



Listing Compliance Update

Compliance and Monitoring, Listing Department
Hong Kong Exchanges and Clearing Limited
September 2015



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Connected transactions

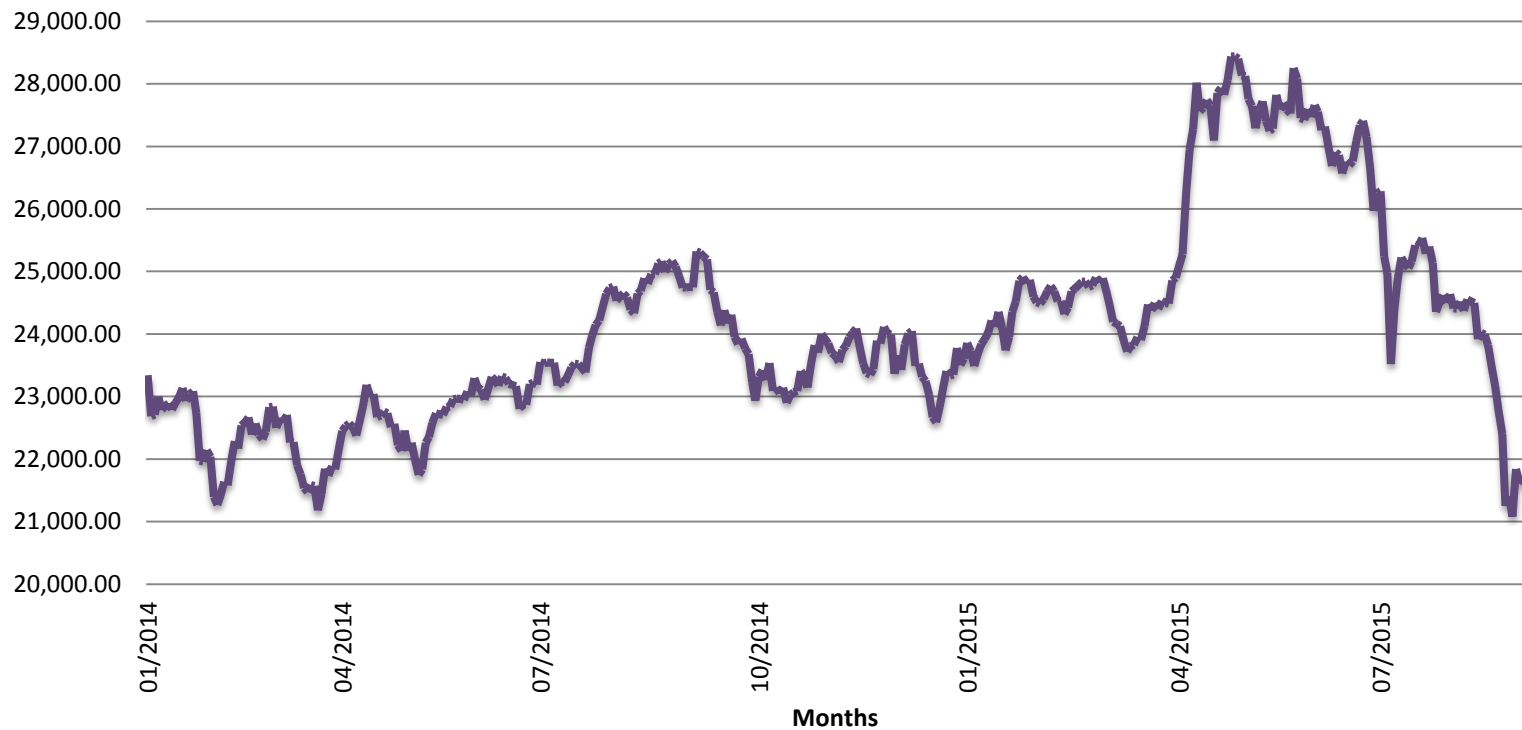
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Other compliance matters

