December 2020

Listed Issuer Regulation Newsletter

Highlights of this issue

- Further guidance on the disclosure of counterparties in transactions
- Update on backdoor listings and continuing listing criteria one year after the Rules amendments
- Planning for the upcoming financial reporting period amid Covid-19
- Introducing our Listing e-Forms

Welcome to the third issue of our Listed Issuer Regulation Newsletter

In this newsletter, we provide guidance on companies' disclosure of counterparties in transactions. We also provide an update on our administration of the amended Rules on reverse takeovers **(RTOs)** and continuing listing criteria since they took effect in October last year, including how we consider the impact of Covid-19 in applying these requirements. As many companies are approaching their financial year-end, we take this opportunity to remind them to plan for their financial reporting and audits, taking into account companies' experience with handling the Covid-19 pandemic surrounding the December 2019 financial year-end.

Further guidance on the disclosure of counterparties in transactions and securities subscriptions

Following amendments to MB Rule 14.58 (GEM Rule 19.58) in October 2019, we gave guidance on the disclosure of counterparties in notifiable transactions and securities subscriptions in our November 2019 newsletter. We highly encouraged companies to disclose the identity of the beneficial owners, particularly where the counterparties are investment holding vehicles. In any event, companies should bear in mind the overriding principle that the Rules' disclosure standards[1] require information in companies' documents to be meaningful, accurate and complete in all material respects.

We are pleased to note that most companies followed our guidance. With experience gained from our post-vetting of companies' announcements, we provide further guidance below.

Disclosure of counterparties and ultimate beneficial owners

The counterparty subject to disclosure is normally the person who negotiated the transaction, not the investment holding company that is the legal buyer, seller or subscriber. In some cases the counterparty may have a continuing relationship with the company, such as continuing to hold interest in the target company. As a general practice, companies should disclose the ultimate beneficial owner (**UBO**). This provides the investing public with information on the party who could exert influence on the transaction.

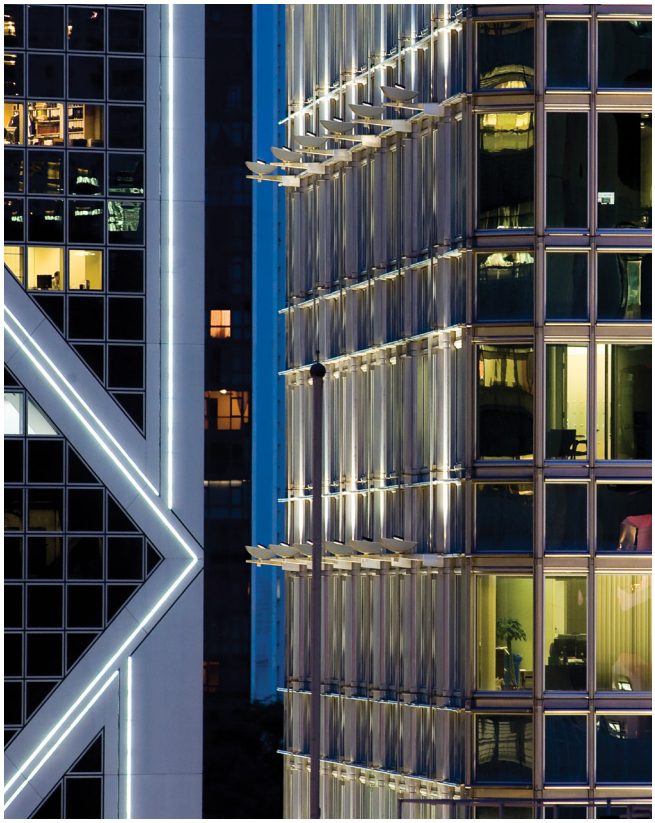
An UBO would normally be a natural person. The following guidance applies to structures involving numerous parties, some of whom may be passive.

- **For a company**, natural persons who control, directly or indirectly, one-third or more of the counterparty. If the counterparty has a diverse shareholder base, the company should disclose at a minimum the UBO of the single largest shareholder;
- **For a trust**, the trustee and beneficiaries of the trust; and
- **For an investment fund**, the licensed investment manager and/or the general partner (which may be a corporate) of a registered investment fund with a wide investor base. For other investment funds, such as a single purpose fund or one with a few investors, the identity of the investors should also be disclosed.

[1] MB Rule 2.13/GEM Rule 17.56

In some situations, disclosure of the counterparty itself or its intermediate owner could provide sufficient information. This may include:

- A listed company;
- A private company which has a substantive business and is generally known to the public, such as a department store or restaurant chain;
- A governmental body or state owned enterprise; and
- Where the company receives or provides services in its ordinary and usual course of business, the customer or service provider, such as the contractor providing construction service, or the landlord in an operating lease.



