To: Hong Kong Exchanges and Clearing Limited

Rule 13.50A: A Double-Edged Sword

A. Introduction: Current Regime and Proposal

In September 2018, the Stock Exchange of Hong Kong issued a Consultation Paper for a proposed new Listing Rule 13.50A. The proposed rule seeks to immediately suspend trading of shares of listed issuers if their auditors are unable to greenlight their financial statements without qualification, with a risk of delisting if the issue is not cured within 18 months (12 months for the GEM Board). .

Under the current Listing Rule 13.49, a listed issuer must announce its preliminary annual results within 3 months of its financial year end to investors, which is based on the issuer's financial statements which have been agreed with its auditor. The role of the auditor is to form an opinion for the benefit of investors indicating that the issuer's financial statements as a whole are free from material misstatements and are presented in accordance with applicable accounting standards. If the auditor is satisfied with the accuracy of the listed issuer's financial statements, it will submit an unqualified opinion. If, however, the auditor is of the opinion that there is a possibility of misstatements, whether owing to fraud or error, in the financial statements provided to it, it may issue one of three types of "modification" on its opinion, each representing a different severity of misstatement risk.

Briefly, the three types of modifications are, in increasing degree of severity, as follows: (i) a *qualified opinion*, which is where the auditor concludes that misstatements, individually or in aggregate, are material but not pervasive to the financial statements, or where the auditor is unable to obtain sufficient audit evidence but concludes that the possible effects on the financial statements of undetected misstatements could be material but not pervasive; (ii) a *disclaimer* of opinion, which is where the auditor is unable to obtain sufficient audit evidence and concludes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive, or, in rare circumstances, where it is able to obtain sufficient audit evidence regarding individual uncertainties but concludes that it is unable to form an opinion on the financial statements owing to the potential interaction of the uncertainties and their cumulative effect on the financial misstatements; and (iii) an *adverse opinion*, which is where the auditor concludes that, after having obtained sufficient audit evidence, concludes that misstatements, individually or in aggregate, are both material and pervasive to the financial statements. In issuing such modified opinions, the auditor will describe the matters justifying the modification.

Under the proposed Listing Rule 13.50A, suspension of trading is "normally required" where a listed issuer publishes preliminary annual results and its auditors has issued, or indicates that it will issue, a disclaimer or adverse opinion on the relevant financial statements (for the avoidance of doubt, the proposal does not apply to qualified opinions). This proposed Rule must be read in conjunction with the recently enacted Listing Rule 6.01A. Under Listing Rule 6.01A, the Stock Exchange has the power to delist any listed issuer whose shares have been suspended from trading for 18 months. In other words, on the issuance of a disclaimer or adverse opinion, the delinquent listed issuer's shares will immediately be suspended from trading and a countdown to delisting begins.

In contrast, under the current regime, where a modification on the auditor's opinion is likely, the issuer is only required to disclose additional information in its results announcement and annual report together with details of the modification. There is no hard and fast rule requiring suspension because of the publication of a disclaimer or adverse opinion. Nevertheless, at present, suspension and delisting are still possible pursuant to Listing Rules 6.01 and 6.01A. Listing Rule 6.01 empowers the Stock Exchange to suspend or cancel the listing of an issuer to protect investors and/or maintain an orderly market, and in the Consultation Paper the Stock Exchange gives the example of an adverse opinion as being one such cause for suspension in the current regime. In the event of suspension, the 18 months to delisting will begin to run. However the major differentiating factor between the current regime and the proposal is that trading suspension, which triggers the countdown to delisting, remains for now at the discretion of the

Stock Exchange and is not a default penalty.

B. Analysis of the Benefits and Disadvantages of the Proposal

The new regime has the stated purpose of protecting investors and, on first blush, does appear to accomplish this objective. It strongly incentivises listed issuers to enhance and comply with internal control and risk management systems to improve the quality and reliability of their financial information, and to cooperate with auditors by disclosing all requisite information to enable the auditor to be assured that the issuer's financial statements are free from material or pervasive misstatement. It accomplishes this by enhancing the punishment and the certainty of punishment, and thus encourages transparency and motivates issuers to promptly cure any defects in the event of a disclaimer or adverse opinion being published. In contrast, as stated in the Consultation Paper, many listed issuers who have received disclaimers or other modifications from auditors have not cured their deficient financial information. For instance, of the 43 issuers that received disclaimers on their 2017 financial statements, over half have had disclaimers for two or more consecutive financial years. Of them, some have had disclaimers for as much as 5 consecutive years. With the risk of delisting looming on the horizon, it is not a far stretch to imagine that listed issuers would be much more motivated to cure the defect within the prescribed 18 months.

