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[online version](http://www.charltonslaw.com/hkex-amends-listing-rules-to-accept-mainland-accounting-and-auditing-standards-and-mainland-audit-firms-for-mainland-incorporated-companies-listed-in-hong-kong/)

# HKEx Amends Listing Rules To Accept Mainland Accounting And Auditing Standards And Mainland Audit Firms For Mainland Incorporated Companies Listed In Hong Kong

## Introduction

Hong Kong Exchanges and Clearing Limited ("**HKEx**") published on 10 December 2010 its Consultation Conclusions on the Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms for Mainland Incorporated Companies Listed in Hong Kong. These conclusions are a follow on to HKEx's August 2009 Consultation Paper, which sought views and comments from market participants on proposals to amend the Main Board and Growth Enterprise Market ("**GEM**") Listing Rules to accept financial statements prepared under Mainland accounting standards and audited by Mainland auditors using Mainland auditing standards for Mainland incorporated companies listed in Hong Kong. A reciprocal arrangement was also proposed. HKEx received thirty submissions in response to the consultation, of which the majority expressed general support for the proposals.

Amendments to the Listing Rules giving effect to the proposals came into effect on 15 December 2010 and can be viewed at [*here*](http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_ruleupdate.htm) and [*here*](http://www.hkex.com.hk/eng/rulesreg/listrules/gemrulesup/gemrule_update.htm).

China Accounting Standards for Business Enterprises ("**CASBE**") can be used to prepare financial reports starting from annual accounting periods ending on or after 15 December 2010. Existing H-share issuers which decide to adopt CASBE will be required to publish an announcement regarding the change since this is regarded as price sensitive information. The announcement should detail the reasons for the change and demonstrate the financial impact, if any, of the transition on its immediately preceding published financial information. Mainland incorporated listing applicants or issuers which decide to adopt CASBE for the preparation of their annual accounts for periods ending on or after 15 December 2010, must ensure that all financial information for all periods presented in a prospectus or circular issued after 15 December 2010 is prepared in accordance with CASBE.

In summary the framework advanced in the consultation paper and adapted by HKEx following their dialogue with the respondent market participants is as follows:

1. to allow Mainland incorporated Main Board and GEM issuers to prepare their financial statements using Mainland accounting standards;
2. to allow Mainland audit firms approved by the Ministry of Finance ("**MOF**") of China and the China Securities Regulatory Commission ("**CSRC**") to service these issuers using Mainland auditing standards; and
3. to provide for a reciprocal arrangement to allow companies incorporated or registered in Hong Kong and listed on the Mainland to prepare their financial statements using Hong Kong Financial Reporting Standards ("**HKFRS**") or International Financial Reporting Standards ("**IFRS**") and have them audited by Hong Kong audit firms registered with the Hong Kong Institute of Certified Public Accountants ("**HKICPA**") using Hong Kong Standards on Auditing ("**HKSA**") or International Standards on Auditing ("**ISA**").

For A and H share companies which are listed both on the Mainland and in Hong Kong, the amended rules allow them to produce just one set of financial statements based on CASBE, whereas previously they had to prepare an additional set in accordance with either HKFRS or IFRS. The MOF and CSRC have reportedly approved a list of 12 Mainland accounting firms to act as reporting accountants and/or auditors of H-share companies which is available in Chinese on HKEx's website at [*here*](http://www.hkex.com.hk/eng/rulesreg/listrules/listsptop/afmlist.htm).

## Background To The New Regime

The backdrop to these developments is the continuing convergence of the CASBE with IFRS and HKFRS, and the convergence of Mainland auditing standards with Hong Kong auditing standards. This commitment to moving towards a single set of accounting standards was made clear in 2006 when the MOF announced the implementation of new Mainland accounting standards that brought substantial convergence between Mainland accounting standards and IFRS. All companies incorporated in China and listed on Mainland stock exchanges were required to use the new standards from 1 January 2007.

