposed to acquire a majority interest in a target with minimal net profit and assets, where the vendor nonetheless guaranteed a 20-times higher profit than for the previous two financial years. The SFC was suspicious as to whether such a guaranteed profit was realistic and achievable. The SFC was also concerned that the acquisition may be prejudicial to the interests of shareholders given that the valuation was very likely not independently determined.

⁹ <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-the-conduct-and-duties-of-directors.html>

¹⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=18EC73>

The SFC issued a letter to the company expressing its concerns. The company later amended the terms of acquisition in the hope of reducing the SFC's concern. The SFC issued two further letters of concern and the company then proposed to acquire only a minority stake in the target at a substantially lower valuation. The SFC's third letter of concern noted that the new valuation seemed arbitrary and without basis. The company subsequently terminated the acquisition.

Another case involved a company which proposed to acquire a stake in a target which recorded losses for two consecutive years, while the company directors, made the assumptions that the target's estimated revenue growth rates would exceed 40% and its profit margin would turn positive. The SFC questioned the reasonableness and achievability of those assumptions, a letter of concern was later sent to the company expressing the SFC's concern as to whether the company's directors had discharged responsibly their fiduciary duties as directors. The company subsequently announced the termination of the proposed acquisition.

- Dubious acquisitions by HKEx Listed Companies

The SFC provided two cases of dubious acquisitions. The first case involved a company which proposed to acquire a target from its controlling shareholder by issuing new shares. The target's principal asset was a mainland property developed into a commercial complex. The SFC raised concerns about the acquisition announcement, which disclosed that the Mainland government prohibited the target from developing real estate. The company announced that it had obtained a legal opinion that this would not hinder it from carrying out the development project. However, after the SFC issued a letter of concern to the company, it announced the termination of the transaction.

Another case involved a company which proposed to acquire a 40.02% stake in a loss-making target with financing from several sources, including Mr. A. The SFC considered that the target did not appear to have a sizable business in property investment, so that it was unreasonable for it to support the company's proposed expansion in its investment property portfolio and to develop a new business in the hotel industry. The SFC raised concerns as to whether there were any disclosed relationships or arrangements among the company, the target, their respective controlling shareholders and Mr. A. The company announced a restructured transaction acquiring 19% of the target instead of 40.02%, and financed entirely by the company's internal cash resources, after the SFC issued a letter to the company. The SFC did not pursue the matter further as the transaction was restructured.

- Dubious fundraising by HKEx Listed Companies

The SFC cited two cases of dubious fundraising. The first case involved a company proposing a placing of new shares to raise money to develop its food and beverage business. However, the placing price was at a steep discount to net asset value and cash, while the company carried no debt. The amount raised from the placing would be small, the company did not appear to have an imminent need for funds and therefore, in this case, the dilution effect on its shareholders would be significant. The SFC therefore cast doubt on this action taken by the company, which it considered to be oppressive and unfairly prejudicial to the shareholders. The SFC later issued an initial letter of concern followed by a letter of mindedness. The company subsequently announced the termination of the transaction.

Another case involved a listed company which conducted two rounds of highly dilutive fundraising and proposed a third round under very suspicious trading circumstances. The SFC discovered undisclosed connections between some of the directors and shareholders who voted in favour of the fundraisings, and some directors also appeared to be connected to the buyers of the company's shares during the fundraising. The SFC later suspended the trading of the listed company.

HKEx Listed Issuer Directors' duties

The SFC expressed concern at the many cases of dubious corporate transactions involving directors' negligent conduct or failed avoidance of their conflicts of interest, particularly in view of the important role directors are supposed to play in managing the affairs of the company and guarding shareholders' interests. Shareholders are highly dependent on company directors having unswerving probity when dealing with conflicts of interest, being professional when deciding on important corporate transactions, and remaining vigilant in promptly and reliably disseminating corporate information.

It is the statutory obligation of directors to ensure that they have first-hand and in-depth knowledge of the business and its prospects and they should place themselves in a position where they can fully discharge their duties. These obligations are also embodied in the common law as well as in non-statutory provisions such as HKEx's Listing Rules.

Independent non-executive directors serve an indispensable role in supervising the corporate management team and protecting shareholders' interests even though they do not take part in the daily management of listed companies.

They thus play an important role in safeguarding the overall quality of the market, albeit indirectly. It is important that they openly communicate their views to all shareholders if there is disagreement between the management team and the independent non-executive directors, or if they believe that the interests of shareholders have been compromised. If they are to resign, substantive reasons for their resignation should be disclosed to investors.

The SFC reminds directors and senior officers that failing to discharge their duties will result in enforcement action. The SFC provided a recent precedent involving a network of listed companies and related entities where it worked with the Independent Commission Against Corruption (**ICAC**) to crack down on a highly suspicious and sophisticated scheme, allegedly designed to defraud shareholders. In that case, the joint operation resulted in four former executive directors of Convoy Global Holdings Limited being charged with conspiracy to defraud¹¹ by the ICAC.

¹¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR72>

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