Yet, despite the good intentions, the new Listing Rule raises many unintended consequences that could well defeat its stated purpose and potentially harm the investors it seeks to protect. Broadly, these ramifications include (i) reluctance on the auditor's part to issue modifications that could lead to suspension and possible delisting, stemming from the fact that the issuer is a paying client, thus severely exacerbating the natural conflict between an auditor's duty and its commercial interests under the proposed new regime; (ii) the reduction of transparency in the market to the disadvantage of investors; (iii) the draconian and unintended consequence of adversely affecting minority shareholders by depriving them of a market to trade their shares and, if delisting occurs, of any value to their investment; and (iv) allowing the opportunity for majority shareholders to purchase the shares, which are worthless upon delisting, at a steep discount irrespective of whether the underlying assets and business of the listed issuer remains valuable.

(i) The Auditor's Position

Regarding the first point, it is worth noting that independent auditors occupy a position of conflicting interests. On the one hand, they are instructed by the directors of and are paid by listed issuers for rendering an independent audit opinion. On the other, their objective is to be independent and protect shareholders. Under normal circumstances these forces are not necessarily opposed but, in the event of disclaimers or adverse opinions, the tension between an auditor's duty and commercial interest becomes readily apparent. This is a view that has been echoed by accountants in Hong Kong in response to the proposed Listing Rule 13.50A. It is not farfetched to think that listed issuers, when faced with a disagreement with the auditors and an impending disclaimer or adverse opinion, would attempt to bully auditors into a favourable opinion. They could threaten to take their business elsewhere and obtain a different audited opinion that is more palatable than it otherwise would be have been had no such pressure existed. This could result in auditors watering down what otherwise would have been a disclaimer or adverse opinion just to appease paying clients. This is not to say there is no conflict under the current regime, but auditors would feel more at ease in issuing a disclaimer or adverse opinion if they were not given the seat of executioner. The proposed Listing Rule would shift the discretionary power currently vested with the Stock Exchange onto accountants, which by their nature as both auditors and service providers to their issuer clients, are ill-placed to take on such authority. In the Consultation Paper, the Stock Exchange stated that some of the 43 modifications in 2017 resulted from differences in judgment between the directors and auditors. In such a case it is not unimaginable for a listed issuer to shop for a new auditor whose views are more aligned with its own.

(ii) Reduction of Transparency

This ties in with the second point regarding disclosure and transparency. As discussed above, ramping up the conflicting pressures on auditors could well undermine their independence, and prompt them to issue audit opinions that are more benign to listed issuers than would otherwise be issued under the current regime. This would introduce a sliver of suspicion for investors who rely on audited financial information and the independence of auditors.

But there is another factor that could further affect transparency which results from the interaction between the existing Listing Rules and the proposed Listing Rule 13.50A. Under Listing Rule 13.50, suspension of trading is required where a listed issuer fails to publish its preliminary annual results announcement within three months of its financial year end. If the new Listing Rule is adopted, it would introduce a form of regulatory arbitrage in which the punishment is the same regardless of the cause. If a listed issuer is unable to agree with its auditors in respect of its financial statements and is faced with a disclaimer or adverse opinion, it could be in the listed issuer's interests to simply delay the publication of their preliminary annual results beyond the deadline of three months and suffer the same fate of suspension. If only from a reputational perspective, a suspension owing to delay could be far more palatable than a suspension owing to defective financial information. As a result, the proposed Listing Rule could inadvertently lead to a lack of transparency for investors, who in such a case would be unable to ascertain the true reasons for listed issuers' suspension. Indeed, in the Consultation Paper the Stock Exchange makes mention of the fact that adverse opinions are rarely ever issued even in the current regime, and in fact no issuers received adverse opinions in the 2017 financial year. It would not be surprising to think that at least some of the listed issuers currently suspended for failing to publish timely preliminary annual results have done so to avoid the taint of an adverse opinion, if they conclude that a temporary suspension for late publication would do less damage than an adverse opinion. The new Listing Rule would only exacerbate this issue and further muddle the waters by enlarging the opportunities for listed issuers to shop around for the preferred indictment.

