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Hong Kong Capital Markets Update

Issue 3 – July 2014

In this issue, we cover:

- Key Regulatory Developments for Q2 2014 – Topical Highlights
- Guidance for listed issuers
- Guidance for new listing applicants
- Updated Guidance Letters

Key Regulatory Developments for Q2 2014 – Topical Highlights

Topics

- Consultation paper on risk management and internal control
- Consultation paper on proposals to improve the regulatory regime for listed entity auditors
- Guidance on application of reverse takeovers requirements
- Guidance on listed issuers using contractual arrangements for their business

I. Consultation paper on risk management and internal control

In June 2014, The Stock Exchange of Hong Kong Limited ("the Exchange") released one consultation paper seeking comments on the proposed changes to the Corporate Governance Code and Corporate Governance Report (the "Code") contained in Appendix 14 of the Main Board Listing Rules ("MB Rule") relating to internal controls. Respondents can provide written comments by completing the questionnaire on or before 31 August 2014.

The following provides a summary of the objectives and the proposals of the consultation paper.

1. Risk management and internal control

To place greater emphasis on the integration of risk management and internal controls, the Exchange proposes to amend the title of Section C.2 of the Code from "Internal controls" to "Risk management and internal controls".

The emphasis on risk management is in line with development in other jurisdictions. The focus on risk management will likely encourage listed issuers to adopt a structured approach to risk management that ensures the risks that threaten the company's objectives are mitigated by internal control systems.

2. Responsibilities of the board and management

To clearly define and delineate the responsibilities of the board, board committees and management in risk management and internal controls, the Exchange proposes to amend the Principle of Section C.2 of the Code to state that:

- the board is responsible for evaluating the risks it is willing to take to achieve the listed issuer's objectives and to ensure the establishment and maintenance of effective risk management and internal control systems.
- the management is responsible for designing, implementing and monitoring the risk management and internal control systems. The management should also provide assurance to the board on the effectiveness of the systems.

In addition to the above, the Exchange also proposes to introduce a new Recommended Best Practice ("RBP") to state that the board may disclose in the Corporate Governance Report ("CGR") that it has received assurance from the management on the effectiveness of the listed issuer's risk management and internal control systems.

In practice, the emphasis on the ongoing nature of the board's oversight of risk management and internal control systems is likely to increase the regularity at which 'risk and control' is discussed at board level. Under the proposal, listed issuers are expected to comply with the new disclosure requirements. This will have a greater impact on companies that do not currently comply with the RBP disclosures.

3. Annual review and disclosure in the CGR

The Exchange proposes to:

- upgrade to a Code Provision ("CP") the existing RBP which sets out the matters that the board's annual review should consider. Matters to consider by the board include the listed issuer's ability to respond to changes in its business and external environment; the scope and quality of management's ongoing monitoring of risk and the internal control system; the extent and frequency of communication of monitoring results to the board; significant control failures or weaknesses that have been identified during the period; and the effectiveness of the listed issuer's processes for financial reporting and listing rule compliance.
- upgrade to a CP the existing RBP regarding disclosure of the listed issuers' process used to identify, evaluate and manage significant risks; review the effectiveness of the risk management and internal control systems; and resolve material internal control defects in the CGR.
- amend an existing CP to require the board to oversee the listed issuer's management and internal controls systems on an ongoing basis, so that such on-going responsibility is not discharged by an one-off annual review.

The Exchange estimates that 49% of the listed issuers may not have an internal audit function. Under the proposed amendments, these companies will have to review the need for an internal audit function (either in-house or outsourced). Ensuring the adequacy of the internal audit function will likely become the explicit responsibility of the board.

Following the above proposal to upgrade/amend the CP, the Exchange also proposes to make the following mandatory disclosures in the CGR, an upgrade from the existing RBP disclosures:

- whether the listed issuer has an internal audit function;
- how often the risk management and internal control systems are reviewed;
- whether a review of the effectiveness of the risk management and internal control systems has been conducted and whether the listed issuer considers them effective/ineffective and adequate/inadequate; and
- any significant views or proposals put forward by the audit committee.

4. Internal audit

The proposals by the Exchange include:

- the upgrade of the existing RBP to a CP and amend it to state that listed issuers should have an internal audit function. If the listed issuer does not have an internal audit function, the listed issuer should review the need for one on an annual basis and disclose the reasons for the absence of such function in the CGR.
- the introduction of new explanatory notes to clarify that:
  - the role of the internal audit function is to carry out the analysis and independent appraisal of the adequacy and effectiveness of an listed issuer's risk management and internal control systems; and
  - a group with multiple listed issuers may share group resources of the holding company to carry out the internal audit function.
- amendment to the existing CP to extend the board's annual review to ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the listed issuer's internal audit function, in addition to its accounting and financial reporting function.

