

Listing enforcement strategy, current themes and case studies

Enforcement, Listing Department
Hong Kong Exchanges and Clearing Limited
September 2015



Overview



1 Regulatory Role of the Exchange

2 Published Enforcement Strategy

3 Current Themes for Enforcement

4 Case Studies

5 Takeaway

Overview



1

Regulatory Role of the Exchange

2

Published Enforcement Strategy

3

Current Themes for Enforcement

4

Case Studies

5

Takeaway

Regulatory Role of the Exchange (1)



Ensure, as far as reasonably practicable, an orderly, informed and fair market for trading of securities (s.21, SFO)

Frontline regulator of listed companies

Enforce Listing Rules to deter future breaches, educate market, influence compliance culture and attitude, and enhance corporate governance

Not a law enforcement agency

Regulatory Role of the Exchange (2)



Play an important part:

- identify possible misconduct through surveillance activities
- report possible misconduct to SFC and other law enforcement agencies
- provide continuing support: advice on Listing Rule implications and witness statements

Regulatory Role of the Exchange (3)



2012 to 2014, approximately:

- 61 referrals to SFC Enforcement and 3 to ICAC / CCB

- 40 requests for documents/ information re: 35 issuers from SFC; 79 requests re: 59 issuers from ICAC / CCB

- 14 witness statements made for SFC and 20 for ICAC / CCB

Overview



1 Regulatory Role of the Exchange

2 Published Enforcement Strategy

3 Current Themes for Enforcement

4 Case Studies

5 Takeaway

Published Enforcement Strategy (1)



- Published on 13 September 2013, accessible on HKEx website

- Outlines Exchange's approach towards Rule enforcement



- enforcement of the law takes priority over Listing Rules
- report possible breaches of law to law enforcement authority

Published Enforcement Strategy (2)

■ Outlines criteria for assessing appropriate level of enforcement action



- focuses resources on pursuing most blatant and serious conduct
- regulatory responses depends on conduct, facts and circumstances
- possible regulatory responses include:
 - disciplinary action for serious breaches
 - warning or caution letters
 - appointment of compliance advisers
 - directors training
 - trading suspension
 - cancel listing

Published Enforcement Strategy (3)

■ Relevant factors for consideration



- nature and seriousness of possible breach
- circumstances and manner of breach
- conduct of directors and senior management, e.g. deliberate, reckless, negligent or egregious
- market impact and prejudice to investors
- any personal benefit

Published Enforcement Strategy (4)

■ Relevant factors for consideration (cont'd)



- post-breach conduct
- adequate and effective internal controls in place?
- serious or systemic weaknesses or failings in issuer's procedures?
- level of cooperation during investigation
- compliance history

Overview



1 Regulatory Role of the Exchange

2 Published Enforcement Strategy

3 Current Themes for Enforcement

4 Case Studies

5 Takeaway

Current Themes for Enforcement (1)

