Charltons - Hong Kong Law Newsletter - 21 January 2011

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# SEHK And SFC Publish Joint Consultation Paper Proposing Changes To Property Valuation Requirements

## Introduction

On 3 December 2010 the Securities and Futures Commission ("**SFC**") and Stock Exchange of Hong Kong ("**SEHK**") released a joint consultation paper (the "**Consultation Paper**") outlining proposals to change the requirements for property valuation disclosure in applicants’ prospectuses and issuers' circulars and seeking responses to those proposals. The central aims behind the proposals put forward in the paper are (i) to remove unnecessary burdens on applicants and issuers and (ii) to require the disclosure of meaningful information to investors.

At present the regulatory framework for property valuations is to be found in the Companies Ordinance ("**CO**") and the Listing Rules. These property valuation obligations have been roundly criticised in the past for being unduly burdensome, unnecessarily costly and for providing information which is actually of little use to investors. They are examined in detail later in this newsletter.

The long term aim of the SEHK and SFC, as stated in the Consultation Paper, is the removal of the property valuation requirements for non-property applicants from the Listing Rules. However this is impossible without the amendment of the CO, so another route must be taken for the time being.

The SFC intends to implement these proposals through the issuance of a class exemption notice [[1]](#footnote-24) under sections 38A(2) and 342A(2) of the CO. The relevant Main Board and GEM Listing Rules will also be amended by the SEHK, in conjunction with the SFC, with the main changes occurring in Chapter 5 and Chapter 8 respectively, both of which are entitled "Valuation of and Information on Properties". This class exemption notice is subject to negative vetting by the Legislative Council. The new class exemption notice and details of amendments to the Listing Rules are contained in Appendix III and IV A and B of the Consultation Paper, which is available at [*here*](http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201012.pdf).  
 The proposals relate to both issuers and applicants. Those relating to applicants have been split into two sections; (i) property valuation requirements in respect of business activities involving property development and investment; and (ii) property valuation requirements in respect of other business activities.

## Background To The Proposed Reform

The Listing Rules' requirements for applicants in relation to property valuation have hardly been altered since the unification of the Hong Kong exchanges in 1986. Listing applicants are required to include property valuation reports and information relating to all their properties in their listing documents. As noted above, property valuation reports are also required to be included in prospectuses, in certain circumstances, under the CO.

In 1997, the Exchange introduced an exemption into the Listing Rules from detailed disclosure in listing documents and circulars for operating leases that have zero value, the purpose of which was to reduce the sheer bulk of a prospectus. A corresponding exemption in the CO was introduced in 2001 [[2]](#footnote-27). The applicant is still required to obtain property valuations for all operating leases and full valuation reports must be available for public inspection.

Property valuations were not originally required for issuers under the Listing Rules but are now required in specific circumstances, for example, where any of the percentage ratios used to classify a property acquisition or disposal is or is above 25%.

Reform is required, according to the SFC and SEHK, due to the changing profile of issuers in Hong Kong. When the rules were devised the market in Hong Kong was dominated by property companies with considerable local interests. However, at the present time, as a result of Hong Kong’s role as an international finance centre, most issuers are international in nature and hold far more property outside Hong Kong. A 2008 review of the Hong Kong Securities Market, conducted by an outside consultant engaged by Hong Kong Exchanges and Clearing Limited ("**HKEx**"), recommended the abolition of property valuation requirements for non-property companies. This recommendation echoed the complaints of market practitioners in that it highlighted the burdensome, costly and not particularly useful nature of the valuation requirements.

## The Current Regulatory Framework

### Current Property Valuation Requirements for Applicants

#### Companies Ordinance Requirements

The CO [[3]](#footnote-31) requires a company to include in its prospectus a valuation report for all its interests in land or buildings (including interests held as a lessee under an operating lease) if the interests shown in the company's last accounts exceed 10% of its assets, or have a value of not less than HK$3,000,000.

Section 6 of the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice ("Operating Leases Exemption Notice"), which applies to prospectuses only, exempts disclosure in the prospectus of detailed valuation reports on operating leases if:

1. the value of the interest of the company, or any of its subsidiaries, in the land or buildings has been determined by an independent qualified valuer;
2. the value of the interest determined is zero;
3. the valuation report has been given to the Exchange and is available for public inspection; and
4. a summary of all interests in land or buildings covered by the exemption is included in the prospectus.

#### Listing Rules

Rule 5.01 states that valuations of and information regarding all the issuer's interests in land and buildings must be included in a listing document issued by an applicant. Practice Note 16 ("**PN 16**") to the Listing Rules is similar to the Operating Leases Exemption Notice mentioned above in relation to the CO but applies to both listing documents and circulars.

