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Hong Kong Capital Markets Update

Issue 1 – January 2015

In this issue, we highlight the latest issues affecting the Hong Kong capital markets with a focus on regulatory reporting and compliance matters.

- **Latest Regulatory Developments**
- **Guidance for Listing Applicants**
- **Other Recent Developments**

Latest Regulatory Developments

Topics

- Consultation conclusions on risk management and internal controls

Consultation conclusions on risk management and internal controls

On 19 December 2014, The Stock Exchange of Hong Kong Limited ("the Exchange") published amendments to the Corporate Governance Code and Corporate Governance Report (the "Code") contained in Appendix 14 of the Main Board Listing Rules ("MB Rule") in their consultation conclusions on risk management and internal controls. Listed issuers will be required to implement the Code amendments for accounting periods beginning on or after 1 January 2016.

Please refer to our *Hong Kong Capital Markets Update published in July 2014* for a summary of the objectives and the proposals of the consultation paper.

The following provides a summary of the consultation conclusions:

1. Risk management and internal control

The Exchange adopted the proposed title amendment of Section C.2 of the Code from "Internal controls" to "Risk management and internal controls".

2. Responsibilities of the board and management

In response to the respondents' comments, the Exchange adopted the proposed amendments to the Principle of Section C.2 of the Code with minor amendments (indicated by " ") to the original proposals as follows:

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

3. Annual review and disclosure in Corporate Governance Report ("CGR")

Other than the mandatory disclosures of significant views or proposals put forward by the audit committee in the CGR, the Exchange adopted the rest of the other proposed amendments. Please refer to a summary of the proposals in *our earlier issue*.

4. Internal audit

In the consultation paper, the proposals by the Exchange include the introduction of new explanatory notes to clarify that a group of multiple listed issuers may share group resources of the holding company to carry out the internal audit function. In response to comments received, the Exchange decided to leave flexibility to the listed issuers to decide which of its group companies, holding or subsidiaries, is best to carry out the internal audit functions of other member companies. Except for this modification, the Exchange adopted all the other proposals.

5. Audit committee's role

The Exchange adopted all their proposals.

A series of *frequently asked questions* was also published by the Exchange to help listed issuers to understand and comply with the rules relating to risk management and internal control section of the Code.

Listed issuers who wish to have an overview of the approved requirements and their impacts may refer to another KPMG publication which sets out our observations on the impact the amended corporate governance code has on Hong Kong listed companies.

HKEx Consultation Conclusions on Risk Management and Internal Control

Guidance for Listing Applicants

Topics

- Guidance on shares lock-up of controlling shareholders
- Guidance on disclosure of directors' remuneration in the accountants' report
- Guidance on the accounting and disclosure requirements for acquisitions of subsidiaries or businesses during or after the track record period

Guidance on shares lock-up of controlling shareholders

In Listing Decision ("LD") *85-2015* (January 2015), the Exchange decided that the controlling shareholder[1] of the listing applicant who ceased to be its controlling shareholder immediately upon listing, will still be subject to the 12-month lock-up of the shares after the applicant's listing.

Guidance on disclosure of directors' remuneration in the accountants' report

Guidance Letter ("GL") *62-13* (July 2013 and updated in January and March 2014 and January 2015) has recently been updated to clarify that for directors of the listing applicants who were not directors or senior management of the listing applicants or any of its subsidiaries during the track record period, their remuneration is not required to be included in the table of directors' remuneration in the accountants' report.

Guidance on the accounting and disclosure requirements for acquisitions of subsidiaries or businesses during or after the track record period

GL 32-12 (March 2012 and updated in January, March and October 2014) was updated to set out the conditions in which the Exchange will grant a waiver for disclosure of the financial information of the subsidiary or business acquired by the listing applicant *subsequent* to the track record period. These conditions include:

- in relation to acquisitions of equity securities in the ordinary and usual course of business of a listing applicant:-
  - (a) the percentage ratios (as defined under MB Rule 14.07) of each acquisition are all less than 5% by reference to the most recent financial year of the listing applicant's track record period;
  - (b) the listing applicant is neither able to exercise any control, nor has any significant influence, over the underlying company or business; and
  - (c) the listing document should include the reasons for the acquisitions and a confirmation that the counterparties and the ultimate beneficial owners of the counterparties are independent third parties of the listing applicant and its connected persons.
- in relation to acquisition of a business or subsidiary:-
  - (a) the percentage ratios of the acquired or to be acquired business or subsidiary are all less than 5% by reference to the most recent financial year of the listing applicant's track record period;
  - (b) the historical financial information of the acquired or to be acquired business or subsidiary is not available or would be unduly burdensome to obtain or prepare; and
  - (c) the listing document should include at least the information that would be required for a discloseable transaction under Chapter 14 of the MB Rule on each acquisition.