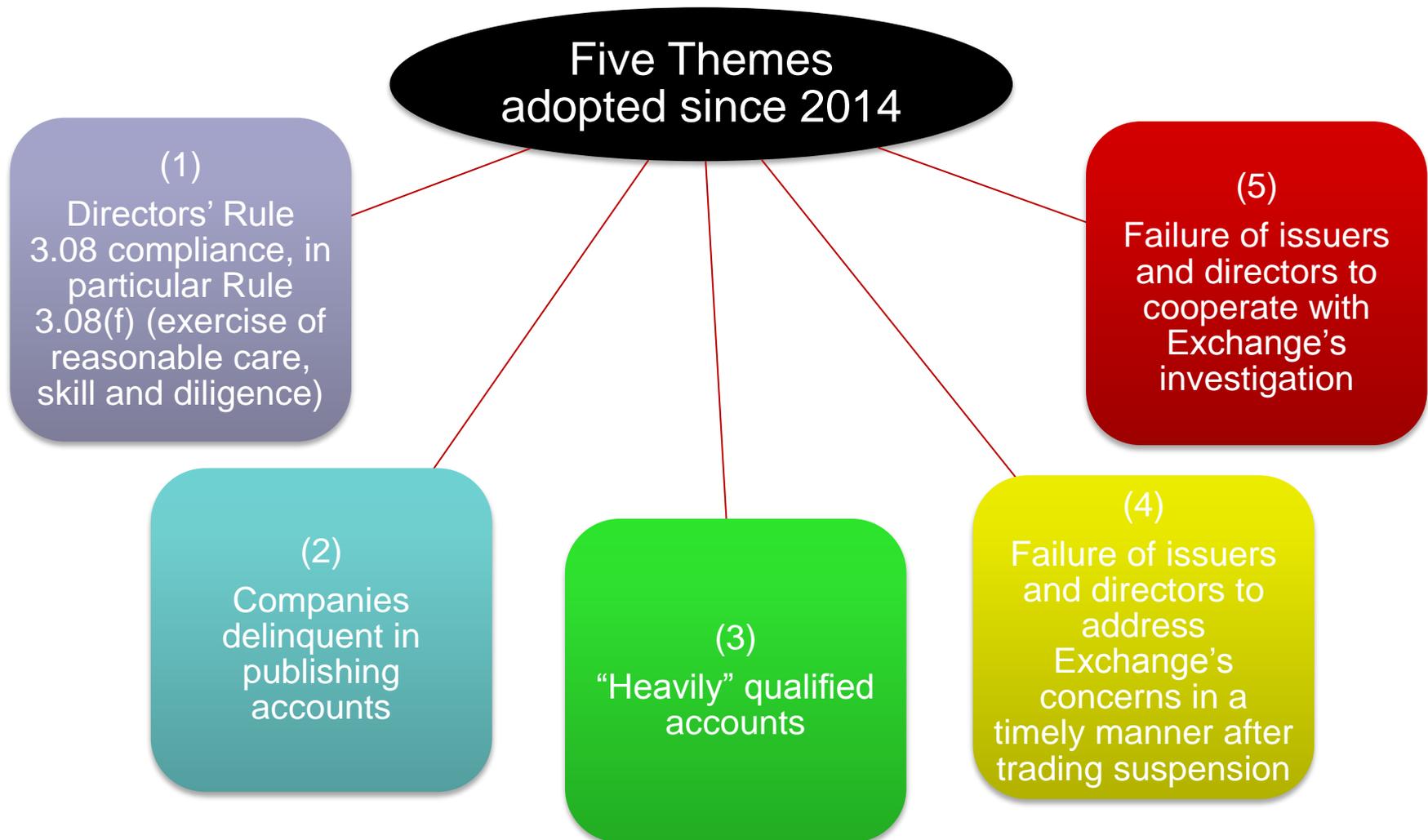
Previously (Before 2014)

- No policy to pursue disciplinary actions by a “theme”
- Group of cases pursued (e.g. failure to disclose price-sensitive information and Model Code cases) as a result of the nature of cases being referred for investigation

Why thematic enforcement?

- Work relating to disclosure of price-sensitive information diminished following implementation of statutory backing
- Assist in achieving the Exchange’s stated goals and using our resources more effectively
- Market education

Current Themes for Enforcement (2)



Current Themes for Enforcement (3)



1

Directors' Rule 3.08 compliance, in particular Rule 3.08(f) (exercise of reasonable care, skill and diligence)

- newly listed companies
- quality of due diligence conducted re: business acquisition
- business failures post-completion of acquisitions
- obligation to take an active interest in issuer's affairs; obtain general understanding of business; follow up anything untoward that comes to attention

Current Themes for Enforcement (4)



2

Companies delinquent in publishing accounts

- Internal control deficiencies which led to failure to publish accounts in a timely manner

Current Themes for Enforcement (5)

3

“Heavily” qualified accounts

- (a) qualified opinion; (b) adverse opinion; (c) disclaimer opinion
- investigate categories (b) and (c):
 - circumstances of issuer; why auditor unable to give true and fair view on financial statements
 - why issuer unable to provide all necessary information to auditors
 - whether adequate and effective internal controls in place