In response to concerns expressed by some market participants during the Consultation Process for the new mutual recognition framework, regarding the need for a mechanism to ensure that this convergence continues, HKEx pointed to the Joint Declaration of 6 December 2007 signed by the HKICPA and the China Accounting Standards Committee. This stated that there was substantial convergence between CASBE and HKFRS and included details of a mechanism designed to guarantee the continuation of this convergence process. This mechanism has been in operation since December 2007 and regular meetings (at least twice yearly) are held by HKICPA, MOF and the International Accounting Standards Board regarding on-going convergence of CASBE and HKFRS/IFRS.

This drive for convergence between Hong Kong and the Mainland is also evident in relation to auditing standards. Also on 6 December 2007, the China Auditing Standards Board and the HKICPA jointly announced the convergence of China Auditing Standards with the Hong Kong Standards on Auditing. As HKICPA adopts International Standards on Auditing, this declaration means the effective convergence of Mainland auditing standards with International Standards on Auditing.

## The New Framework For Accounting And Auditing Standards

The new system developed by the HKEx during the consultation process is designed to provide Mainland incorporated companies listed in Hong Kong with the option of preparing financial statements using CASBE and auditing those statements in accordance with Mainland auditing standards. It also allows Mainland audit firms approved by MOF and CSRC to act as auditors and reporting accountants of Mainland incorporated companies listed in Hong Kong. Finally provision is made for a reciprocal arrangement permitting companies incorporated or registered in Hong Kong and listed in the Mainland to prepare their financial statements using HKFRS/IFRS and allowing those statements to be audited by Hong Kong audit firms registered with the HKICPA using HKSA or ISA.

All of the amendments to the Main Board and GEM Listing Rules are discussed briefly in the annex to this note but the following matters in relation to accounting standards should be highlighted:

1. Reconciliation: Due to convergence between HKFRS and IFRS, the requirement for reconciliations between IFRS and HKFRS will no longer be necessary. Likewise, given the convergence between CASBE and HKFRS, the requirement for reconciliation between CASBE and HKFRS or IFRS is no longer be necessary.
2. Five-year historical summary: The Rules (Main Board Appendix 16.19, GEM Rule 18.33) require listed issuers to provide a five-year historical summary of financial data. An issuer adopting CASBE may not have financial data based on CASBE for five years since CASBE was only introduced from 1 January 2007. Accordingly, if an existing listed issuer has a financial history which extends to a date before 1 January 2007, the issuer is expected to explain the reasons and show financial information for the earlier years under HKFRS or IFRS, as the statements from these years would have been prepared under the previous Rules.
3. Transaction Circulars: An issuer that elects to adopt CASBE for annual financial reporting purposes will also be required to prepare financial information included in transaction circulars under CASBE.

### In relation to the acceptance of Mainland audit firms the key elements of the new regime are as follows:

The principle underlying the proposals is that Mainland audit firms of companies listed in Hong Kong should be subject to a level of regulation equivalent to that in Hong Kong. The framework governing Mainland auditors includes the following elements:

1. reliance and co-operation with existing Mainland regulatory authorities that regulate Mainland audit firms;
2. approval and registration of the audit firms that will be eligible to service companies listed in Hong Kong;
3. monitoring and continuing oversight of the quality of the work of the approved audit firms;
4. arrangements for investigation and sanctions against approved audit firms; and
5. the requirement that the approved audit firm have an appropriate level of knowledge of the Hong Kong listing rules, the Hong Kong Companies Ordinance, the Financial Reporting Council Ordinance and Hong Kong local practices as required by Mainland audit firm professional standards.

### Approval and registration of Mainland audit firms

Under the framework, a Mainland audit firm proposing to act as an auditor or a reporting accountant for a Mainland incorporated company listed in Hong Kong will have to be separately approved and registered by MOF and CSRC. The qualification requirements will be agreed between the Hong Kong and Mainland regulators. The agreed qualification requirements are required to cover the relevant auditing standards, quality control standards and code of ethics for professional accountants and the experience, resources and capabilities of the audit firms in auditing listed companies (paragraph 6 of the Proposed Framework for Implementation at Appendix 1 to the Consultation Paper). The Mainland regulators may add to the agreed qualification requirements. The Hong Kong regulatory authorities will be notified of approved Mainland audit firms and the Exchange will maintain a list of such firms on its website.

