

Listing Compliance Update

September 2013



Agenda

1 Disclosure of information to prevent or correct a false market

2 Reverse takeovers

3 Issue of securities

4 Annual report review program

(1) Disclosure of information to prevent or correct a false market

Issuers' disclosure obligations under the Rules

New Rule 13.09(1):

- Where, in Exchange's view, there is / is likely to be a false market in the issuer's securities, issuer must, as soon as practicable after consultation with Exchange, announce the information necessary to avoid a false market

New Rule 13.09(2):

- Issuer required to disclose inside information under the Inside Information Provisions must simultaneously announce the information

→ Trading halt if issuer fails to promptly announce information under Rule 13.09

What is a “false market”?

- A situation where there is material misinformation or materially incomplete information in the market compromising proper price discovery

- Examples:
 - False or misleading announcement by issuer
 - False market rumours
 - Failure to disclose inside information under Inside Information Provisions
 - Uneven dissemination of inside information of issuer

Example 1: Misleading announcement

- Listco announced placing of new shares under general mandate
 - Placing discount >20% → fail to meet Rule 13.36(5)
- Exchange's post-vet follow up:
 - Listco needs to amend placing price, otherwise listing not approved
- Trading halted pending Listco's clarification of the placing announcement
- Trading resumed after Listco announced amendment to placing price to meet the 20% discount restriction

Example 2: False market rumours

- Press reported that Listco received takeover offer from another company
- Exchange made enquiry before market open:
 - Listco confirmed the press report unfounded
- Share price increased by more than 20%
- Exchange requested Listco to issue a clarification announcement under Rule 13.10 to deny the press report

Handling of market comments and negative publicity

- Issuers have positive obligation to disclose information to prevent/ correct a false market

- Issuers need not respond to all market comments, unless material market reaction to rumours
 - issue clarification announcement containing sufficient details to address negative publicity
 - request trading halt pending clarification announcement

- Issuers may choose to respond to rumours
 - should do so by formal announcement

Compliance reminders

1. Suspension does not remove issuer's disclosure obligation under Inside Information Provisions
 - Issuer should publish a holding announcement if it needs more time to prepare a full announcement
 - Suspension period must be as short as reasonably possible (Rule 6.05)

Compliance reminders

2. Issuers should establish appropriate systems and procedures to
 - identify and escalate reliable information to board on a timely basis
 - maintain periodic financial reporting procedures to ensure structured flow of financial and operational data
 - maintain authorization and vetting processes to ensure that decisions and regulatory announcements are timely
3. Issuers are encouraged to improve transparency through announcement of trading update

Compliance reminders

4. Issuers should select all headline categories (App-24) applicable to announcement content
 - Should not select “Other” unless all other headlines not applicable
 - Select “Inside Information” if the subject matter is inside information (e.g. major transactions, VSA, issue of securities)

5. Announcement title should help investors understand the relevance and significance of information disclosed
 - Should not use “voluntary announcement”

6. Issuers should disseminate material overseas regulatory announcements (e.g. business update) in both languages

(2) Reverse takeovers

Rule 14.06(6)

(1) Bright-line tests

- Change in control?
 - Size of asset acquisition from incoming controlling shareholder: VSA?
- Bright-line tests will apply if the VSA takes place at the time of, or within 24 months after, change in control

Rule 14.06(6)

(2) Definition

Acquisition of substantial assets which is:

- an attempt to achieve listing of the acquired assets
- a circumvention of the new listing requirements

Criteria to assess “circumvention of new listing requirement”

- Assessment criteria include:
 - Is relative size “extreme”?
 - Quality of the acquired business?
 - Is the company a listed shell?
 - Fundamental change of principal business?
 - Other transactions together forming a series of arrangements to circumvent the RTO Rules?