Current Themes for Enforcement (6)

4

Failure of issuers and directors to address Exchange's concerns in a timely manner after trading suspension

- prolonged suspension as issuer delays addressing Exchange's comments
- issuer fails to take measures to restore minimum public float in a timely manner

5

Failure of issuers and directors to cooperate with Exchange's investigation

- Rule 2.12A: obligation on issuers to provide as soon as possible or in accordance with time limits imposed by the Exchange:
 - information the Exchange reasonably considers appropriate to protect investors or ensure smooth operation of the market
 - any other information or explanation that the Exchange may reasonably require for investigating a suspected Rule breach or verifying Rule compliance

Current Themes for Enforcement (8)



5.1

➤ Director's Undertaking – contain obligation:

- mirrors Rule 2.12A; and to
- cooperate in any investigation conducted by Listing Department and/or Listing Committee, including:
 - answering promptly and openly questions
 - promptly producing originals or copies of any relevant documents
 - attending before meeting or hearing at which they are requested to appear

Current Themes for Enforcement (9)



5.2

- More vigorous enforcement of these obligations.
- Important to enable the Exchange to discharge its function to maintain and regulate an orderly market. Failure to comply with the Exchange's requests in connection with its investigation without reasonable excuse will, in appropriate cases, lead to public sanction or be subject to more serious consequences.
- Such a breach will be taken into account in the Exchange's consideration of suitability of the individual concerned to be appointed as a director of a listed issuer in Hong Kong in the future

Overview



1

Regulatory Role of the Exchange

2

Published Enforcement Strategy

3

Current Themes for Enforcement

4

Case Studies

5

Takeaway

Case Study A



Richly Field China Development Limited (Stock Code: 313) (Press Release dated 21 January 2015)

Facts

- Between Mar 2011 and Nov 2012, Company's two principal subsidiaries conducted 4 connected transactions.
- At the time, there were (a) 2 EDs including Mr He (also Chairman); and (b) 5 NEDs/INEDs.
- Mr He had knowledge of and involvement in all 4 transactions. He did not notify the Company Board or any other directors of the transactions.
- Auditors alerted the Company to the first 3 transactions and the associated rule breaches. Company made enquiries of Mr He, and conducted internal control review. Whilst these were going on, in Nov 2012, Mr He directed the 4th transaction to be conducted again without knowledge or approval of the Board, and without disclosure and shareholders' approval.

Case Study A (2/6)



Findings

Company

- Breached the rules for failing to comply with announcement and shareholder approval requirements.
- Lacked adequate and effective internal controls for the identification, reporting and approval of connected transactions and in turn to ensure rule compliance.
 - Repeated breaches.
 - Breaches not prevented or detected by the Company's internal controls but by external parties.

Case Study A (3/6)



Mr He

- Breached Rule 3.08(f) (failing to exercise skill, care and diligence required of him as a director); and Directors' Undertakings to use his best endeavours to procure the Company's rule compliance and that he complied with the rules to the best of his ability.
- Wilful and persistent disregard of the rule requirements and his duties under the Listing Rules.

Case Study A (4/6)



Six other Directors

- Breached their Best Endeavour Undertakings:
 - When they ratified Transaction 1 in Jun 2011, they ought to have but did not enquire into the reasons for non-compliance and adopt measures to prevent similar non-compliance.
 - They did not ensure adequate internal controls were in place.
 - 3 directors remained in office when Transaction 4 occurred: Interim measures put in place pending outcome of the then ongoing internal control review, were inadequate leading to Transaction 4 occurring in breach of the rules.