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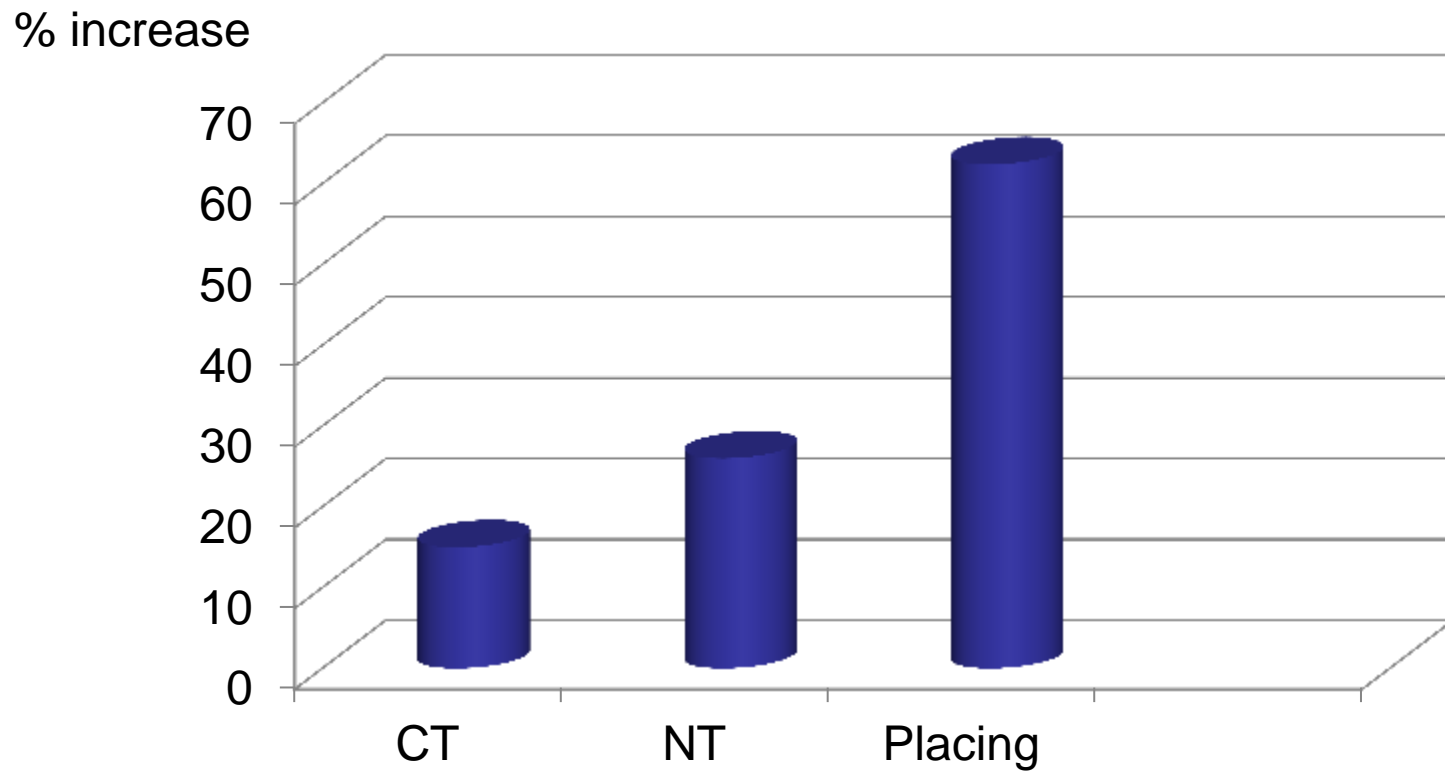
High market volatility

Heng Seng Index Movement



Introduction

Increase in market activities in 1H2015 vs 1H2014



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Fund raisings

Significant increase in placings

1 – 6/2014		1 – 6/2015	
No. of cases	Fund raised	No. of cases	Fund raised
205	HK\$59,966m	333 (+62.4%)	HK\$295,146m (+392.0%)

Fund raisings

Equity fund raisings: general mandate or specific mandate

	General mandate	Specific mandate
Shareholder approval	Usually obtain at AGM, <u>before</u> any equity fund raising	Usually obtain <u>after</u> the specific fund raising is materialized
Issue limit	20% of total issued shares at time of approval	Subject to the specific terms of the fund raising
Discount limit of issue price	<20% of the benchmark price of the shares when issue	
Time to complete	Overnight completion possible	At least after the shareholder meeting

Fund raisings

- General mandate
 - Issue price must be at fair value, and within the discount limit
 - Mandate issue limit must not be exceeded
 - Completion should take place in a reasonable short period
 - Disclosure of use of proceeds must be specific, with subsequent report on the actual application