5. Audit committee's role

Under the current provisions of the Code, the audit committee is responsible for the review of the listed issuer's financial information and the oversight of the listed issuer's financial reporting system and internal control procedures. The Exchange proposes to amend the audit committee's responsibilities to incorporate risk management responsibilities.

The main impact on the audit committee is likely to be to provide oversight with regards to the implementation of the amendments. While a separate board risk committee could be an effective way for providing such oversight, the Exchange recognises that this should be a matter left to the listed issuers to decide for themselves.

At present, Hong Kong's regulatory regime for auditors is primarily administered by the HKICPA. In recent years, many jurisdictions with major capital markets have established independent oversight regimes over auditors of listed issuers. The HKSAR Government's proposal to reform Hong Kong auditor regulation is in line with the international trend that the oversight of the regulation of auditors should be independent of the professional itself.

II. Consultation paper on proposals to improve the regulatory regime for listed entity auditors

In June 2014, the HKSAR Government launched a three month consultation on reform of the oversight of auditors of Hong Kong listed issuers. The consultation period will end on 19 September 2014 and legislative changes are expected to be introduced to the Hong Kong Legislative Council in 2015. Under the HKSAR Government's proposals, the Financial Reporting Council ("FRC"), which already has investigation powers over auditors of listed issuers, would take on the additional independent oversight roles. The proposed reform covers six key areas which include (i) registration; (ii) setting ethics, audit and assurance standards; (iii) continuing education; (iv) inspection; (v) investigation; and (vi) disciplinary proceedings.

Registration, standard setting and continuing education

- It is proposed that HKICPA will continue to perform the statutory functions of registration, setting of continuing professional development requirements and setting of standards on professional ethics, auditing and assurance for auditors of listed issuers, subject to oversight by the FRC.

Inspection

- The FRC would conduct recurring inspections of listed issuer auditors in respect of their audit engagements for listed issuers.

Investigation

- The FRC already has independent investigation powers over auditors of listed issuers. The present arrangements would continue following the reforms.

Disciplinary proceedings

- It is proposed that the FRC itself will be responsible for both investigation and disciplinary matters. In addition, the FRC would also have a range of disciplinary powers and sanctions.
- A new independent appeals tribunal would be set up to hear appeals. It is also proposed that further appeals may be made to the Court of Appeal on a question of law and/or fact.

Funding of the FRC's expanded role:

- It is proposed that the funding of the FRC under the new regulatory regime would be shared equally by (i) listed entities; (ii) investors; and (iii) auditors of listed issuers.

III. Guidance on application of reverse takeovers requirements

The Exchange published a new Guidance Letter ("GL") 78-14 (May 2014) to describe its current application of the reverse takeover ("RTO") requirements and the related administrative requirements under MB Rule 14.06(6).

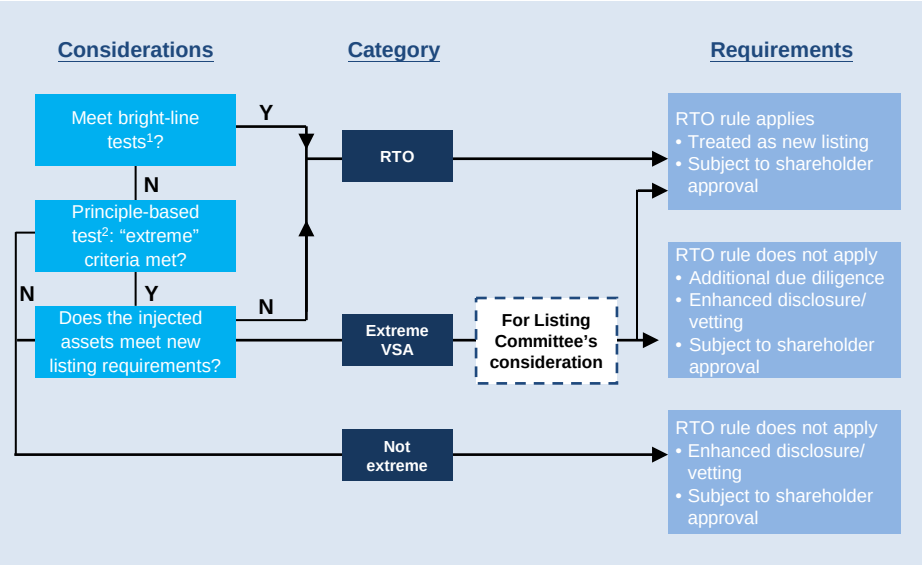
RTO Rules – Compliance with new listing requirements

Where a transaction is treated as a RTO, the listed issuer will be treated as if it were a new listing applicant under MB Rule 14.54. The enlarged group or the assets to be acquired must meet the trading record requirements for new applicants under MB Rule 8.05, and the enlarged group must meet all other new listing requirements under Chapter 8 of the MB Rule. MB Rule 14.55 requires the RTO transaction to be approved by shareholders. Furthermore, the procedures and requirements for new listing applications are to be followed.