Case Study A (5/6)



Sanctions

- Public censure of the Company, Mr He and the other ED
- Public criticism of the other 5 directors
- Directors to undergo 24 hours training on Rule compliance, particularly in relation to notifiable and connected transactions as a pre-requisite of future appointment as a listed company director.
- The Listing Committee expressed the view that, had Mr He remained in office, the Listing Committee would have directed publication of a statement that in the Exchange's opinion, the retention of office by Mr He would have been prejudicial to the interests of investors.
- Should Mr He wish to become a director of another issuer in the future, his conduct in this matter will be taken into account in assessing his suitability under Rule 3.09 of the Listing Rules.

Case Study A (6/6)



Takeaway

Ensure adequate internal controls are in place. Poor internal controls and a failure to enforce them can lead to rule breaches and disciplinary action.

Important to keep shareholders and the public fully informed of material information which might affect their interests to enable them to make an informed assessment of the issuer.

Case Study B



Opes Asia Development Limited (Stock Code: 810) (Press Release dated 24 June 2015)

Facts

Transaction

- On 13.6.2012, the Company signed an agreement to subscribe for RMB20m convertible bonds. Under the size test as of 13.6.2012, the Transaction was a major transaction. However, directors relied on a size test done at an earlier time. The Company did not issue an announcement, publish a circular or seek shareholders' approval required by Listing Rules Chapter 14.
- After becoming aware the transaction was a major transaction in Sept 2012, the Company decided not to convene a SGM to ratify the Transaction claiming that the subscription monies could not be refunded if shareholders did not ratify it.

Case Study B (2/4)



Late Accounts

Results/Report	Due date	Publication date
2012 Annual Results	31.3.2013	23.7.2013 (delay of 3 months and 23 days)
2012 Annual Report	30.4.2013	8.8.2013 (delay of 3 months and 8 days)
2012 AGM	30.6.2013	21.10.2013 (delay of 3 months and 21 days)

- Company had similar non-compliance record: Delayed publication of 2011 Results/Report and in holding 2011 AGM.
- The Directors considered two options (a) the implications of breaching the Listing Rules (for delaying results publication); and (b) publishing the results by the deadline with a qualified auditors' opinion.
- Relying on the advice of the company secretary and chief financial officer, the Directors decided that option (b) above would have more serious consequences for the Company and delayed results publication.

Case Study B (3/4)



Findings

- Company breached:
 - Rules 14.34, 14.38A, 14.40 and 14.41 in respect of the Transaction; and
 - Rules 13.49(1)(ii), 13.46(2)(a) and 13.46(2)(b) in respect of the Late Accounts
- Directors breached their Undertakings:
 - Directors should understand when a size test should be conducted (when the terms of Transaction have been finalised).
 - By not holding a SGM to ratify the Transaction and in relying on the Advice from the Company Secretary and CFO without question or consideration of alternatives available, the Directors failed to give sufficient priority to rule compliance.

Case Study B (4/4)



Sanctions

- Public criticism of the Company and the directors

Takeaway

Directors must have proper regard to and understanding of Listing Rule compliance. Rule compliance by issuers and their directors is imperative. It is not optional, regardless of the commercial situation.

Important to keep shareholders and the public fully informed of material information which might affect their interests to enable them to make an informed assessment of the issuer.

Case Study C



Larry Jewelry International Company Limited (Stock Code: 8351) (Press Release dated 6 August 2015)

Facts

- On 26.4.2011, the Company announced that its subsidiary had signed an agreement to acquire the ultimate holding company of the retail outlets carrying business under the “Larry Jewelry” brand name for \$400m (a VSA).
- The Vendor guaranteed that FY2011 and FY2012 net profit after tax of the Target Companies would be no less than \$70m. Any shortfall in the profit guarantee was payable by the Vendor on a dollar-for-dollar basis.
- Company shareholders approved the Acquisition.
- The profit guarantee was subsequently waived by a supplemental agreement dated 26.3.2012. Company Directors had approved the Waiver on 18.1.2012. The Company did not issue any announcement or seek shareholders’ approval of the Waiver.

Case Study C (2/4)



Findings

- Company breached GLR19.36:
 - The profit guarantee was an important term of the Acquisition which the shareholders have approved.
 - The Waiver was a material variation of the terms of the Acquisition requiring announcement and shareholders' approval. The Company did not comply with the requirements.