Fund raisings

- Placing of warrants

Example 1

- Company A is a manufacturer of electronic components.
- Company A proposed a placing of warrants under general mandate:

Terms of warrants	
Issue price	\$0.01
Term	2 years
Exercise price	\$2.2
Current share price	\$2
Placees	> 6 independent third parties
Reason	Raise additional fund for business operation

Fund raisings

- Placing of warrants

Guidance on placing of warrants under general mandate:

- Issue at or approximate fair value
- Starting point to refer to valuation based on common option pricing model
- General mandate not for issue at a discount to valuation and which is unable to demonstrate that the issue price represents fair value of the warrants

(LD90-2015)

Fund raisings

- Placing of warrants

Example 2

- Company A proposed to issue warrants under general mandate to its senior management.

Terms of warrants	
Issue price	\$0.01
Term	2 years
Exercise price	\$2.2
Current share price	\$2
Subscribers	Senior management of Company A
Purpose	Reward and incentive for past and future contribution

Fund raisings

- Placing of warrants

Guidance on issue of warrants to directors/employees

- Arrangement analogous to a share option scheme
- Chapter 17 requirements apply, e.g. shareholders' approval and other restrictions.

(LD89-2015)

Fund raisings

- Issue of convertible securities

Guidance Letter (GL80-15) on Issue of Convertible Securities (**CB**) by issuers

- Sufficiency of general mandate
- Material change in terms of the CB
- Tracking of convertible securities

(GL80-15)

Fund raisings

- Issue of convertible securities

General mandate limit

Example 3

- Company A proposed to issue CB under general mandate
- Based on initial conversion price, 20% of issued shares may be issued
- Conversion price may be adjusted for future corporate actions

What if mandate limit is exceeded after such adjustments?

- Must ensure, at the time of issue, there is sufficient mandate to cover all the conversions shares at all times

(GL80-15)

Fund raisings

- Issue of convertible securities

Proposed change in terms

Example 4

- Company A issued CB under general mandate
(i.e. 10% total shares upon full conversion based on initial conversion price)

- Proposes to:
 - reduce the initial conversion price
 - extend the conversion period and maturity by 1 year

- Material changes in terms = new issuance
- Company A has to:
 - ensure there is a valid and sufficient **existing** general mandate; **OR**
 - seek specific mandate (GL80-15)

Fund raisings

- Issue of convertible securities

CB with amended terms

Example 5

- Company A issued CB under general mandate, with fixed conversion price of HK\$1.7
 - After issued, it entered into a supplemental agreement to add an annual adjustment to conversion price (based on the share price at the year-end)
 - Maximum no. of conversion shares exceeds the general mandate limit
- The supplemental agreement = issuance of new CB
- No sufficient general mandate. Company A has to seek specific mandate

(GL80-15)

Fund raisings

- Issue of convertible securities

Tracking of convertible securities

- To track the number of conversion shares issued/ issuable under the CB terms
- To alert on any corporate actions which would trigger the adjustment provisions under the CB terms
- To maintain a systematic workflow to calculate the adjusted conversion price and number of conversion shares issuable
- To monitor the sufficiency of existing general mandate

(GL80-15)

Fund raisings

- Large scale share subscription

A large scale fund raising may substantially increase the cash level of an issuer and even result in it being a cash company.

Example 6

Company A's principal business	Shoe manufacturer	
Existing number of Issued Shares:	1,000 million shares	
Proposed subscription:	10,000 million shares @ HK\$1 per share	
Total Proceeds:	HK\$10,000 million	
Intended use of Proceeds:	Development of power stations	
	<u>Existing (HK\$ million)</u>	<u>After Completion (HK\$ million)</u>
Total Asset	1,000	11,000
Net Asset	800	10,800
Cash	300	10,300

Fund raisings

- Large scale share subscription

Example 6 (Cont'd)

- Upon completion, Company A's assets would consist substantially of cash
- Company A failed to demonstrate that a high level of cash was required for genuine business purposes
- Company A would become a cash company.

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Notifiable transactions

- Material asset disposal or distribution

Example 7

- Parent Shareholder proposed to dispose of its controlling interest in Company A.
- Company A proposed a distribution in specie of a substantial part of its existing business.
- Remaining business:
 - Part of existing distributed business
 - 6% of original size
 - Loss-making, with negative operating cash flow
- Company A would not comply with Rule 13.24 upon completion.