One issue considered by the Hong Kong regulators in formulating the proposals, was whether the Exchange should have the right to reject a Mainland audit firm. It was decided that this was not necessary since the Exchange already has the power to pre-vet listed companies'/listing applicants' documents (e.g. prospectuses and transaction circulars) prior to their release and may reject documents. The powers to reject documents are contained in Main Board Rules 9.07 and 13.52 (GEM Rules 12.15 and 17.53) under which documents may not be issued until the Exchange has confirmed that it has no further comments. In particular cases, the Exchange may refuse to accept documents that have not been properly prepared.

In the case of documents that are post-vetted (e.g. annual and interim reports and announcements), the Exchange can require supplementary announcements to be published and can make a complaint to the FRC or the HKICPA to take appropriate action. Under the proposed framework, complaints in relation to a Mainland auditor of a Hong Kong listed issuer can be referred by FRC to MOF and CSRC.

### Deregistration of Mainland audit firms

The MOF and CSRC will remove a Mainland audit firm from the approved list if they become aware that the firm ceases to meet the qualification requirements for registration or fails to take appropriate steps to rectify the position. They will advise the Hong Kong regulators of withdrawals of approvals and the Exchange will remove the firm from the approved list.

### Monitoring and continuing oversight of Mainland firms

Monitoring and continuing oversight of approved Mainland audit firms will be carried out by MOF and CSRC. Those firms will be subject to monitoring through practice review inspections by on-site visits and reviews of audit working papers and other files. In their oversight of such firms, MOF and CSRC will assess and monitor compliance with the China Standards on Quality Control and other Mainland auditing standards. Generally speaking, the Hong Kong regulators will not request practice review inspections of Mainland audit firms, as these will be conducted by MOF and CSRC.

### Investigations and Sanctions

Mainland audit firms will be required to respond promptly to any enquiries from MOF or CSRC and will be subject to any sanctions which such bodies consider appropriate. If the Hong Kong regulators have reason to believe that a Mainland audit firm should not be an approved audit firm, the FRC will be able to ask MOF and CSRC to investigate the matter and advise the Hong Kong regulators of the outcome. MOF and CSRC are also able to initiate enquiries. To facilitate enquiries, Mainland audit firms are required to retain their working papers for at least 10 years from the date of the auditors' report. This is more stringent than the Hong Kong requirement which requires retention of working papers for a minimum of 5 years.

As is the case for all audit firms servicing Hong Kong listed companies, Mainland audit firms servicing such companies will be subject to the provisions of the Financial Reporting Council Ordinance. As the FRC and HKICPA have no statutory power to impose fines and penalties on Mainland audit firms, the MOF and CSRC will be responsible for imposing appropriate disciplinary actions and sanctions against Mainland audit firms.

## The Consultation Response - Some Of The Key Points Addressed

As noted above the reaction to the HKEx proposals was largely positive, with the following being put forward by market participants as the central reasons for their support:

1. Mainland accounting and auditing standards are substantially converged with Hong Kong and international standards and it is appropriate to accept them.
2. The framework is in line with the direction of global convergence and will reduce the cost of preparing financial statements, increase cost effectiveness and encourage more timely disclosure to the market, enhancing market efficiency.
3. The scheme provides flexibility in the choice of auditors and reporting accountants and will create new opportunities for auditing and accounting professions in Hong Kong and the Mainland. It should also encourage more Mainland company listings in Hong Kong.

However despite the vast majority of the feedback being supportive in nature some of the concerns raised by the respondents merit discussion:

### Regulatory Regime for Mainland Audit Firms

Some respondents expressed concern that Hong Kong investors do not have a clear understanding of the regulatory regime which applies to Mainland audit firms and this may have an impact on investors' confidence and, by extension, the quality of the capital market in Hong Kong. There was also concern that Mainland auditors lack familiarity with Hong Kong's regulatory requirements which could adversely affect audit quality. However HKEx noted that Mainland auditors are required to comply with China Standards on Quality Control, which requires them to be knowledgeable regarding any relevant local rules, regulations and practices concerning their clients.