Disclosure of other parties associated with the target company

The UBOs of other parties related to the subject matter of the transaction may also be material information requiring disclosure[2], particularly where the issuer may have a continuing relationship with these parties. This includes other shareholders of the target company acquired by the issuer. For example, a 30% shareholder of the issuer's 70% owned subsidiary, or the 30% and 21% minority shareholders of the issuer's 49% owned investee company. This is particularly the case where the other shareholders of the target company may exert influence on the target company.

Disclosure of other relationships between the counterparties and connected persons

The Rules[3] also require an issuer to confirm that the counterparties to a transaction and their beneficial owners are third parties independent of the issuer and its connected persons. In this regard the issuer should also disclose any significant relationships between the counterparties (and their UBO) and the connected persons. For example, material financing arrangements such as loans to or from a connected person provided prior to the transaction, or funding provided by the connected person to finance the counterparty's original acquisition of the target company. If the relationship gives rise to concerns that the connected person was in a position to exercise significant influence over the issuer on the transaction, the Exchange may deem the counterparty as a connected person of the issuer under Chapter 14A[4].

[2] MB Rule 2.13/GEM Rule 17.56
[3] Rule 14.58(3)/GEM Rule 19.58(4)
[4] Rule 14A.19/GEM Rule 20.17

Update on backdoor listings and continuing listing criteria one year after the Rules amendments

In October 2019, we amended the Rules on backdoor listings and continuing listing criteria. The amendments allow the Exchange to take a purposive approach to address corporate activities that undermine market confidence, and particularly, shell activities that were conducted by a small group of listed companies and certain market participants.

RTOs and Very Substantial Acquisitions (VSA)

One year on, we share some observations of VSA and RTO transactions.

- The RTO Rules did not restrict legitimate business activities - We were mindful that the amended Rules were not intended to restrict legitimate business activities of companies, and consequently, we have taken a purposive approach in our RTO assessments. In fact, 20[5] companies announced VSAs in the last 12 months, which, despite their substantial size, were not ruled as RTOs. These transactions generally involved acquisitions of businesses in the same line of businesses as the companies' or were expansions or vertical integration to their existing businesses. We also granted waivers from applying the bright line RTO Rules to two transactions that were, in substance, group reorganisations where the companies continued the same principal businesses after the reorganisations.

- We took a targeted approach to address backdoor listing and shell activities – In the last 12 months we ruled 18 transactions as RTOs or extreme transactions, applying the principle based test to assess whether those transactions constituted an attempt to circumvent the new listing requirements. All but one of the RTO transactions terminated after the RTO ruling[6]. Of the six assessment factors, we note that, in addition to the acquisitions being extreme in size,
  - Most acquisition targets were different from the principal business of the companies, and would result in a fundamental change in the companies' business after the acquisitions because of the extreme size of the targets;
  - A majority of the companies had shell characteristics, including recent changes in control and cessation of their original businesses;
  - Some companies that had acquired new businesses sought to dispose of their original businesses thereafter. This constituted a series of transactions leading to a backdoor listing, and the disposals were subject to RTO Rules requiring that the new business complies with the new listing requirements; and
  - In some cases, the quality of the target assets was questionable, for example, newly commenced businesses without track records and businesses that had applied for new listings but had not satisfactorily addressed the concerns of the Listing Division.

- The number of RTO rulings represents a notable increase over 2019[7]. We will continue to closely monitor this area and take a robust approach to address shell activities. As part of this initiative, we recently issued a consultation paper proposing amendments to the eligibility criteria for new listing applicants to address concerns about shell manufacturing activities through new listings.

[5] There were 19 VSA transactions for the first nine months of 2019 before the Rule amendments took effect.
[6] The transaction that proceeded was subject to the RTO bright line test. All but one of the extreme transactions also proceeded.
[7] There were 6 RTO rulings for the nine months of 2019 before the amended RTO Rules took effect.

Administering Rule 13.24 in the Covid-19 environment

In the last 12 months, 13 companies were ruled by the Listing Division to have failed to meet the continuing listing criteria under MB Rule 13.24 (GEM Rule 17.26) to carry on sufficient operations[8]. These companies had disposed of their principal businesses, or such businesses had substantially downsized or ceased operations for years.

Recent events, such as the Covid-19 pandemic and the US-China trade disputes, have caused severe disruptions to the operations of many companies. Our Guidance Letter explains that an issuer experiencing a temporary reduction or suspension of operations due to market conditions or business strategies would not be considered to have failed Rule 13.24 only because of the temporary circumstances.