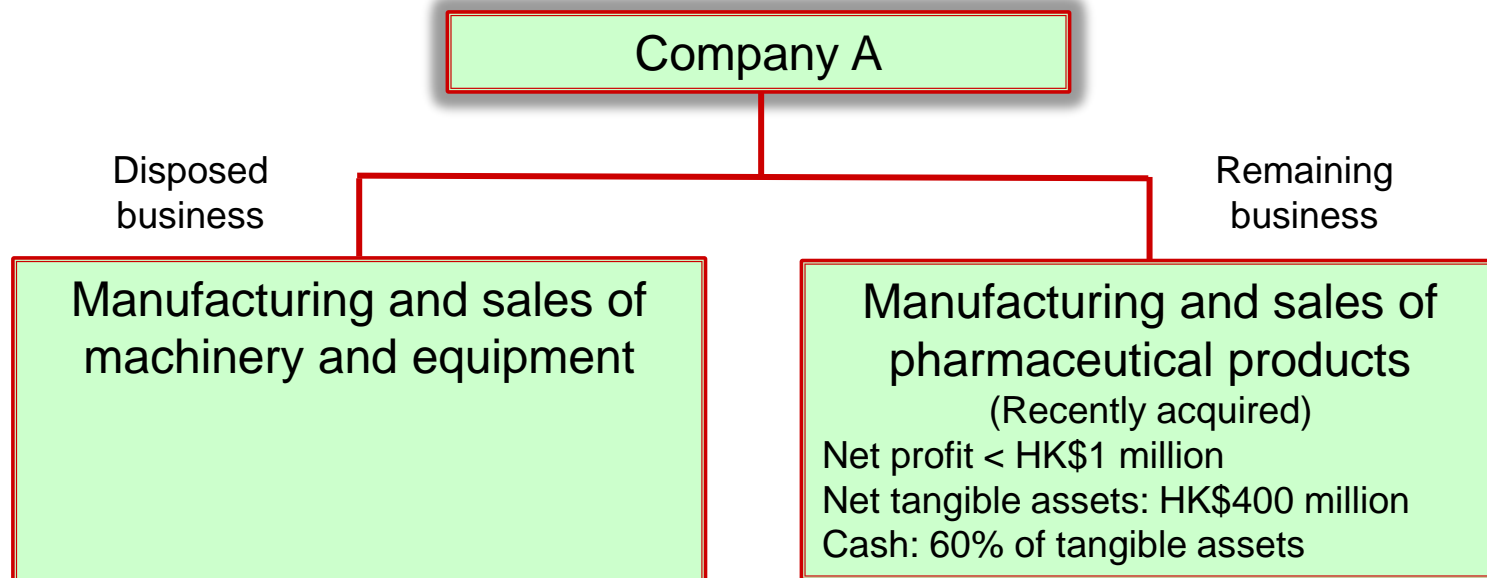
(LD35-2012)

Notifiable transactions

- Material asset disposal or distribution

Example 8

Company A proposed to dispose of its machinery and equipment business.



- Whether the remaining business is viable and sustainable
- Whether the remaining assets are sufficient (LD88-2015)

Notifiable transactions

- Material asset disposal or distribution

Example 8 (Cont'd)

- Company A would not comply with Rule 13.24 upon completion.

(LD88-2015)

Notifiable transactions - Finance leases

More issuers enter into finance leases, either as lessors or lessees.

- By definition, entering into a finance lease is a transaction and subject to notifiable transaction requirements.
- Exemption for revenue transactions is not applicable.
- The requirements apply to both lessors and lessees.

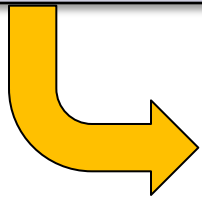
Notifiable transactions - Finance leases

Example 9

- Company A is principally engaged in leasing business. It leases machineries to other companies through finance lease arrangements.
- Company A enters into two finance leases with Company B, an independent third party.
- The finance leases should be aggregated.