If a transaction falls outside the bright line tests, the Exchange will apply the principle based test to assess whether the acquisition constitutes an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for a new listing.

A transaction would be treated as an *extreme very substantial acquisition* ("extreme VSA") when the Exchange considers it "extreme" (i.e. "borderline case") by reference to the assessment criteria but the assets to be acquired can satisfy the minimum profit requirement under MB Rule 8.05 and circumvention of new listing requirements would not be a material concern. Extreme VSAs are presented to the Listing Committee for its decision as to whether RTO Rules will apply. If the Listing Committee resolves that the RTO Rules will apply, the listed issuer will be treated as if it were a new listing applicant (i.e. it will be subject to all applicable listing requirements for new applicants).

Where the Listing Committee concludes that the RTO Rules will not apply to extreme VSA, the listed issuer will be required to prepare a transaction circular under an enhanced disclosure and vetting approach. The listed issuer is also required to appoint a financial adviser to conduct due diligence on the acquisition.



The Exchange will normally take into account the following criteria in assessing whether an acquisition by the listed issuer was a transaction to circumvent the requirements for a new listing:

- the size of the transaction relative to the size of the listed issuer;
- the quality of the business to be acquired – whether it can meet the trading record requirements for listings, or whether it is unsuitable for listing;
- the nature and scale of the listed issuer's business before the acquisition;
- the principal business of the listed issuer differs significantly from that of the target;
- any fundamental change in the listed issuer's principal business;
- the acquisition is a means to achieve the listing of the target company's shares;
- other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO Rules; and
- any issue of restricted convertible securities to the vendor which would provide it with *de facto* control of the listed issuer.

[1] MB Rules 14.06(6)(a) and (b) set out two specific forms of RTO: (a) an acquisition (or series of acquisitions) which constitute a very substantial acquisition ("VSA") where there is, or which will result in, a change in control of the listed issuer (as defined in the Takeovers Code); or (b) acquisition(s) from the incoming shareholder or his associate(s) within 24 months of the incoming shareholder gaining control, which individually or together constitute a very substantial acquisition.

[2] MB Rule 14.06(6) defines a RTO to be an acquisition (or series of acquisitions) which constitute, in the opinion of the Exchange, an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants.

Disclosure in Investment Circulars

When a transaction is treated as a RTO, the listed issuer is required to issue an investment circular that complies with the new listing requirements.

Even if the RTO Rules do not apply, the listed issuer should still provide enhanced disclosure in the investment circular. Key areas to disclose include:

Issuer's business plans and future prospects

Issuer's intention to make significant changes in i) the enlarged group's business and/or arrangements for potential acquisitions or disposals of assets; ii) the listed issuer's board composition; and iii) the management of the target business.

Disclosure of impairment assessment

For purposes of preparing pro forma financial information to be included in the investment circular, a listed issuer should take into account any impairment of assets, based on the relevant valuation reports and the accounting standards and policies adopted by the listed issuer. Should there be material impairment issues, the listed issuer should disclose the results of the impairment assessment in the investment circular, together with information (including the methodology adopted and the key assumptions) about the valuation.

Disclosure in Annual Reports

A listed issuer should include in its annual report:

- a discussion and analysis of the acquired business' performance;
- material factors underlying its results and financial position, including a discussion on trends and significant events during the financial year; and
- a discussion of any material change to the acquired business' financial position and prospects from the original disclosures in the investment circular prepared in connection with the VSA.

The disclosure guidance set out by the Exchange in GL78-14 is generally consistent with the findings of the Financial Statements Review Programme Report 2013 published by the Exchange in February 2014 where the Exchange has highlighted that the issuers should pay special attention to the key areas of financial reporting that involve significant management judgments and provide the best possible disclosure in their financial reports. Specifically, the particular concerns noted by the Exchange include proper identification of identifiable assets (including intangible assets) at business acquisition date, goodwill recognition, asset impairment at each reporting period end and the reasonableness of the underlying assumptions in impairment testing.