Based on these criteria, we will consider whether the acquisition is an “extreme case” → RTO rules may apply

Current approach

- Extreme cases:
 - Circumvention of new listing requirements
 - Ruled as RTO → new listing requirements apply

- Other cases:
 - Straight-forward VSAe.g. acquisition of same line of business

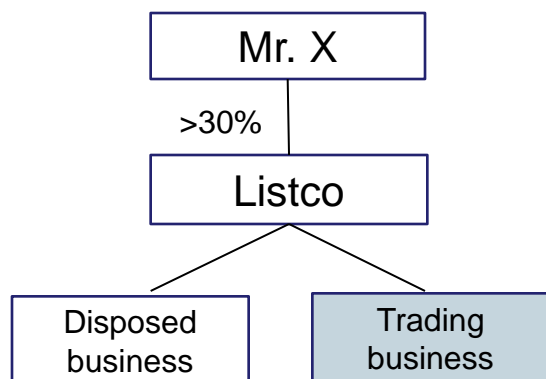
Circular disclosure

Circular includes:

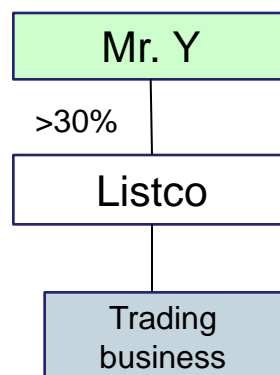
- Risk factors, industry overview, business plan and management profile, etc.
- May impose specific due diligence standards (e.g. Practice Note 21)
- Disclosure of issuer's intention
- If subsequent actions contradict disclosure made, case referral to SFC

Example 3: Significant change in business more than 2 years after change in control

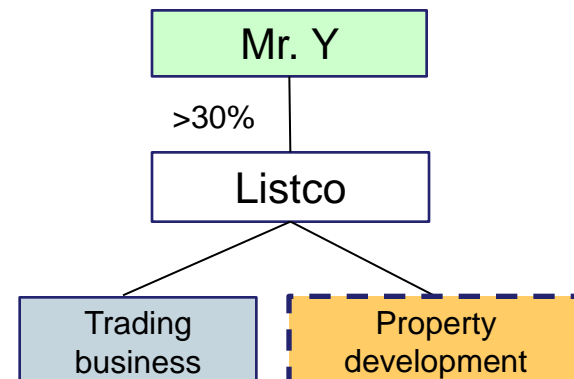
Before disposal and change in control



After disposal and change in control & before proposed acquisition



After proposed acquisition



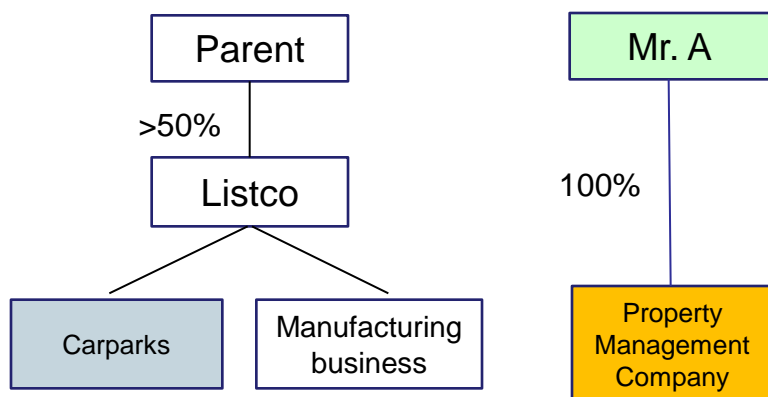
Facts

- More than 2 years after change in control, Listco proposes to buy property development business from an independent party → **VSA**
- Remaining business has minimal operation and majority of assets was cash & bank balances → Listco is a live shell
- Property development business is newly startup and has no track record

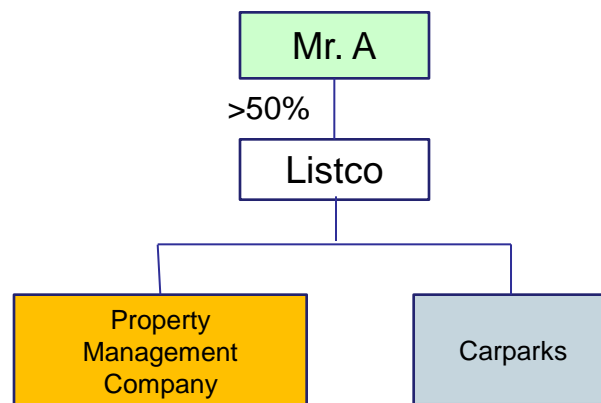
Our Decision: Extreme case - RTO Rule applies

Example 4: Change in control and fundamental change in business

Before change in control and acquisition



After change in control and acquisition



Facts

- Upon change in control, Listco will
 - acquire Property Management Company from Mr. A (Major acquisition)
 - dispose of manufacturing business to Parent (Major disposal)
 - retain existing carparks (insignificant in value)