Notifiable transactions - Reverse takeovers

Principle based test	Bright line tests
An attempt to achieve a listing of acquired assets and A means to circumvent the new listing requirements	VSA that results in a change in control or VSA from the incoming controlling shareholder within 24 months after the change in control



Assessment criteria:

- i) transaction size
- ii) asset quality
- iii) nature and scale of issuer's business
- iv) fundamental change in the issuer's business
- v) change in de facto control
- vi) part of a series of arrangements to circumvent RTO Rules

Notifiable transactions

- Reverse takeovers

- Guidance letter (GL78-14)
 - summarises our practice in application of the RTO requirements
 - tightens restriction on a change in de facto control arising from issue of restricted convertible securities.
- Since the release of the Guidance letter in May 2014:

	6/2013 – 5/2014	6/2014 – 5/2015
RTOs	13	8
- Bright line tests	2	7
- Principle based test	11	1

Notifiable transactions

- Reverse takeovers

Observations

- Increase in the number of RTOs under bright line tests
 - More acquisitions that complied with new listing requirements

Notifiable transactions

- Reverse takeovers

- Decreases in the number of RTOs under principle based test
 - Reduction in cases that circumvented the listing suitability requirements

Examples of circumvention cases:

- *Acquiring mining business with legal issues on over-mining*
- *Acquiring business with heavy reliance on connected persons for important functions such as sales or procurement functions*
- *Acquiring gambling business that could not meet the Exchange's guidance on gambling activities undertaken by listed issuers*
- *Acquiring property company which did not have proper legal titles to its property interests*

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Other compliance matters

Connected transactions

- Issue of shares to connected persons

Issue of new securities by a listed issuer to any of its connected persons is a connected transaction.

- It is subject to all connected transaction requirements under Chapter 14A
- Exemption applies only in circumstances set out in Rule 14A.92, including:
 - Pro rata entitlement to shareholders
 - Excess application / underwriter in rights issue or open offer
 - Share option scheme
 - Top-up placing and subscription