Some examples of temporary circumstances include:

- A company suspended its breeding farms and slaughter house in early 2018 upon the outbreak of the Asian Swine Flu in Mainland China. Since then, it undertook various actions; it refurbished the facilities, redesigned the QC procedures, maintained continuous dialogue with the government and reapplied for licenses. The company obtained licenses to recommence part of its operations in late 2020.

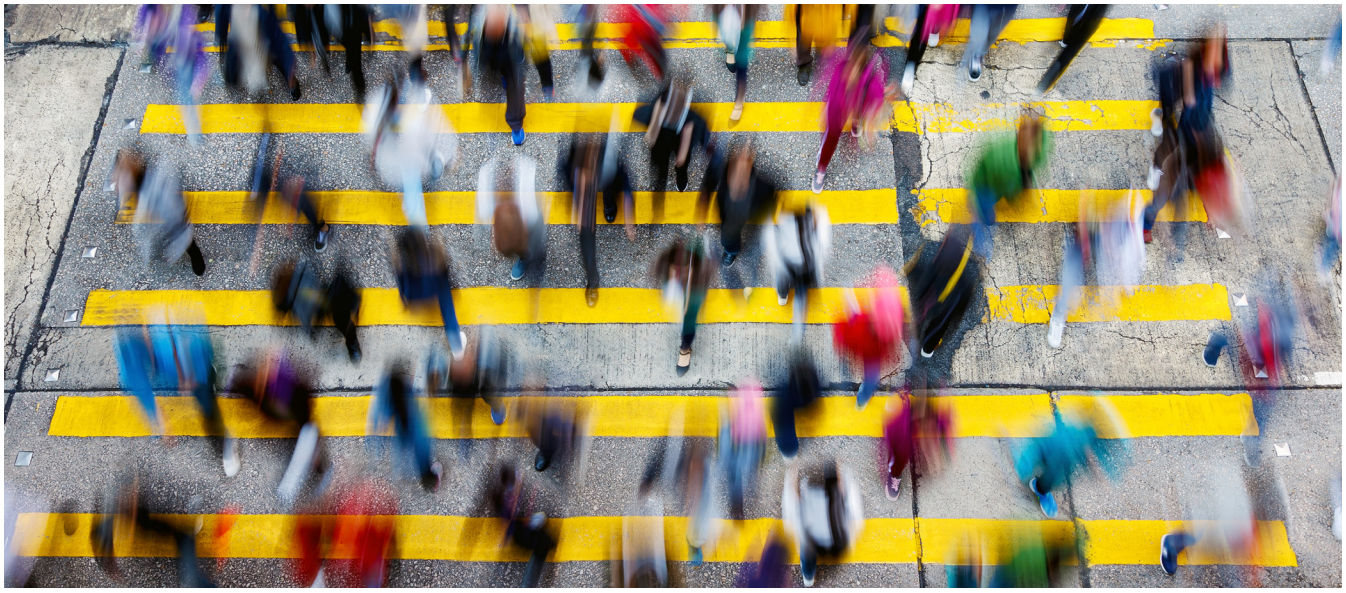
- A small property development consultant experienced significant business downturn over the last three years due to the US-China trade dispute and tightened housing policies affecting small developers. Recently the government lifted certain restrictions which would stimulate market demand. The company provided a profit forecast (supported by signed contracts) with an increase in the level of operations.

If a company can demonstrate that such external circumstances materially disrupt its business operations, we would refrain from taking immediate action against the company. The company should formulate a business plan, and we will monitor its business development and review the outcome against its plans to assess its compliance with Rule 13.24.

Handling of long-suspended companies in the Covid-19 environment

We apply the same principle to suspended companies facing a delisting deadline. We would consider any request for a time extension if it could be demonstrated that an inability to meet the resumption conditions and re-comply with the Rules was caused by disruptions arising directly from the Covid-19 outbreak, and not from other substantive issues. The company is expected to provide a concrete action plan with an expected time table. We will consider such request case by case based on its specific circumstances.

Consistent with our stated policy to discourage shell activities, an extension would not be given to, among others, facilitate a reverse takeover, or for the development of a new business unrelated to its current business after the suspension of the current business.



[8] Some of these companies appealed against the ruling, and to date the appeal process for one case is still ongoing.

Planning ahead for the upcoming financial reporting period amid Covid-19

Earlier this year, we published Guidance providing timing relief for approximately 1,800 companies[9] for the publication of preliminary results and audited financial reports. We are pleased to report that approximately 80% of companies with December year ends were able to publish preliminary results agreed with auditors, and audited financial reports before the Rules deadlines, both in full compliance with our Rules.