- Property Management Company cannot meet the new listing requirements

Our Decision: Extreme case - RTO Rule applies

(3) Issue of securities

- (A) Rights issue - allocation of excess shares
- (B) General mandate placing with prolonged long-stop date
- (C) Convertible securities

(A) Rights issue - allocation of excess shares

- Issuer must disclose the proposed basis for allocating unsubscribed shares
 - Rules do not prescribe the allocation basis, it must be “fair” (Rule 7.21(1))
 - Commonly adopted allocation basis:
 1. Give preference to top-up applications
 2. Based on number of excess shares applied for by other applicants
- Facilitate topping up to full board lot to avoid a higher cost of trading of shares in odd lots

(A) Rights issue - allocation of excess shares

- Some shareholders abuse the allocation mechanism by splitting their shareholding into odd lots
- Directors' obligations:
 1. Take appropriate steps to avoid abuse and ensure fair treatment of shareholders [*Listing Decision 70-2013*]

2. Disclosure in shareholder circular/ listing document:

“The Directors will allocate the excess Rights Shares at their discretion on a fair and equitable basis on the following principles: Preference will be given to applications for less than a board lot of Rights Shares where they appear to the Directors that such applications are made to round up odd lot holdings to whole-lot holdings and that such applications are not made with the intention to abuse this mechanism ...”

3. Exercise discretion to allocate excess rights shares on a fair basis

(B) General mandate placing with prolonged long-stop date

Example 5

- Listco announced placing of new shares under general mandate
 - Best effort basis
 - Placing discount < 20%
 - Long-stop date is 1 month after agreement date

Issue

- Circumvention of general mandate Rules
 - Best effort placing → No firm commitment from placees/ placing agent
 - Placing discount may be more than 20% at the time of placing

(C) Convertible securities

Example 6

- Listco proposes to issue convertible bonds with conversion price of \$0.20
- Conversion price will be adjusted downward if 30 days' daily average share price falls below \$0.20
- Conversion price adjustment is beyond Listco's control
- Listco does not have sufficient general mandate
 - Must obtain specific shareholder approval for issuance of conversion shares

(C) Convertible securities

Compliance reminder

- Issue of convertible securities under general mandate
 - If conversion price adjustment is not at issuer's discretion:
 - Calculate the maximum number of conversion shares based on lowest possible conversion price
 - If conversion price adjustment is at issuer's discretion:
 - Must avoid corporate actions that may result in the number of conversion shares exceeding mandate limit

(C) Convertible securities

Example 7

- Listco proposes to issue convertible bonds
- Full exercise of conversion rights will result in public float falling to 19%
- Listco proposes to give the Exchange an undertaking to maintain minimum public float (25%)
 - Not acceptable because CB holders may enforce conversion rights resulting in breach of Rule
 - Agreement must contain conversion restriction to ensure Rule compliance
 - Otherwise the Exchange will not grant listing approval

[Listing Decision 56-2013]

(C) Convertible securities

Example 8

- Listco issued convertible bonds with conversion price of \$0.50, which will be matured on 31 August 2013
- Listco failed to settle the convertible bonds and proposed to
 - extend the maturity date for another 2 years
 - decrease the conversion price to \$0.20
- Since the proposed changes represent a new issue of convertible bonds, Listco must re-comply with the Rules:
 - utilise new mandate or seek shareholder approval [*Listing Decision 54-2013*]
 - timely announce the change
 - obtain the Exchange's prior consent

(4) Annual report review program

- Purpose
 - Better disclosure promotes an informed market

- Program
 - Use issuers' annual report as a starting point, review
 - Rule compliance
 - Continuity and consistency of disclosure

 - Cover annual report of all issuers

 - Focus on particular themes

- Published report on “Review of Disclosure in Issuer’s Annual Reports to Monitor Rule Compliance” in March 2013
<http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/Documents/rdiar-2012.pdf>