Connected transactions

- Issue of shares to connected persons

- **Separate** shareholder approval requirement under Rule 13.36

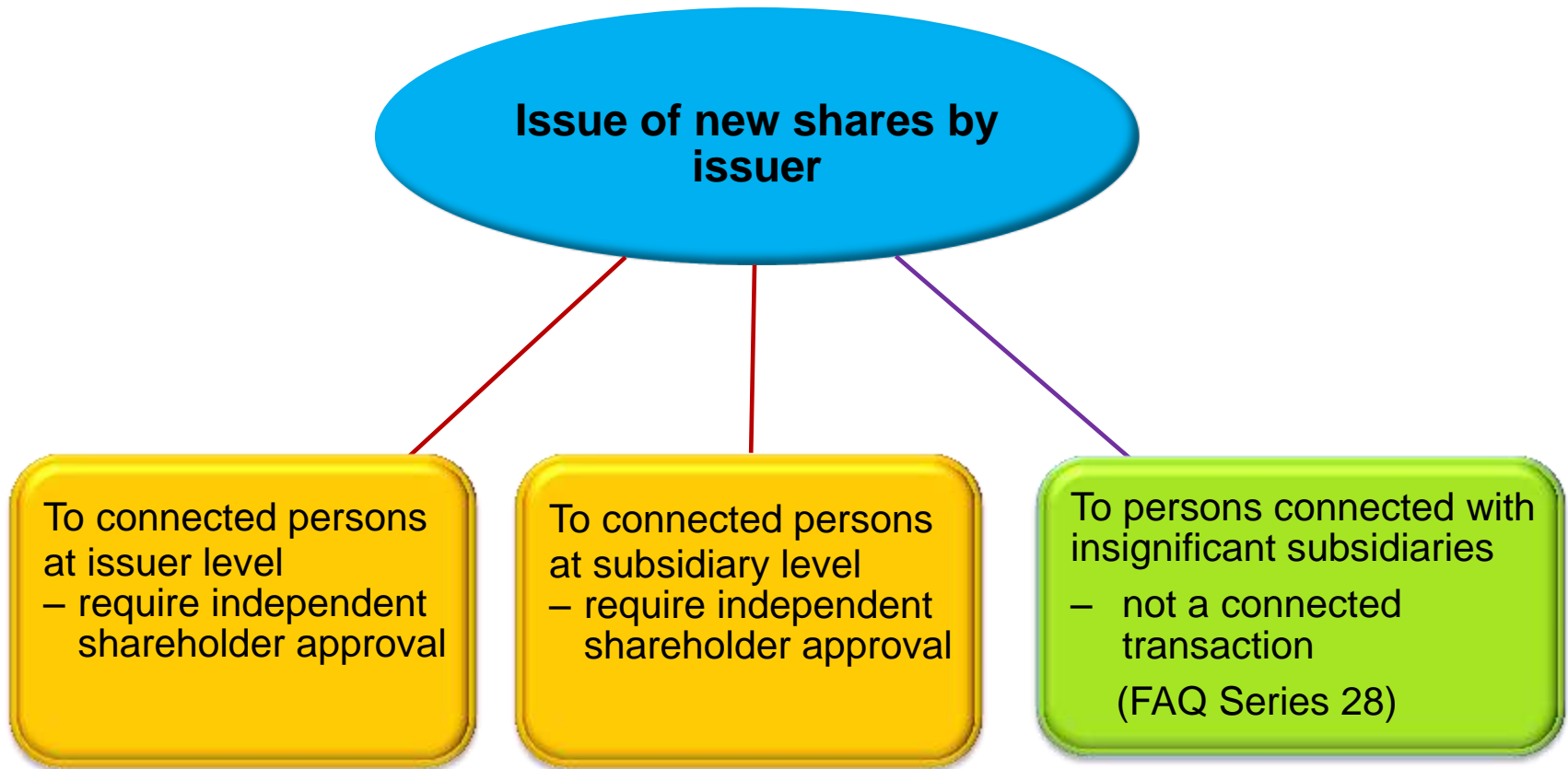
Note 1 of Rule 13.36(2) states,

“Other than where independent shareholders’ approval has been obtained, an issue of securities to a connected person pursuant to a general mandate.... is only permitted in the circumstances set out in rule 14A.92”

- Unless qualified for the exemption under Rule 14A.92, any issue of new securities under general mandate to a *connected person* still requires independent shareholders’ prior approval under Rule 13.36.