In addition to the above, the guidance letter was also updated to clarify the requirements under MB Rule 4.05A. Under MB Rule 4.05A, if the listing applicant acquires any material subsidiary or business *during* the track record period and such an acquisition if made would have been classified at the date of application as a major transaction or a very substantial acquisition, it must disclose pre-acquisition financial information on that material subsidiary or business from the commencement of the track record period to the date of acquisition. For the purposes of evaluating the size of the acquisition, the total assets, profits and revenue for the most recent financial year of the trading record period (i.e. year 3) of the subsidiary or business being acquired would be compared against those of the listing applicant for the same year. The Exchange has clarified in the updated guidance letter that if the financial year of the subsidiary or business being acquired is not coterminous with that of the listing applicant, the total assets, profits and revenue for the most recent financial year of the subsidiary or business should be compared to those of the listing applicant for the most recent financial year of its track record period.

As an illustration, for the purposes of determining whether the acquisition of a March year end subsidiary by a December year end listing applicant in January 2015 constitutes a major or very substantial acquisition, the total assets, profits and revenue of the subsidiary as at and for the year ended March 2014 will be compared against those of the listing applicant as at and for the year end December 2014.

[1] "Controlling shareholder" is defined under the listing rules as any person who is or group of persons who are together entitled to exercise or control the exercise of 30% (or such other amount as may from time to time be specified in the Takeovers Code as being the level for triggering a mandatory general offer) or more of the voting power at general meetings of the issuer or who is or are in a position to control the composition of a majority of the board of directors of the issuer.

Other Recent Developments

Topics

- Concept paper on Weighted Voting Rights
- Consultation paper on review of listing rules on disclosure of financial information with reference to the new Companies Ordinance and Hong Kong Financial Reporting Standards
- Shanghai-Hong Kong Stock Connect – FAQ's in relation to listed issuers' continued obligations

Concept paper on Weighted Voting Rights

The Exchange released a *Weighted Voting Rights Concept Paper* ("the Concept Paper") on 29 August 2014 seeking market views on whether, in concept, governance structures that give certain persons voting power or other related rights disproportionate to their shareholding (weighted voting right structures or "WVR structures") should be permissible for companies currently listed or seeking to list on the Exchange. There was a three-month consultation period which ended on 30 November 2014.

The fair and equal treatment of shareholders is a general principle of the Hong Kong listing rules. Under this principle, a shareholder cannot have a greater voting power than another if both have the same amount of equity in a company ~ the "one-share, one-vote" concept. This concept has been seen as an important aspect of investor protection in Hong Kong in the sense that it helps align controlling shareholders' interests with those of other shareholders and makes it possible for incumbent managers to be removed, if they underperform, by those with the greatest equity interest in the company.

The use of WVR structures is accepted by other international stock exchanges such as the New York Stock Exchanges ("NYSE") and the NASDAQ.

A number of arguments have been put forward by commentators and others as grounds for either maintaining the status quo or allowing WVR structures for companies currently listed or seeking to list on the Exchange. These arguments are summarised in the Concept Paper. The Exchange indicated that it is not their current intention to put forward specific changes to the existing rules for market consultation. Rather, the Exchange is seeking market views on the concept of WVR structures to promote a focused and coherent discussion.

The Exchange stated that they anticipate the paper may lead to one of two possible outcomes:

- A conclusion that no amendment to the listing rules to allow companies to use WVR structures is appropriate. In this case, the Exchange would publish conclusions explaining the reasons for any such an outcome.
- Support for a change to the listing rules on the acceptability of WVR structures. Under this scenario, the Exchange would conduct a second stage formal consultation on the details of the scope and language of any proposed changes to the listing rules.

Should the use of WVR structures be accepted, we believe amendments to the existing listing rules (including the Corporate Governance Code) with the aim to put in place sufficient safeguards on investor protections would be necessary. Possible safeguards may include: (i) requiring enhanced corporate governance structures by WVR structure companies as a way to protect minority shareholders (for example, increase the minimum number of independent non-executive directors); (ii) limiting the use of WVR structures to companies that are above certain size as WVR structures may not be suitable for smaller companies that do not have a proven track record of high quality corporate governance; and (iii) imposing mandatory restrictions on the share structures for companies adopting a WVR structure.

We further note that it may not be feasible to restrict WVR structures to particular industries (such as information technology companies) as this may create subjectivity and definitional issues and limiting the use of WVR structures to companies from a particular industry sector is contradictory with the "level playing field" principle currently adopted.