Assets acquisition

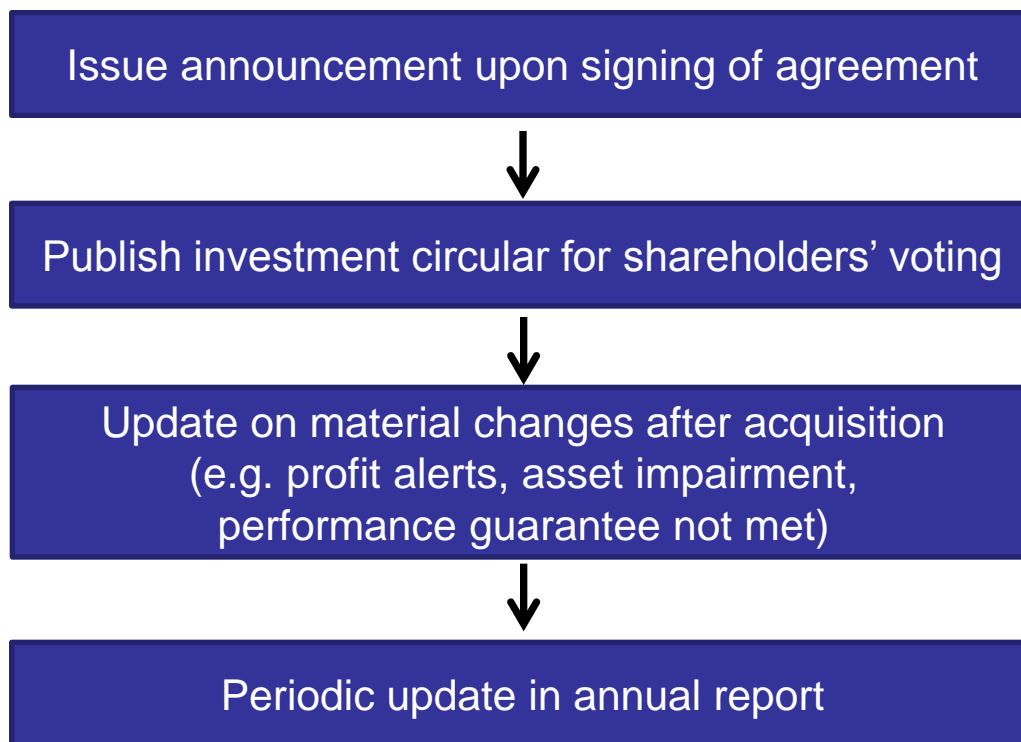
Findings:

- Material write-downs of acquired assets
 - Overstatement of asset valuation in investment circulars
 - Disclosure of material changes to acquired business not timely
 - Reasons for write-off not fully explained

- Lack of transparency in outcome of performance guarantee
 - Performance guarantee met?
 - If not, guarantor's compensation obligation enforced?

Assets acquisition

- Issuers should ensure **transparency** and **continuity** in keeping shareholders informed about the acquisition/ target on a timely basis



Assets acquisition

Investment circular

- Provide material information about target and acquisition impact
 - Disclosure of target's valuation, business plan, cashflow forecast must be materially accurate and not misleading
 - Financial information of acquired business and pro forma financials of enlarged group must use consistent accounting policy as the issuer
- Clearly disclose the terms of the agreement
 - including details of performance guarantee and methods to determine the compensation where the guarantee is not met

Assets acquisition

Update on material changes after acquisition

- Timely announcement of material changes to the acquired business' performance or terms of the transaction

- Announcement of outcome of performance guarantee
 - **Connected guarantor:** Rules require announcement with prescribed disclosure
 - amount of shortfall, adjustment to consideration, vendor's obligation fulfilled or not, issuer exercised option to sell back acquired business or not, INED's view

 - **Independent guarantor:** should follow the above

Assets acquisition

Periodic update in annual report

- Acquired business' performance and reasons for write-down
- Information to support valuation of intangible assets
 - Value of inputs used (projected cash flows, discount rate, growth rate), basis and assumptions and reasons for change
 - Valuation methods, why those methods, and explanation of changes

Significant changes to financial position

Findings

- Some issuers gave minimal information on change in financial position or performance
- Some issuers merely repeated information presented in their financial statements in narrative form
- Issues:
 - Major customer data do not support company's revenue growth
 - Ratios out of industry averages
 - Lack of explanation on accounts fluctuations

Significant changes to financial position

MD&A section should disclose meaningful information e.g.

- Company's business model and material business developments (by major product lines/ business sectors)
- Detailed explanation about material fluctuations of accounts e.g.
 - **Trade receivables**: debtors' turnover days, credit period analysis, customer profile, subsequent settlement
 - **Tax balances/ effective tax rate**: tax rates applicable to major operating subsidiaries, effective period of tax holidays and reduced tax rates
- Key performance indicators to measure company's performance, and their trends, changes and reasons for changes

Thank you