Moreover, Mainland auditors are governed by the PRC Law on Certified Public Accountants and are subject to a system of practice review by the MOF and the China Institute of Certified Public Accountants to monitor and ensure audit quality. A HKICPA study allowed HKEx to conclude that the practice review systems of the PRC and Hong Kong are of similar quality, with the latter more timely and efficient and the former more thorough, as the Mainland regulators take additional time to complete their practice reviews, their work involves re-performance of audit tests undertaken by the audit firms and they perform surprise visits of audit firms. Finally, HKEx highlighted the fact that the memoranda of understanding and co-operation agreements between the Hong Kong and Mainland regulators in relation to the new framework will enable efficient and effective monitoring and investigation of Mainland audit firms.

### Quality of Mainland Audit Firms

Another respondent expressed anxiety that it would be difficult for investors to ascertain the quality of Mainland audit firms serving Hong Kong listed companies. However HKEx responded that MOF and CRSC intend to ensure only the larger Mainland audit firms are allowed to service Hong Kong listed entities and also that the framework was developed based on mutual recognition. This latter point means that audit firms only need to comply with requirements imposed by their home registration jurisdiction and it would be therefore inappropriate to apply further regulation in Hong Kong.

### Reduced Influence of Hong Kong Regulators Research

A further concern expressed by market participants related to what they saw as the reduced influence of Hong Kong based regulators, as they feared that too much reliance was being placed on Mainland regulators with regard to Mainland auditing firms, with Hong Kong's regulators lacking the necessary capability to oversee their activities. However, as HKEx pointed out, the framework was devised on the basis that it would have no change in existing legislation including the establishment of additional regulatory bodies. The aim is rather that the memoranda of agreement and cooperation agreements between the regulators of the two jurisdictions ensure that regulation occurs at the optimum level and in the optimum location. Furthermore, it should be highlighted that nothing in the new framework affects the rights of investors to take action against a company, its directors and its auditors. Finally any suspicion of possible misconduct by Mainland audit firms may be reported to the Financial Reporting Council, who may seek assistance from MOF in order to investigate the matter.

### Disclosure in Financial Statements of transition to use of CASBE

The suggestion was made that when an issuer made the transition to CASBE from another accounting standard there should be a requirement to make a specific disclosure of the same and to include a reconciliation statement in the financial statements to reconcile the net profit or loss under CASBE to the figure under HKFRS/IFRS. HKEx addressed this by noting that in the Consultation Paper it had been made clear that issuers who take the decision to start preparing financial statements under CASBE should release an announcement regarding the change, detailing the reasons why the change was made and demonstrating the financial impact, if any, of the transition. It was also noted in the Consultation Conclusions that an issuer should not normally revert back to another standard once it decides to change to CASBE. Listed issuers should choose which set of accounting standards is most appropriate for them and use that set of accounting standards continuously. Finally, there should not generally be any significant impact on the issuers' results or financial position due to the adoption of CASBE.

*This note contains a summary only of the amendments to the Listing Rules set out in HKEx's Consultation Conclusions on the Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms for Mainland Incorporated Companies Listed in Hong Kong. Specific advice should be sought in relation to any particular situation.*

## Annex

### Amendments to Rules for Main Board Listed Companies

In order to implement the new proposals the Main Board Listing Rules have been amended as follows:

Rule 1.01 has been amended to include definitions for CASBE, CAS, ISA and "practising accountants"

Rule 4.03 has been amended by the inclusion of the word "normally", with the effect that it is no longer a strict requirement that accountants' reports be the work of certified public accountants with certain qualifications and levels of independence. They may now be prepared by "practising accountants" (defined as an individual, firm or company qualified for appointment as an auditor or reporting accountant of a company) if the Exchange deems this acceptable.

Rule 4.05 has been amended to allow segmental information in the balance sheet and income statement to be prepared in accordance with the HKFRS, IFRS or CASBE in the case of PRC issuers who have adopted CASBE for the preparation of its annual financial statements.

Rule 4.10 regarding disclosure of the information noted in Rules 4.04 to 4.09 now allows for said information to be prepared in accordance with CASBE in the case of PRC issuers who have adopted CASBE for the preparation of their annual financial statements.