Consultation paper on review of listing rules on disclosure of financial information with reference to the new Companies Ordinance and Hong Kong Financial Reporting Standards

In August 2014, The Stock Exchange of Hong Kong Limited ("the Exchange") released *Consultation Paper on Review of Listing Rules on Disclosure of Financial Information with reference to the new Companies Ordinance and Hong Kong Financial Reporting Standards and Proposed Minor/Housekeeping Rule Amendments*.

The following provides a summary of the proposed changes:

1. Rule amendments to align the requirements for disclosure of financial information with reference to the disclosure provisions in the new Companies Ordinance ("new CO")

   Based on the principle of maintaining a level playing field for all listed issuers, an issuer (irrespective of whether it is incorporated in Hong Kong) shall include disclosures under the provision of the predecessor Companies Ordinance. With the new CO comes into effect, consequential changes to disclosures under the provisions of the new CO will be made to the existing rules.
2. Rule amendments to streamline the disclosure requirements of financial information that are already under Hong Kong Financial Reporting Standards ("HKFRSs")

   The new CO gives statutory backing to HKFRSs issued or specified by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). To avoid potential duplication with the disclosure requirements under HKFRSs, the Exchange proposed to:
   - streamline disclosure requirements of financial information;
   - repeal the disclosure requirements in relation to financial conglomerates; and
   - repeal Appendix 15 "Bank Reporting" to the MB Rule.
3. Other rule amendments to enhance the Exchange's compliance and monitoring role relating to disclosure of financial information

   Currently, there is no explicit provision in the listing rules concerning revision of financial statements. The new CO provides that the directors can seek to revise the financial statements and make necessary consequential revisions to the directors' report or summary financial report, if the directors discover that the financial statements do not comply with the new CO when the financial statements have already been sent to members.

   In consideration of the above, the Exchange proposed to:
   - impose an explicit requirement for an issuer to publish an announcement as soon as practicable when the board decides to revise its published financial statements;
   - impose the requirement for an issuer to flag prior period adjustments due to correction of material errors in the results announcements/financial statements via a new headline category; and
   - provide references to disclosure requirements relating to periodic financial reports required in other parts of the listing rules.
4. Other proposed rule amendments which include:
   - the requirement that an issuer's announcement of the board decision on any dividend or other distribution must include the expected payment date of the dividend or other distribution;
   - the requirement of a property valuation for the circular of any connected transaction that involves an acquisition or disposal of any property interest or property company; and
   - the removal of the requirement to disclose information about competing interests of directors of the issuer's subsidiaries and their close associates in transaction circulars.

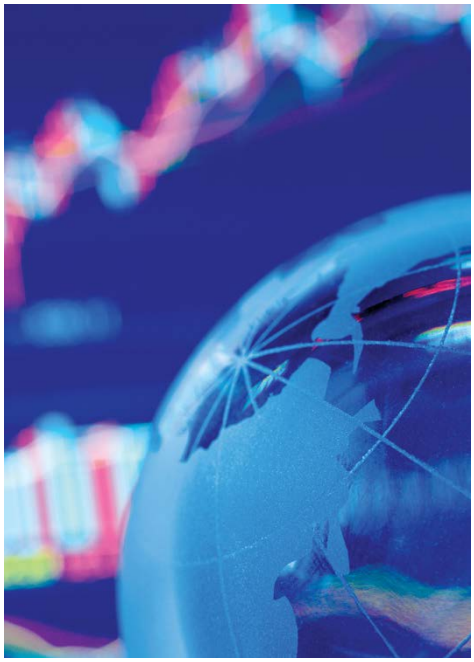
   The consultation period has ended in October 2014 and the consultation conclusions are expected to be published by the Exchange during the first quarter of 2015.

Shanghai-Hong Kong Stock Connect – FAQ's in relation to listed issuers' continued obligations

The Shanghai-Hong Kong Stock Connect, which is a pilot programme developed for establishing mutual stock market access between Mainland China and Hong Kong and approved by the China Securities Regulatory Commission ("CSRC") and the Securities and Futures Commission ("SFC"), was launched on 17 November 2014.

For Hong Kong listed issuers whose securities are eligible for southbound trading through the Shanghai-Hong Kong Stock Connect, they are, and will continue to be, governed by the Hong Kong listing rules. The implementation of the Shanghai-Hong Kong Stock Connect is not expected to cause any material changes to the listed issuers' continued listing obligations.

However, as the shareholder base of the Hong Kong listed issuers may expand to include Mainland investors, to ensure the principle of fair and equal treatment of all shareholders are properly compiled with, the Exchange published a set of frequently asked questions, *FAQ Series 29*, to provide guidance to the Hong Kong listed issuers when they propose (i) corporate actions (such as pre-emptive issues or distributions in specie to shareholders), (ii) trading suspension arrangement and communication with the exchanges for A+H listed issuers, and (iii) corporate communications to the investors.



Contact us

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