Connected transactions

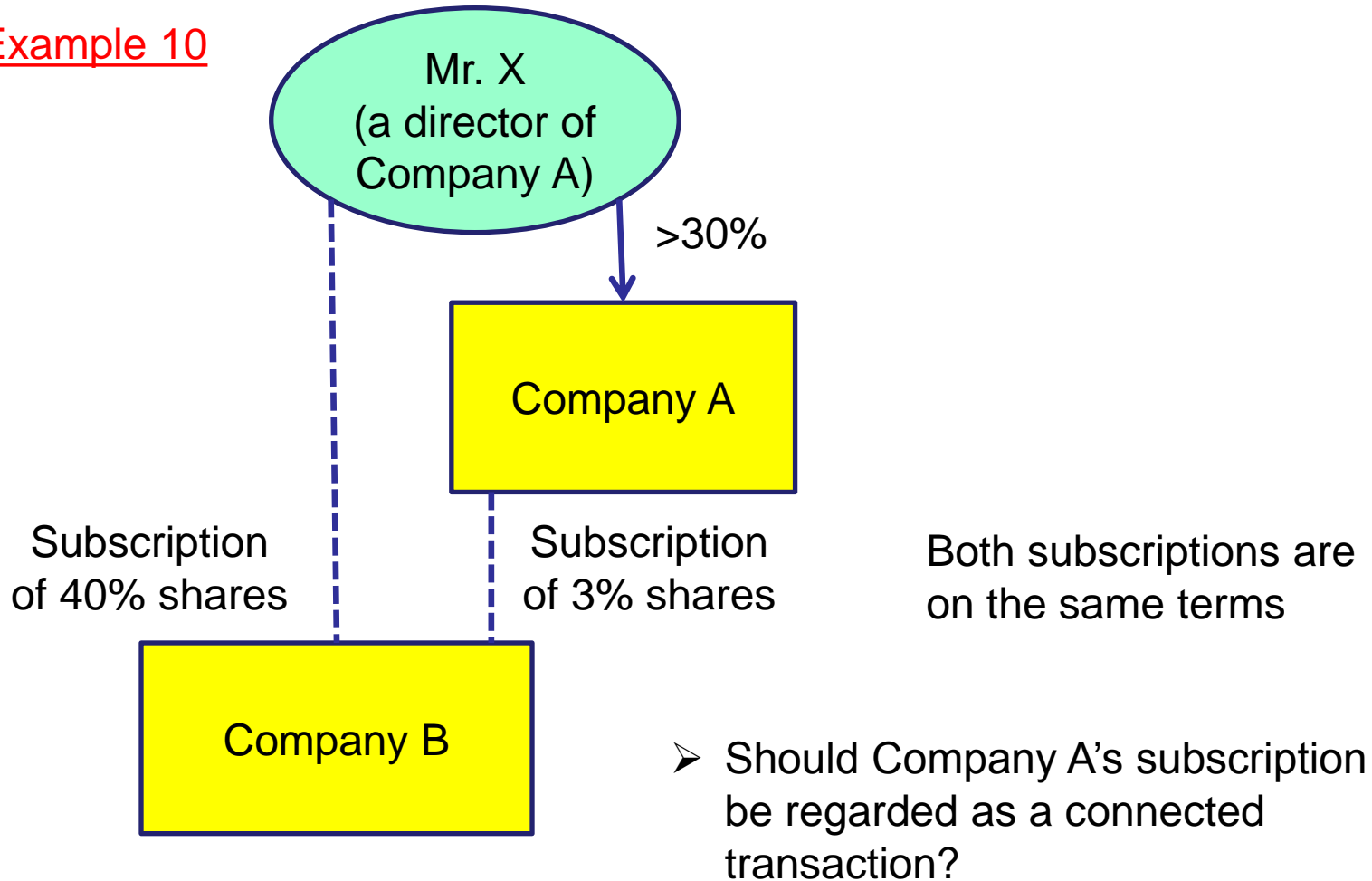
- Issue of shares to connected persons



Connected transactions

- Deemed Connected Person

Example 10



Connected transactions

- Deemed Connected Person

- Factors to consider when exercising the deeming power:
 - Relationship between the connected person and the party to the transaction
 - Nature / terms of agreement or transaction
 - Role and Influence of connected person in the transaction
 - Potential benefits to the connected person
- Company B was deemed as a connected person.
- Mr. X to abstain from approving the subscription of Company A

Connected transactions

- Continuing Connected transactions

Examples of terms of framework agreement

“The transactions will be conducted on normal commercial terms. The consideration will be based on arms’ length negotiation with reference to the prevailing market prices.”

“The transactions will be agreed between the issuer and the connected person on a “cost plus” mechanism.”

“The transaction shall be priced in accordance with the following terms:

(i) government-prescribed price; (ii) where there is no government-prescribed price, the government-guidance price; (iii) where there is neither a government-prescribed price nor a government-guidance price, the relevant market price; (iv) where none of the above is available or applicable, the price to be agreed between the parties which shall be determined on the basis of reasonable cost plus reasonable profit margin and by reference to the historical price”

Connected transactions

- Continuing Connected transactions

Issuer shall ensure meaningful disclosure of pricing policy for continuing connected transactions

- Pricing terms or policies for transactions of different nature must be separately disclosed.
- Disclosure of the pricing terms must be specific, with the quantum expected.

(HKEx-GL73-14)

Connected transactions

- Continuing Connected transactions

fixed monetary / per unit consideration	<p><i>“HK\$10,000 per month” / “HK\$10 per piece”</i></p>
source of any reference price	<p><i>“...the interest rates shall not be lower than the lowest rate allowed by the People’s Bank of China (as shown on http://www.pbc.gov.cn/) for similar types of deposits”</i></p> <p><i>“The fees for the provision of electricity, water and natural gas... will be determined in accordance with the relevant pricing standards issued by the relevant government authorities... include: Jing Fa Gai [2014] No.118, Jing Fa Gai [2014] No.884 and Jing Fa Gai [2014] No.1874.”</i></p>
pre-determined formula	<p>Consideration for purchase of used equipment will be determined based on the formula: <i>“Original purchase price – Original purchase price x (1-3%) x (no. of years since the equipment in use/ 10 years)”</i></p>
Other pricing policies, and the process for estimating and approving the price	<p><i>“... costs involved plus the margin, ranging from 37% to 41% for domestic sales and from 25% to 29% for overseas sales...”</i></p> <p><i>“fees to be negotiated on an arm’s length basis and, for services of the same quality, on terms no less favourable than those offered by independent third parties (at least two quotations from independent third parties would be obtained for similar transactions for comparison)”</i></p>

Connected transactions

- Independent advice from the IBC

Independent board committee has the duty to advise shareholders on the fairness of the transactions