Please see the article entitled 'Listing of Restricted PRC Business using Structured Contracts' in our Hong Kong Capital Markets Update published in October 2012 for a more detailed discussion on the typical structure of business using Structured Contracts, the standards of review by the Exchange in considering the suitability of listing of these Restricted PRC Business, the additional disclosure requirements in the listing document .

IV. Guidance on listed issuers using contractual arrangements for their business

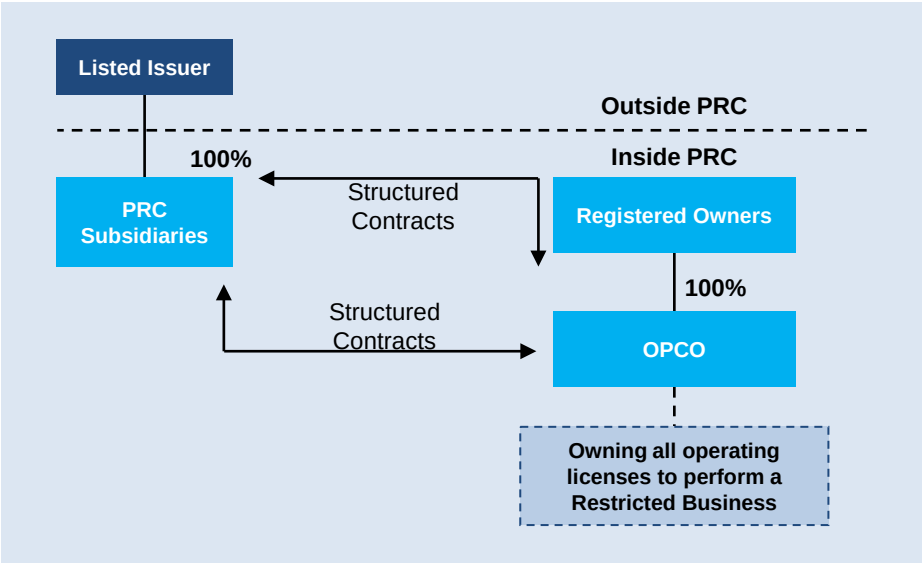
In Listing Decision ("LD") 43-3 (as updated) the Exchange addresses the suitability for listing when a new listing applicant controls (and consolidates for financial reporting purposes) companies operating in the PRC using a series of contractual arrangements ("Structured Contracts") despite the listing applicant does not have the legal or registered controlling ownership interest in the PRC companies. Structured Contracts are typically seen in industry sectors subject to local legal and regulatory restrictions on foreign ownership ("Restricted PRC Business"), such as internet, telecommunications and mining of certain types of natural resources.

Structured Contracts are designed to confer upon the listing applicant that is incorporated outside the PRC:

i. the right to enjoy all the economic benefits, management control, control over voting, operation and management of the Restricted PRC Business;
ii. the right to all the intellectual properties through assignments from the Restricted PRC Business;
iii. the right to acquire, if and when permitted by PRC law, the equity interests in and/or assets of the Restricted PRC Business for a nominal price or a pre-paid amount; and
iv. a first priority security interest in the shares owned by the registered owners of the Restricted PRC Business (the "Registered Owners"). substantial acquisition.

In May 2014, the Exchange published a new guidance Letter, GL77-14, to provide guidance to listed issuers using Structured Contracts to indirectly own and control any part of their businesses. The guidance and requirements as set out in GL77-14 for listed issuers are largely consistent with those set out in LD43-3.

If the Structural Contracts are built on the premise of circumventing PRC laws, rules and regulations, the arrangement may not be upheld by Chinese courts and thus leading to the risk that the Structured Contracts may be disallowed. Listed issuers should consult their legal counsels on the enforceability of the contracts and the level of protection offered prior to engaging in these structures.



New Guidance Letter for listed issuers published in Q2 2014

Topics

- Guidance on opinion letters prepared by independent financial advisers under the MB Rule

Guidance on opinion letters prepared by independent financial advisers under the MB Rule

Under the MB Rules, a listed issuer is required to appoint an independent financial adviser ("IFA") to advise its independent board committee ("IBC") and shareholders on:

- connected transactions;
- equity fund raisings that would result in a material dilution of shareholders' interests, i.e. rights issue or open offer that would increase the listed issuer's share capital or market capitalization by more than 50%; and
- other corporate actions which would affect the listed issuer's listing status (such as the withdrawal of listing and a material spin-off).