(iii) Harm to Investors

The third point relates to the unintended harm that will be done to the investors the Listing Rule purports to protect. Suspension and delisting deprives investors of a market for their shares and makes them worthless, even if the underlying assets and business of the listed issuers are healthy and profitable. Investors will be deprived of the ability to exit a poor investment in the event of suspension as should be their prerogative, and would see their investments becoming absolutely worthless if it is ultimately delisted. If for instance a financially distressed listed issuer disputes the judgment of its auditors in respect of whether it can continue as a going concern, investors should be able to elect to dispose of their shares and exit their investment or hold and perhaps allow the company access capital from the markets and work its way out. A total defeat of investment hardly protects their interests.

Furthermore, as the Consultation Paper states, many of the modifications issued recently also resulted from failures by listed issuers to obtain documents following material changes to the board and non-cooperation from former management and failures to maintain proper records due to internal control issues. It would be rather unfair for an investor to lose the entire value of his investment to an uncooperative and difficult former director or poor record-keeping policies, which are factors that are unrelated to the performance or value of the underlying assets and business of the issuer.

More faith should be given to market forces. If disclaimer or adverse opinion issued, investors can make an election to liquidate their investment or hold it out. As the circumstances may demand, the Stock Exchange still retains the power to suspend the listed issuer if deemed necessary, such as in the case of an adverse opinion that reveals a severe risk of pervasive and material misstatement in the issuer's financial reports. Indeed, the Stock Exchange has historically used its suspension powers under Rule 6.01 against listed issuers whose financial statements have been qualified by modifications.

(iv) Squeeze Out

Finally, the total defeat of investment upon delisting can also become an opportunity for opportunistic shareholders. As discussed, disclaimers and adverse opinions are not true reflections of the value of the company but only results of misstatements of financial information. Suspension and delisting would reduce the share price to worthlessness irrespective of the underlying value of the listed issuer, and would also provide opportunity for controlling shareholders to buy-out other investors at steep and possibly unfair discounts. Investors would be happy to recoup anything from their then-worthless shares even though the price offered does not reflect the proper underlying value of the issuer's assets.

C. Conclusion

We believe the current regime should be left intact, as it keeps the power of suspension and delisting with the Stock Exchange. Auditors are ill-placed to and should not assume the responsibilities of the Stock Exchange. Although the intention underlying the proposal is correct, the execution of Listing Rule 13.50A could ultimately harm all stakeholders. And while tighter regulation might be more attractive to investors, it may ultimately be the investors who lose out under the proposed regime.

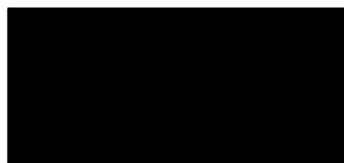
It appears from our observation that certain major stock exchanges also keep the power of suspension and delisting with the stock exchange or their regulators and it is telling that their regulations more closely align with Hong Kong's current system than with the proposed one.

Besides, the question of whether 18 months (or 12 months, in the case of GEM Board listed issuers) is sufficient for issuers to cure their defects has also been raised by parties affected by the proposed Listing Rule. Where the disclaimer or adverse opinion is caused by financial distress, corporate governance or internal control issues, it takes substantial period of time for a company to fix these problems and to gain approval from the Stock Exchange. There is therefore the additional question of whether a hair-trigger suspension, and concomitant countdown to delisting, in response to auditors' modifications could force a healthy issuer off the capital markets before it is given sufficient opportunity to rehabilitate.

Hong Kong is a mature market populated by diligent investors. In the event a poor opinion is published against the financial information of a listed issuer, a selloff and price correction would be due and expected. If the issuer shows no intention to or fails to cure its problems within a reasonable period, the Stock Exchange can then take action under Rule 6.01 and 6.01A under the current rules. It seems the elusive "right balance", which all regulation ultimately seeks to strike, more closely approximates the present regime than the proposed one.

Yours faithfully

Suen Chi Wai



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