Rule 4.11 regarding Accounting Standards now permits the financial history of results and the balance sheet included in the accountant's report to be assembled in conformity with CASBE in the case of PRC issuers who have adopted CASBE for the preparation of their annual financial statements. In addition should this information be prepared in accordance with IFRS the requirement to explain the differences in accounting practices with HKFRS and their financial effects has been removed. Issuers must apply IFRS, HKFRS or CASBE consistently and should not switch between them.

Minor amendments have been made to Rules 14.04, 14.15, 14.17, 14.19 in order to remove the requirements to comply with IFRS or HKFRS and allow compliance to be achieved through a PRC issuer applying the accounting standards adopted for the preparation of its annual financial statements.

Rule 14.68 in relation to circulars concerning very substantial disposals of a business or company/companies has been amended so that the review of the financial information involved must be performed in accordance with the standards of either the Hong Kong Institute of Certified Public Accountants or the International Auditing and Assurance Standards Board of the International Federation of Accountants or the China Auditing Standards Board of the China Ministry of Finance. Previously only the standards of the Hong Kong based body were acceptable.

Rule 19A.01 regarding the application of the Listing Rules to PRC issuers has been amended to allow such issuers to present their annual accounts in accordance with HKFRS, IFRS or CASBE.

Chapter 4 of the Listing Rules concerning Accountants' Reports and Pro Forma Financial Information has been quite extensively altered in order to give effect to the new regime. Rule 19A.08 now includes the word "normally" in relation to the independence and qualifications of the reporting accountants of the PRC issuer. This extra flexibility provided by the word "normally" is included in order to give full effect to the new Rule 4.03 above and allow the Exchange to accept a firm of "practising accountants" which has been approved by the China Ministry of Finance and the China Securities Regulatory Commission as being suitable to act as an auditor or a reporting accountant for a PRC incorporated company listed in Hong Kong.

Rule 19A.09 now allows for reports which include accounts audited under International Standards on Auditing or China Auditing Standards. Rule 19A.10 has been changed to the effect that there is no longer a need for reconciliation between PRC accounting standards and those of the IFRS or HKFRS.

Rule 19A.31 has been amended to include the following among the categories of those who may audit the accounts of a PRC incorporated issuer: "practising accountants" of international name and reputation, who are members of a recognised accounting body and acceptable to the Exchange, firms of "practising accountants" which are joint ventures acceptable to the Exchange and approved by competent authorities in the PRC and finally, in a completely new category, a firm of practising accountants which has been approved by the China Ministry of Finance and the China Securities Regulatory Commission as being suitable to act as an auditor or a reporting accountant for a PRC incorporated company listed in Hong Kong.

Rule 19A.32 no longer specifically demands that accounts be audited to the standards of named professional bodies in Hong Kong, such as the International Federation of Accountants, and now simply requires they be audited to a standard comparable to that required in Hong Kong, or under the International Standards on Auditing or the China Auditing Standards.

Rule 19A.36 now allows auditor reports in relation to PRC issuers whose primary listing is to be on another stock exchange to conform to International Standards on Auditing or China Auditing Standards.

Rule 19A.39, which explains what references to an issuer's accounts in Chapter 14 shall mean in relation to PRC issuers, now states that the word "accounts" in this context refers to the most recently published audited or consolidated accounts prepared in accordance with the HKFRS, IFRS or CASBE.

In Appendix 15, Banking Reporting Part 1, which sets out the information which must be contained in specified disclosures by the issuer (e.g. in an interim report), the acceptable accounting standards have been widened to include the CASBE. Parts 2 and 3 which specifically discuss interim and annual reports have also been amended to give effect to the new rules on acceptable accounting standards.

Appendix 16 sets out Requirements for All Financial Statements and paragraph 2.1 has been amended to ensure that accounting policies and explanatory notes are now acceptable if they conform with HKFRS, IFRS or CASBE in the case of PRC issuers who have adopted CASBE for the preparation of annual financial statements. The requirement for annual accounts to include reconciliation between IFRS and HKFRS, and the exemption for PRC issuers from that requirement (at paragraph 2.3), have been removed. Note 2.2 now includes the word "normally" in the sentence prohibiting changing from one standard to another, giving issuers some flexibility in relation to the standard used. Finally Note 2.6 ensures that reconciliation with HKFRS/IFRS is not required for PRC issuers using CASBE but is required in the case of overseas issuers using accounting standards other than those mentioned in Note 2.1.