The Exchange provides guidance on the disclosures required in the opinion letters prepared by the IFAs in GL76-14 (May 2014). GL76-14 also sets out certain recommended best practices for IFAs, listed issuers and IBCs in performing their duties under the MB Rule. GL76-14 also summarises the relevant provisions of the MB Rule and the practical guidance that listed issuers, IBCs and IFAs are expected to observe when performing their duties.

New Guidance Letter for listing applicants published in Q2 2014

Topics

- Guidance on consents for placing of shares to connected clients who will hold the shares on behalf of independent third parties

Guidance on consents for placing of shares to connected clients who will hold the shares on behalf of independent third parties

In GL75-14 (May 2014), the Exchange provides guidance for cases where the lead broker or any distributors as defined in Appendix 6 to the MB Rule (the "Placing Guidelines") place shares of a listing applicant to their connected clients who in turn will hold such shares on behalf of independent third parties.

The Exchange clarified that the allocation of shares by the lead broker, or any distributors to their affiliated companies within the same group and who will hold the shares on behalf of the independent investors, is technically an allocation of shares to connected clients under the Placing Guidelines and therefore requires the Exchange's prior written consent for the allocation.

It is stated in GL75-14 that the Exchange will ordinarily give its written consent as long as:-

i. the shares are held on behalf of independent third parties;

ii. the sponsor(s) and the (joint) bookrunner(s) confirm that the shares will not be offered to the connected clients on a preferential basis. In case where the shares will be offered to connected clients who will hold shares on behalf of a cornerstone investor, the terms of the agreement with the relevant investor should be substantially the same as with the other cornerstone investors participating in the offering; and

iii. details of the allocation to the connected clients are disclosed in the allotment result announcement. This will include disclosing the name of the connected clients and their relationship with the lead broker or the distributor(s), number and percentage of shares allocated to each connected client and lock-up arrangement (if any).

Updated Guidance Letters published in Q2 2014

Topics

- Guidance on the financial information for the trading record period expected in the first draft listing document for listing applications
- Guidance on disclosure of material non-compliance incidents in the listing documents

Guidance on the financial information for the trading record period expected in the first draft listing document for listing applications

GL6-09A (July 2013 and updated in January and May 2014) was updated to provide guidance on the accounting and disclosure requirements under MB Rules 4.04(2), 4.04(4) and 4.28 in respect of subsidiaries or businesses acquired or agreed/proposed to be acquired ("Target") by a listing applicant after the latest audited financial year/period end (the "Acquisition"). Under these relevant MB Rules, certain historical financial information of the Target and, if applicable, pro forma financial information of the enlarged group are required to be included in the Application Proof. The Exchange, however, indicated in the revised GL6-09A that the inclusion of the above financial information can be omitted in the Application Proof if the listing applicant's financial information in its subsequent draft listing document will be updated to cover a later period which includes the Acquisition. Nevertheless, pre-acquisition financial information for acquisitions made during the trading record period, as required by MB Rule 4.05A, must be included in the Application Proof.

Please see our April 2014 issue for additional information on GL6-09A and our April 2012 issue for guidance and clarification published by the Exchange (GL32-12) on the accounting and disclosure requirements in respect of subsidiaries or businesses acquired or agreed/proposed to be acquired by a new listing applicant during or after the track record period.

Guidance on disclosure of material non-compliance incidents in the listing documents

GL63-13 (July 2013 and updated in September 2013 and May 2014), which provides guidance on the disclosure of material non-compliance incidents in listing documents, was updated by the Exchange to introduce three different categories of non-compliances. These three categories are:

- material impact non-compliances: these include non-compliance incidents which individually or in the aggregate have had or may have in the future, a material financial or operational impact on the listing applicant, e.g. non-compliances giving rise to significant financial penalties or which may result in the closure of material operating facilities.
- systematic non-compliances: these are non-compliance incidents which are not material non-compliances, but which reflect negatively on the listing applicant's or its directors'/senior management's ability or tendency to operate in a compliant manner, e.g. repeated and/or continuous breaches of laws.
- immaterial non-compliances: these are non-compliance incidents which do not fall within the above two categories.

GL63-13 was also updated to state that if non-compliance incidents are of a serious nature, the Exchange may request a demonstration period of compliance from the cessation of the non-compliance incident(s) to demonstrate that the rectification measures and enhanced internal control measures adopted are effective, and that there is no financial impact on the listing applicant. In the extreme case, the application may be rejected.

Contact us

If you have any questions about the matters discussed in this publication, please feel free to contact Paul Lau or Katharine Wong of our Capital Markets Group ("CMG").

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