- ED Ms Tsang, two NEDs and three INEDs breached (a) GLR5.01(6) in failing to exercise the skill, care and diligence reasonably required and expected of them (and Ms Tsang also the compliance officer of the Company); and (b) their Best Endeavour Undertakings. Reasons:
 - They failed to consider the application of GLR19.36 to the Waiver.
 - Alternatively, if they did consider GLR19.36 application at the material time, they failed to properly understand GLR19.36 requirements.
 - They did not consult the Company's compliance adviser.

Case Study C (3/4)



Sanctions

- Public criticism of the Company
- Public censure of Ms Tsang
- Public criticism of the two NEDs and three INEDs
- A former NED (who remains a director of another issuer listed on the Exchange) is to attend 24 hours training on GLR compliance, director's duties and corporate governance matters and 4 hours on GLR Chapter 19 requirements.
- Ms Tsang and the other NED/INEDs (who are no longer directors of any listed issuers) are to undergo the Training as a pre-requisite of future appointment as a director of a company listed on the Exchange.

Case Study C (4/4)



Takeaway

Poor knowledge of the application of the rules, self serving interpretations of the rules and failure to take professional advice can have the same consequences.

Important to keep shareholders and the public fully informed of material information which might affect their interests to enable them to make an informed assessment of the issuer.

Case Study D



Mr Xu Lian Guo (“Mr Xu”), an executive director of Zhongda International Holdings Limited (Stock Code: 909)
(Press Release dated 21 July 2015)

Facts

- Mr Xu was the Chairman and an ED of Zhongda.
- The Exchange conducted investigation into possible listing rule breaches by the Company and/or its directors in relation to various matters including the alleged failure by Mr Xu to supervise the application of a RMB150m deposit in accordance with the Company Board’s instructions.
- The Exchange sent an enquiry letter to Mr Xu, followed by written and verbal reminders.
- Mr Xu did not provide information and documents as requested despite repeated requests.

Case Study D (2/3)



Findings

- Mr Xu breached his Undertaking to co-operate

Sanctions

- The sanctions imposed took into account Mr Xu's compliance history: He had previously been publicly censured for a similar breach and other breaches of Undertaking:
 - Public censure of Mr Xu
 - A public statement that by reason of Mr Xu's wilful and persistent breaches of the Director's Undertaking, in the Exchange's opinion, the retention of office by Mr Xu is prejudicial to the interests of investors under Rule 2A.09(7); and
 - Mr Xu's conduct in this matter and previous disciplinary actions and compliance record will be taken into account in assessing his suitability should he wish to become a director of another issuer in the future.

Case Study D (3/3)



Takeaway

Failure to comply with the Exchange's requests in connection with its investigation, without reasonable excuse, will, in appropriate cases, lead to public sanction of delinquent directors and consequences for suitability as a director in the future.

Overview



1

Regulatory Role of the Exchange

2

Published Enforcement Strategy

3

Current Themes for Enforcement

4

Case Studies

5

Takeaway

Takeaway (1)



Ensure adequate internal controls are in place. Poor internal controls and a failure to enforce them can lead to rule breaches and disciplinary action.

(Richly Field Decision)

Directors must have proper regard to and understanding of Listing Rule compliance. Rule compliance by issuers and their directors is imperative. It is not optional, regardless of the commercial situation.

(Opes Asia Decision)

Poor knowledge of the application of the rules, self serving interpretations of the rules and failure to take professional advice can have the same consequences.

(Larry Jewelry Decision)

Important to keep shareholders and the public fully informed of material information which might affect their interests to enable them to make an informed assessment of the issuer.

(Richly Field, Opes Asia and Larry Jewelry Decisions)

Takeaway (2)



Failure to comply with the Exchange's requests in connection with its investigation, without reasonable excuse, will, in appropriate cases, lead to public sanction of delinquent directors and consequences for suitability as a director in the future.

(Decision in the case involving Mr Xu)

The End