Rule 5.07 provides that the effective date at which the property was valued must not be more than three months before the issue date of the listing document. The Listing Rules also set out the content requirements for valuations reports and an independence requirement for the valuer.

#### Key Problems with these Regulations as identified by the Consultation Paper

An applicant seeking a listing in Hong Kong must obtain independent valuations for all its property interests and include the valuation reports in its listing document. As noted above these requirements are often unnecessarily costly, unduly burdensome and do not provide information which is of use to investors. These considerations apply in particular to valuations of property interests which are not material to an applicant’s business, valuations conducted when property development and investment is not the core business activity of the applicant and valuations of properties held under operating leases.

### General Disclosure Obligation for All Applicants - Guidance from the SEHK and SFC

There are at present very similar general disclosure obligations in the CO [[4]](#footnote-35) and the Listing Rules [[5]](#footnote-36), which effectively state that the prospectus must include sufficient information to allow an investor to come to an informed judgment regarding the securities, profitability and financial condition of an applicant, at the time of the issue of the prospectus. These general disclosure obligations may make more specific property valuation rules redundant in the future, although that would require an amendment to the CO.

The general disclosure obligations may require more disclosure than the minimum proposed in the Consultation Paper by the SFC and SEHK and the factors which they state should be taken into account by applicants when deciding if additional disclosure is required are as follows:

#### In relation to disclosure of material property interests

Applicants must disclose information on material property interests and that information must be of meaningful use to investors when assessing the status of the company. The SFC and SEHK state that when considering what information is material and must therefore be disclosed, sponsors and applicants are expected to take into account all relevant circumstances and disclose property valuations and/or relevant information for material property interests. The following are listed in the Consultation Paper as a non-exhaustive list of relevant factors when considering materiality:

1. whether the property interest is used for a reportable segment of the applicant and if so, whether it contributes a significant amount of revenue;
2. whether any encumbrances exist on the property or use of the property that may, at any time, directly or indirectly impact the operations of the applicant’s reportable segment;
3. whether there are any defects relating to the property or its operations that may have major impact on the applicant’s business or operations, e.g. title defects
4. whether there is re-development potential for the property that may impact the applicant’s financial position.

Sponsors and applicants are also expected by the SFC and SEHK to conduct adequate due diligence on the properties, even in the absence of an obligation to obtain an independent valuation or include a valuation report in a prospectus or circular. It is noted in the Consultation Paper that special attention should be paid to the issue of legal title.

The SFC and SEHK also propose the following non-exhaustive list of factors as guidance for applicants when considering what descriptive information should be released regarding material properties. This kind of information is expected to be released regardless of whether valuation reports are already specifically required to be disclosed by the Listing Rules.

1. a general description of where the property is located (rather than simply its address) and some market analysis. For example, whether the property is located in the central business district, supply and demand information, occupancy rates, trends in property yield, sales prices, rental rates etc.;
2. use and approximate area;
3. any restrictions on its use;
4. an indication of how the assets are held. For example, owned or leased. If leased, the remaining term;
5. details of encumbrances, liens, pledges, mortgages against the property;
6. environmental issues, such as breach of environmental regulations;
7. details of investigations, notices, pending litigation, breaches of law or title defects;
8. future plans for construction, renovation, improvement or development of the property and estimated associated costs; and
9. any other information considered important for investors.

## The New Regulatory Framework For Valuation Reports For Applicants

### The Definition of Property Activities and Property Interests under the Proposals

#### For valuation requirements the SFC and SEHK propose to define "property activities" as:

*"holding (directly or indirectly) and/or development of properties for letting and retention as investments, or the purchase or development of properties for subsequent sale, or for retention as investments. It does not include holding of properties for own use."*

#### Property interests are to be defined as:

*"land or buildings (completed or constructions in progress). For buildings, we propose to include fittings and fixtures, which should include building services installation such as plumbing and pipes, electrical instalments, ventilation systems, escalators and improvements generally. We do not intend to include equipment and machinery used for production."*

The Consultation Paper also provides some examples as to what the SFC and SEHK consider a property interest to be for the purposes of the proposals:

1. one or more units in the same building;
2. one or more properties located at the same address or lot number;
3. one or more properties comprising an integrated facility;
4. one or more buildings, structures or facilities comprising a property development project (even if there are different phases);
5. one or more properties held for investment in one complex;
6. one or more buildings, structures or facilities located contiguous to each other or located on adjoining lots and used for the same or similar operational / business purpose; or
7. project presented as a whole to the public as one project or forming a single operating entity.