Appendix 15 paragraph 1(III) on the requirement for banks' financial reports to include segment information has been altered to ensure that this information is acceptable if prepared in accordance with CASBE. Note 7 on Information in Financial Reports has been altered to the same effect.

Appendix 16 paragraph 8 (3) regarding related party transactions has been amended so that there are no longer references to specific accounting standards but only to "applicable accounting standards adopted for the preparation of its annual financial statements". Similarly, paragraph 38 replaces references to specific accounting standard rules with a more general requirement to abide by the requirements of the HKFRS, IFRS or CASBE in relation to interim reporting.

### Amendments to Rules for GEM Listed Companies

The effect of the changes to the GEM Rules is very similar to that outlined above for Main Board Companies. The same new definitions have been inserted into Rule 1.01 and the same changes made to Rules 7.02 on Reporting Accountants and 7.04 on Segment Information as to their Main Board counterparts. Rules 7.11 and 7.12 on Disclosure and Accounting Standards have been amended in almost identical fashion to the corresponding Main Board Rules 4.10 and 4.11 respectively

Rule 11.12A (1) regarding the requirement to submit a cash flow statement to the Exchange has been amended to the effect that the statement no longer need comply with Hong Kong Accounting Standard 7 but rather with the relevant rules in the HKFRS, IFRS or CASBE. Rules 18.04 - 18.06 on accounting standards have been changed to ensure that CASBE may be used by PRC issuers when preparing the annual accounts and that no reconciliation with HKFRS or IFRS is required for such issuers.

Rule 18.08 has been amended to the effect that the segmental information an issuer provides in its financial statements must be that which is required under the standard it adopts for its annual statements, i.e. the HKFRS, IFRS, Generally Accepted Accounting Principles in the United States of America ("**US GAAP**") or CASBE. The same alteration is made to segment information in respect of banking companies in Rule 18.80. The explicit acceptance of US GAAP in certain specified circumstances is a key difference between the Main Board and GEM Listing Rules in this area. Rules 18.09 and 18.20 regarding disclosure of related party transactions and departures from permitted accounting standards have been amended to give effect to the new framework by allowing them to be made in accordance with the applicable accounting standard used for the issuer's annual financial statements.

The additional segmental information required of Financial Conglomerates by Rule 18.37A must now be issued in the accounting standard in which the issuer's annual reports were prepared, be it IFRS, HKFRS or CASBE. The same result is achieved with regard to segment information in the balance sheet and income statement of an issuer by Rule 18.50B due to the changes to Rule 18.55, regarding half yearly reports.

Other minor alterations are made in Notes 2 (b) and (c) to Rule 19.04, Rule 19.15 (1),Rule 19.17 and Rule 19.19 all of which are aimed at giving full effect to the new ability of PRC issuers to prepare their annual financial statements under CASBE.

Rule 19.68 in relation to circulars concerning very substantial disposals of a business or company/companies has been amended so that the review of the financial information involved must be performed in accordance with the standards of either the Hong Kong Institute of Certified Public Accountants or the International Auditing and Assurance Standards Board of the International Federation of Accountants or the China Auditing Standards Board of the China Ministry of Finance.

Rule 25.01 concerning PRC incorporated issuers is modified in almost an identical manner to the equivalent Rule 19A.01 in the Main Board Rules. This is also the case with GEM Rules 25.25 and 25.26 on auditors, amended in the same fashion as Main Board Rule 19A.31 and 19A.32. Similarly GEM Rule 25.44 on the meaning of the word "accounts" in relation to PRC issuers is amended in the same way as the corresponding Main Board Rule 19A.39.

With regard to the continuing obligations of issuers, Rule 31.40 on accounting standards now permits the use of CASBE as set out in Rules 18.04 to 18.06, Rule 31.43 demands that accounts be audited either to the standards required in Hong Kong or to those set out by the International Standards on Auditing or China Auditing Standards and Rule 31.56 is amended to ensure that issuers must publish a statement explaining the reason for a departure from the accounting standard used in preparing the issuer's annual accounts.

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