Material differences between published management accounts and audited results

- Approximately 20% of companies relied on our Guidance and timely published management accounts that were not agreed with auditors, but reviewed by the audit committees. About 80% of these companies subsequently published audited results consistent with the management accounts, and the rest reported differences between the audited results and management accounts[10]. We note that there were some common reported differences:
  - A majority of companies made additional impairment assessments or adjusted the valuation of assets or liabilities;
  - Some adjustments related to the application of accounting standards. For example, some companies made adjustments to net-off revenue and costs of sales based on auditors' advice to recognise revenue on a net (instead of gross) basis in accordance with HKFRS 15, notwithstanding that the standards had been adopted in prior years' financial statements; and
  - A few companies did not make sufficient provision for accrual of expenses, such as interest expenses.
- Despite these reported differences, upon our review of these accounts we were generally satisfied that the directors discharged their duties to act diligently in preparing and publishing the management accounts. **We also commend the work of the directors of the companies and their audit committees in providing timely financial information to the market despite the strenuous circumstances.**
- With more time allowed for planning and preparation, we note that more than 90% of companies with a March or June financial year-end were able to release final results this year within the Rules deadline. We remind companies to stay vigilant to the development of Covid-19 and its impact on their financial reporting. **Companies that experience difficulties in meeting the financial reporting deadlines under the Rules should consult us at the earliest instance.**

[9] Companies with a December financial year end.

[10] This represents more than 10% variance in revenue, net profit, total assets or net assets.

Planning ahead for the upcoming financial year end

In just a few months, companies with a December financial year are due to publish their 2020 accounts. To cope with challenges related to the Covid-19 restrictions and to ensure timely response to the evolving situation, we encourage companies to start planning for their financial reporting and audits. We recommend the following:

- The audit committee should:
  - Review companies' internal control on financial reporting systems to ensure they are adequate; and
  - Take a proactive role in discussing with management and auditors the plan for the upcoming audit and ensure sufficient resources are deployed at both companies and auditors' levels.
- During the audit planning process, companies should discuss with their auditors any significant accounting matters for the reporting year, such as material acquisitions, disposals, valuation, and impairment.
- Companies should engage professional parties such as valuers at the earliest instance to discuss their plans and timetables. They should closely monitor subsequent developments that might necessitate swift responses and alternative course of actions.
- Companies anticipating material audit issues, or having received a modified audit opinion last year, should take prompt and necessary actions to resolve the audit issues. For example, where the issues relate to reported values, companies should produce supportable assumptions for their asset valuation and impairment tests. Where the companies held material divergent views from their auditors, they should communicate with auditors early and work closely to explore ways for reconciliation and resolution. Under the recently amended Rules, if the auditor has issued, or indicated it would issue, a disclaimer or adverse opinion on the financial statements, we would normally require a suspension of trading in the company's securities[11].
- For companies whose audited accounts showed material differences from their previously announced unaudited preliminary results, they should review the underlying causes of such differences to identify areas for improvement.
- Companies should also consider appropriate disclosure in their annual reports related to the Covid-19 pandemic. This may include:
  - Qualitative disclosures about its effect on companies' operations, and the relevant risks or uncertainties that will materially affect their future performance;
  - Quantitative measures of the financial impact of the pandemic;
  - Assessments of the liquidity positions and working capital sufficiency with reference to the operations and capital commitments; and
  - Measures such as cost control, funding and business plans taken or which will be taken to manage the impacts of the pandemic.

The FRC published its interim inspection report

The Financial Reporting Council (**FRC**) published on 11 December 2020 an interim report on its inspection which aims to enhance audit quality and maintain investor confidence in corporate reporting. We strongly recommend companies and their audit committees to review the report, and consider the report's recommendations when planning their financial reporting and audits.

[11] Suspension will normally not be required for (i) disclaimer or adverse opinion relating to going concern issue only; or (ii) the underlying issues giving rise to the disclaimer or adverse opinion have been addressed before the issuer publishes the preliminary results announcement.

Listing e-Forms went live on 29 November

We have recently introduced Listing e-Forms which allow companies to submit certain notices and documents in an electronic format through our e-submission system (ESS).

These documents include blackout period notifications, director/supervisor's undertakings and contact details, size tests for notifiable and connected transactions, trading arrangement forms, and listing applications.

During the transitional period (ending 31 December), companies can submit e-Forms or pdf documents. Starting 1 January 2021, we will only accept e-Forms for the above mentioned matters. To familiarise yourselves with these e-Forms, you may refer to the guidance materials (English and Chinese).

We welcome your feedback.
Please send your thoughts and comments to
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