The Consultation Paper also addresses here the issue of operating leases, the valuations of which have been criticised as unnecessary and irrelevant for investors. An operating lease is treated as a property interest. Under current accounting standards, rental payments under operating leases from a lessee's view point are normally recognised as expenses and the carrying amount in the balance sheet is zero. As a direct result of this, under the proposals, valuations will not be required for operating leases. The SFC intends to repeal the Operating Leases Exemption Notice as operating leases will be covered under the proposed definition of "property interest" in paragraphs 67 to 69. Similarly, the Exchange also intends to repeal PN 16.

However, the Consultation Paper also highlights the possibility that the International Accounting Standards Board ("IASB") and the US Financial Accounting Standards may, in the second quarter of 2011, follow through on proposals to recognise the right to use leased items under operating leases as an asset and the related obligation to pay rentals as a liability. If these proposals on lease accounting are adopted, and at that time the Operating Lease Exemption Notice and PN 16 have already been repealed and the proposals in the Consultation Paper have been adopted and become effective, the SFC and SEHK will consider consequential amendments to the new class exemption notice and Listing Rules.

### Contents of Valuation Reports

In addition to the Listing Rule requirements, the SEHK and SFC expect that the valuation reports should include "relevant information". This information, which may not currently be disclosed in valuation reports, is required under the applicable valuation standards mentioned under Rule 5.05. They include:

1. the basis of and approach to valuation for the property interest;
2. when the site was last inspected;
3. extent of investigation, including details of inspection, such as building conditions, availability of building services, etc.;
4. nature and source of information relied on;
5. details of title and ownership;
6. details of encumbrances; and
7. how the properties are grouped together for each valuation certificate.

The SFC proposes that the disclosure requirement in the class exemption notice should, to the extent necessary, reflect the Listing Rules requirements.

### Proposal for Effective Date of Valuation

Rule 5.07 states that the effective date at which the property was valued must not be more than 3 months before the date on which the relative listing document is issued. Rule 8.06 states that the latest period reported on by the reporting accountants must not have ended more than 6 months before the date of the listing document. It is not proposed in the Consultation Paper to amend these dates.

## Proposals For Property Activities

The proposals are as follows:

1. Valuation reports for all property interests, bar those with a carrying amount [[6]](#footnote-45) below 1% of the applicant’s total assets, must be obtained. The total carrying amount of property interests not valued must not exceed 10% of the applicant's total assets [[7]](#footnote-46). Full text valuation reports for valued property interests will be required to be disclosed in the listing document, except where summary disclosure is allowed.
2. In order to reduce the volume of listing documents required, summary disclosure of valuation reports for property interests valued at below 5% of the applicant’s total valued property interests will be permitted, although detailed valuation reports must be made available to the public.
3. An overview of property interests not required to be valued must be disclosed, including information on their location, number, intention of use, type of holding and approximate size range.

The Consultation Paper also proposes that the terms of the class exemption notice apply to prospectuses for unlisted companies, as well as applicants for listing.

## Proposals For Non-Property Activities

Generally an applicant will own and occupy, for its own use, the property interests of its non-property activities. The Consultation Paper proposes disclosure in respect of these interests as follows:

1. Publication of a valuation report for each property interest with a carrying amount of 15% or above of total assets. However an applicant may be required to include a valuation report if this is needed to satisfy the general obligation requirements. The applicant will also be required to include a statement that no other single property interest of its non-property activities has a carrying amount of 15% or above of its total assets.
2. The listing document must include an overview of property interests not required to be valued, including information on their location, number, intention of use, type of holding and approximate size range.
3. Valuation of property interests ancillary to mining activities will not be required, if the prospectus includes a valuation by an independent professional valuer of the assets in question, as the true value of these activities lies in the control of extraction rights over the natural resources.
4. A further statement that other than the property interests noted in the valuation reports, there is no single property interest in the group which has a carrying amount of 15% or more of total assets.

As with Property Activities, the Consultation Paper also proposes that the terms of the class exemption notice apply to prospectuses for unlisted companies, as well as applicants for listing.