- Before (or at the early stage of) the transaction
 - take active and primary role in the IFA selection and engagement
 - check IFA's independence, qualification, experience and resources
- During the preparation of the transaction circular
 - ensure sufficient time and access to information
 - take part in addressing the Exchange's comments on the draft IFA letter
- When making the recommendations
 - exercise independent judgment
 - critically review the IFA letter and challenge its view and analysis
 - take responsibility to give its own views and recommendations

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Other compliance matters

Other compliance matters

- Structured contracts

- Listed issuers shall comply with Guidance on structured contracts (GL77-14)
- Ensure the legality and validity of structured contracts
 - Compliance with applicable laws (obtain legal opinion and, where available, regulatory assurance)
 - Narrowly tailored to address foreign ownership restrictions only
 - Include power of attorney and dispute resolution clauses

Other compliance matters

- Structured contracts

- Unwind structured contracts when no longer required
- Keep abreast of development in relevant laws and regulations
 - Publication of consultation draft of new PRC Foreign Investment Law in January 2015
- Consult the Exchange on proposals to use structured contracts

Other compliance matters

- Short-seller reports

Major allegations included

- genuineness of sales figures or overstatement of assets value reported in audited financial statements
- the trading price of the shares of the relevant issuer is over-valued

Serious concerns could be arisen

- reliability of the published financial information?
- development of a false market?

➤ result in a prolonged suspension of trading

Material adverse impact on not only the issuer but also its stakeholders!

Other compliance matters

- Short-seller reports

- Allegations are usually based on
 - Inconsistent public filings by the issuer/ its subsidiaries (e.g. SAIC filings/ import or export quotas/ tax payment records of local tax bureau, etc.)
 - Investigation findings
 - Higher-than-peers sales growth rate or profit margin; or unexplained long debtors or inventory turnover period
 - Undisclosed relationships between, on one hand, the issuer/ controller, and on the other hand, its customers/ distributors/ suppliers
 - Lack of legal ownership over major subsidiaries/ assets/ business

Other compliance matters

- Recent Rule amendments

- Consultation conclusions in relation to financial information disclosure in February 2015
- Purpose of amendments
 - Align financial information disclosure requirements in Appendix 16 to the new Companies Ordinance
 - Streamline financial information disclosure requirements with Hong Kong Financial Reporting Standards

Other compliance matters

- Recent Rule amendments

- Specific financial disclosure requirements
 - Include a new “Business Review” section in Appendix 16
 - Revise Chapter 4 and Appendix 16 to avoid duplication with accounting standards
 - Repeal disclosure requirements in relation to financial conglomerate
 - Repeal Appendix 15 in relation to bank reporting
- Other Rule amendments and consequential changes
 - Expected payment dates of dividends and distributions
 - Inclusion of property valuation for connected transactions
 - Nominal or par value of shares
 - New headlines for financial information

Other compliance matters

- Disclosure under s.436 of CO

- New Companies Ordinance came into effect for the first financial reporting year beginning on or after 3 March 2014
- Disclosure requirements under section 436 of the new Companies Ordinance apply to Hong Kong incorporated issuers only
- Hong Kong incorporated issuers shall disclose
 - A statement indicating that they are not statutory financial statements
 - Whether an auditor's report has been prepared
 - Whether the auditors gave a qualified or modified audit opinion

Other compliance matters

- Review of ESG reporting guide

- Currently, Environmental, Social and Governance (**ESG**) reporting is voluntary under the ESG Guide
- Consultation paper in July 2015, proposing
 - Upgrade some recommended disclosures to “Comply or Explain”
 - General disclosure under each aspect
 - Key performance indicators under “Environmental” subject area
 - Need to disclose whether issuer has complied, or give considered reasons for deviation in ESG report
 - Intended implementation schedule: financial years commencing on or after 1 January 2016

Other compliance matters

- Review of the CG Code and CG Report

- December 2014 – Publication of Consultation Conclusions on Risk Management and Internal Control: Review of the Corporate Governance Code and Corporate Governance Report
- Effective for accounting periods beginning on or after 1 January 2016
- Emphasis on risk management and internal control

Other compliance matters

- Use of plain language

- Issuers should use plain language to present information.
- Use summary box to summarise information of
 - nature of the transaction
 - reason for the transaction
 - its practical effect
 - its relevance to shareholders and investors
- Use headings to break up information into manageable sections
- Highlight warnings and use plain language

Thank you