Charltons - Hong Kong Law Newsletter - 11 June 2012

[online version](http://www.charltonslaw.com/hong-kong-stock-exchange-publishes-guidance-on-listed-issuers-continuous-disclosure-obligations-and-on-disclosure-of-distributorship-business-models-in-listing-documents/)

# Hong Kong Stock Exchange Publishes Guidance On Listed Issuers’ Continuous Disclosure Obligations And On Disclosure Of Distributorship Business Models In Listing Documents

## Hong Kong Stock Exchange Publishes Reminder Of Listed Issuers’ Continuous Disclosure Obligations

In a letter published on 10 May 2012, the Stock Exchange of Hong Kong Limited (the Exchange) reminds listed issuers of their continuous disclosure obligation in light of enquiries regarding the handling of market comments and negative publicity on their accounting and corporate governance issues.

The Listing Rules require an issuer to keep its investors and the public up-to-date with any information that they would need to appraise the position of its group or that could be reasonably expected to have a material effect on market activity in and the price of its securities. Information necessary to avoid the establishment of a false market in an issuer’s securities must also be disclosed.

## Responding to Market Rumours

Where rumour or speculation in relation to an issuer is circulated in the market, its directors should promptly and carefully assess whether a disclosure obligation arises under the Listing Rules. Although the Exchange does not expect an issuer to respond to all market comments, if any comment has, or is likely to have, an effect on the issuer’s share price such that there may be a potentially false market, it should make a clarification announcement or request a trading halt pending the clarification to address potential or actual market disorder.

The Exchange also refers issuers to its 2008 letter regarding the continuous disclosure obligation, which provides general guidance on handling market rumours. That letter is available [here](http://www.hkex.com.hk/eng/rulesreg/listrules/listletter/documents/20081031.pdf). That letter included the following guidance on dealing with market rumours:

* the Exchange does not usually require an issuer to make a negative statement denying a wholly unfounded rumour;
* if an issuer decides to make a denial, it should do so by making a formal announcement, rather than by making a remark to a single publication or by way of press release;
* issuers should bear in mind that rumour denials can sometimes have a material effect on the share price. If this is likely to be the case, a formal announcement is required;
* if the reaction to a wholly unfounded rumour will or is creating a disorderly market, the issuer should issue a corrective announcement without delay.

The Exchange’s recent letter also reminds issuers that they must have in place procedures to actively monitor their share price and any news, comments or reports relating to them circulated in the market. Directors must also have a proper understanding of the issuer’s business, financial position and prospects and ensure that there is an effective system for them to continuously monitor developments so that they can promptly and accurately respond to enquiries from the Exchange regarding the issuer’s affairs and where necessary publish announcements to correct or prevent a false market.

The Exchange also encourages issuers to adopt the practice of publishing announcements relating to their business and developments voluntarily and regularly to increase transparency and reduce the likelihood of having to make unplanned announcements.

## Hong Kong Stock Exchange Issues Guidance Letter On Disclosure Of Distributorship Business Model In Listing Documents

The Exchange has issued a guidance letter HKEx-GL36-12 (**Guidance Letter**) which sets out the information that listing applicants should disclose in their listing documents in relation to any distributorship business model they have adopted. Listing applicants should provide sufficient details in their listing documents so that investors may understand how their revenues are generated and what risks are associated with the business model.

The HKEx’s Guidance Letter can be viewed [here](gl36-12.pdf).

## General Disclosure in Listing Documents

Given that sellers will have different arrangements and degrees of control over distributors, franchisees and consignees (together **distributors**), the Exchange requires listing applicants to clearly explain their business model in the listing document to enable investors to understand how revenue is generated.

The Exchange expects sponsors to perform sufficient due diligence in relation to the fairness and reasonableness of sales to distributors recorded during the track record period and to disclose in the listing document the following details in relation to the listing applicant:

1. the distribution channels and their total revenue contribution during the track record period;
2. the degree of control over the distributors and their compliance with the pricing policy, sales and avoidance of competition between different levels of distributors;
3. the benefits of using the distributorship model and whether this is an industry norm;
4. whether the applicant and the distributors are in a seller/buyer or principal/agent relationship;
5. the distributors’ turnover rate and changes in the number of distributors during the track record period and the reasons for any major changes;
6. the amounts of sales to, and goods returned from, distributors during the track record period;
7. the applicant’s revenue recognition and unsold goods return policies; and
8. the principal terms of the distribution, consignment or franchise agreements. Such terms include:
	1. the duration of the agreements;
	2. the exclusivity of the agreements;
	3. the rights and obligations of the relevant parties;
	4. sales and pricing policies;
	5. obsolete stock arrangements;
	6. goods return arrangements;
	7. sales and expansion targets;
	8. sales and inventory reports and estimates;
	9. any minimum purchase amounts;
	10. payment and credit terms; and
	11. conditions for termination and renewal of the agreements.

### Areas of Concern

The concerns arising from business models involving sales of goods or services through multi-level distributors are:

#### Inventory Risk Remains with Applicant

The listing applicant’s returned goods policy and the amount of returned goods should be examined to determine if its sales are artificially increased by deliveries to distributors that do not put the products in the hands of end customers. This practice is commonly known as channel stuffing. For example, a minimum purchase condition may increase the risk of inventory accumulation.

Sponsors and reporting accountants must reasonably believe that the listing applicant’s revenue recognition policies are appropriate. Delayed recognition of revenue may be necessary if any of the following are true:

* the listing applicant bears the risks of ownership even after legal title of the products has been transferred to the distributors;
* sales to distributors are made on a “right of return” basis and payment is delayed or different from normal sales agreements;
* the listing applicant is required to repurchase the product at an adjusted price that compensates the distributor for its holding and financing costs; or
* the listing applicant guarantees a minimum resale value.

#### Cannibalisation

It is possible to inflate revenues artificially and aggressively by suddenly increasing the number of distributors, who would pay royalty payments to the listing applicant for initial set up. Therefore, sponsors must assess the turnover of the distributors during the track record period as well as the reasons for their termination or replacement so that they can reasonably believe that the listing applicant’s revenue was not achieved by cannibalisation among distributors. The sponsors must state their findings in the listing document for the benefit of investors.

#### Recoverability of Accounts Receivables

The listing applicant’s directors and sponsors must provide their assessment of the applicant’s credit management policy and provisions for trade receivables if there is a persistent increase in accounts receivables and debtors’ turnover days during the track record period. The listing document should include a commentary on the recoverability of the accounts receivable and the settlement of the balance as at the latest practicable date, as well as the impact of the increased accounts receivable and debtors’ turnover days on the listing applicant’s liquidity and cash flow.

#### Independence of Distributors

There may be uncertainty as to the independence of customers and the authenticity of sales where goods are sold to distributors or sales representatives who are former employees of the listing applicant or sales partners who trade under the listing applicant’s name.

In its listing document, the listing applicant should disclose:

* the terms of agreement with its sales partners, including the conditions of using the listing applicant’s name;
* measures to address potential conflict of interests between sales representatives and sales partners;
* internal controls and corporate governance measures to monitor its sales activities to detect potential abuses; and
* management of sales partners that use its trading name and the risks of improper use of that name.

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**Charltons - Hong Kong Law Newsletter - Issue 158 - 11 June 2012**