## Proposals To Amend Property Valuation Requirements For Issuers

### The Current Regulatory Framework for Property Valuation Requirements for Issuers

#### The Main Board Listing Rules:

* Rule 5.02 requires a valuation of and information on property for an acquisition or realisation of a property, or a company whose assets consist solely or mainly of property, where any of the percentage ratios (as defined in Rule 14.04(9)) to classify the transaction is or is above 25%. A valuation report is not required if the property is acquired from the Hong Kong Government at a public auction or by sealed tender. In the circular for a major transaction or very substantial disposal, an issuer needs to include a valuation report on the property interest being acquired or disposed of (Rule 14.66(11)).
* For a very substantial acquisition (i.e. where any of the percentage ratios to classify the transaction is 100% or more), the issuer also needs to include a valuation report on the enlarged group’s property interests. This includes assets being acquired and existing properties (Rule 14.69(3)).
* Rule 5.03 requires that, for an acquisition or realisation of any property from or to a connected person, a valuation of and information on the property must be included in any circular issued to shareholders for the transaction. A circular is required where any of the percentage ratios (as defined in Rule 14.04(9)) is or is above 5%. Rule 14A.59(6) requires the circular to include "*an independent valuation if the primary significance of the asset being acquired or disposed of is its capital value (for example, real property)"*.
* As noted above in relation to applicants, PN 16 exempts disclosure of detailed valuation reports on properties held under operating leases in circulars, if certain conditions are met.
* Rule 5.07 states that the effective date at which the property was valued must not be more than three months before the issue date of the circular.

### The New Framework for Property Valuation Requirements for Issuers

The SFC and SEHK note that the goal of the proposals is to alleviate the negative effects of the current regime, which has become an encumbrance on issuers, and to enhance the quality of information provided to investors.

#### The proposals are as follows:

1. The Consultation Paper states that disclosure of valuation reports in a circular for an acquisition or disposal of a property is a vital mechanism for sharing information with the market. Therefore it is proposed to retain the property valuation requirements for an acquisition or disposal of a property or a company whose assets consist solely or mainly of property where any of the percentage ratios to classify the transaction is or is above 25% (i.e. a major transaction).
2. However, where the issuer is acquiring or disposing of an interest in a company listed on the Exchange, it is submitted in the Consultation Paper that the disclosure of valuation reports in a circular will not be required, as investors already deal with the shares of that company on the basis of the data in the market. Instead the circular will disclose an overview of property interests not covered by a valuation report, although a valuation report will be needed in the case of a connected transaction.
3. Valuations will be required for all property interests, except those with a carrying amount below 1% of the issuer’s total assets. However, the total carrying amount of property interests not valued must not exceed 10% of the issuer’s total assets. An overview of property interests not covered by a valuation report will be required to be disclosed in the circular.
4. To reduce the information volume of circulars, it is submitted that summary disclosure of valuation reports be permitted, if the market value of a property interest is below 5% of the total property interests that are required to be valued. The Exchange can vary this summary form of disclosure according to the issuer’s circumstances. Detailed valuation reports will be required to be available for public inspection.
5. The proposals discussed above regarding operating leases are to apply also to issuers.
6. As with the arrangements for applicants, valuation of property interests ancillary to mining activities will not be required, if the prospectus includes a valuation by an independent professional valuer of the assets in question. Again, this is because the true value of these activities lies in the control and extraction rights over the natural resources.
7. For very substantial acquisitions, the existing properties of the issuer making the acquisition do not need to be valued, as investors already have access to sufficient market information regarding the issuer’s shares to make an informed decision.
8. Connected transactions: it is proposed that the existing valuation requirements remain unchanged and that the obligation to disclose a valuation report where the connected transaction involves the acquisition or disposal of a company listed on the Exchange will also remain unaltered. This is motivated by the desire to ensure greater investor protection in the case of connected transactions.
9. Reverse takeovers: the issuer will be treated as an applicant under the proposals.
10. Contents of Valuation Reports: as is the case with applicants discussed above, the valuation reports of issuers must contain all "relevant information".

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1. The Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) (Amendment) Notice 2011 [↑](#footnote-ref-24)
2. Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice (Chapter 32L of the Laws of Hong Kong) [↑](#footnote-ref-27)
3. Paragraph 34 of the Third Schedule to the Companies Ordinance [↑](#footnote-ref-31)
4. Paragraph 3 of the Third Schedule to the Companies Ordinance, "Matters to be specified in prospectus and reports to be set out therein" [↑](#footnote-ref-35)
5. Main Board Listing Rule 11.07 [↑](#footnote-ref-36)
6. "Carrying amount" means the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon [↑](#footnote-ref-45)
7. "Total assets" means the total fixed assets, including intangible assets, plus the total current and non-current assets, as shown in the latest audited consolidated financial statements in the accountants' report [↑](#footnote-ref-46)