

HKEX's proposal to suspend and then delist companies with disclaimed audits works against investor interests in several ways while doing nothing to address the root causes of corporate illness. In a partial revival of the 2002 Penny Stocks proposals, the self-interest of HKEX in ditching unprofitable business cannot be ignored. We again call for the regulatory function to be transferred to the SFC and HKEX's monopoly to be abolished. Only when there is competition can they pick and choose their customers. HKEX fails to name the 43 firms that would have been suspended on their 2017 audits. Answers by Tuesday morning, please!

## HKEX: shoot patients to prevent illness

### 30 September 2018

On Friday (28-Sep-2018), HKEX (0388) [announced](#) a proposal to change the Listing Rules to suspend trading in shares of companies where the auditor issues a disclaimer of opinion or an adverse opinion on the financial statements. This comes after a recent [rule change](#) which allows the Exchange to delist a company if it has been suspended for 18 months on the Main Board, or only 12 months on the GEM.

HKEX and the SFC (which approved the delisting change) appear to believe that the way to improve (or euphemistically, "maintain") "market quality and reputation" is to more quickly delist suspended companies, and in combination with that, to make it easier to suspend them in the first place. This is a complete fallacy. In medical terms, it is a belief that the incidence of disease, accidents or self-harm can be reduced by walking around the intensive care ward and shooting the patients. Put simply, this confuses cause and effect.

The result of this corporate euthanasia is to penalise minority shareholders who might have had at least some recovery of their investment if the company had been able to work through its difficulties, perhaps with fresh capital, new management or the acquisition of a new line of business, and emerge from its corporate coma to satisfy the requirements for resumption of trading, if necessary by being treated as a new listing applicant.

Some victims are in fact perfectly healthy and their shares are suspended not because of any internal corporate problem but because their public float has fallen below the 15% threshold due to purchases by large (often minority) shareholders, allowing the Exchange to suspend the stock and depriving the remaining minorities of a market for their shares. That can happen even if the remaining float has a market value exceeding the entire market value of some other small listed companies. It makes no sense whatsoever and we've called before to [scrap the public float rule](#). The disclosure of large shareholdings and the resultant float is sufficient information for investors on this point.

By the Exchange's own data, there were 50 long-suspended issuers whose securities resumed trading between 2012 and 2016. Of these, 46 resumed trading within 36 months. By cutting the recovery period to 18 months (the new Main Board rule), only 33 of them would have survived, and in 12 months (the new GEM rule) only 26 would have survived.

If HKEX, the SFC and Government really want to address the root causes of corporate illness, then there are plenty of ways to improve HK's laws and Listing Rules - for example, by prohibiting controlling shareholders from voting in the elections of so-called "[independent non-executive directors](#)", giving the INEDs a proper mandate and accountability by having them elected or removed by independent shareholders alone; by introducing legal [class action rights](#) for shareholders and allowing contingent legal fees and litigation funding; by preventing directors from picking shareholders via the [general issue mandate](#); and by [requiring banks and brokers](#) to seek voting instructions for client shares they hold, facilitating the retail investor vote.

## The proposals

The latest proposals take the corporate cleansing campaign one step further, by shoving more patients into the intensive care ward. The regulators are aware that some companies publish their results on time (avoiding suspensions for late filing), but for various reasons, their auditors either disclaim their opinion on the accounts or (rarely) give an "adverse opinion" that the accounts are not a true and fair view.

According to the [consultation paper](#), for periods ending in 2017, 43 issuers received a disclaimer of opinion (excluding 14 long-suspended companies), or about 2% of [listed companies by number](#). There were none with an "adverse opinion". 13 of the 43 were disclaimed only because of their

financial difficulties leading to doubt about whether they should be accounted for on a "going concern" basis.

You might think that given the purported concern of the Exchange, it would have included a list of these companies in the paper or elsewhere, to give investors fair warning that if the companies' 2019 audits are disclaimed, they will be suspended and probably delisted. Perhaps by making them harder to find, the Exchange is seeking to avoid a repeat of the infamous [Penny-Stocks Incident](#) of 26-Jul-2002 when stocks were dumped on misguided delisting proposals announced the night before, one of which was to delist companies with a disclaimer or adverse audit opinion. Yes, 16 years later, part of that proposal is back - but these days all proposals are announced on Friday nights to avoid immediate market reaction.

However, although there is no list of disclaimed opinions, the Exchange does maintain a list of filings under the broader category of "[Auditors' Reports with "Qualified Opinion" and/or Explanatory Paragraph](#)" so journalists or other readers can wade through that to find the ones with "disclaimer of opinion". Alternatively, you can search for the exact phrase "disclaimer of opinion" on the page at [this link](#). Perhaps someone would be kind enough to [send us a list](#) of the doomed companies before trading resumes on Tuesday.

To be clear, a "qualified opinion" is not a disclaimer, merely an opinion that the accounts are true and fair but with a qualification. The milder "Explanatory Paragraph" is just an audit report with an emphasis on some matter that does not amount to a qualification.

To be sure, companies with disclaimed audit reports should be treated with extreme caution by investors, but anyone who does their homework on a company before investing will see the disclaimer. For those who don't, as a further step, the Exchange could add a "D" suffix to the short name of the stock, to warn investors of the risk - after all, they are doing that now in the 15-character short names with the "W" flag for second-class shares with inferior voting rights in companies such as "XIAOMI-W" (1810) and "MEITUAN-W" (3690).

Meanwhile, if the SFC suspects wrongdoing by directors of listed companies, it can launch a formal investigation and if necessary intervene and petition the courts to wind up the company or order other remedies, in which case the stock would likely be suspended anyway. If the SFC suspects that directors are withholding material Inside Information, then that is Market Misconduct and the SFC can direct a suspension until the situation is remedied. But if they lack sufficient suspicion (let alone evidence) of wrongdoing to act, then it is not fair to suspend and delist the stock and destroy the interests of minority shareholders in the process, or to deprive a financially distressed company of an opportunity to recapitalise. Nobody has to buy such a distressed stock if they don't want to, but the regulators appear biased towards protecting those who don't own it rather than those who do.

## Auditor pressure and opinion-shopping

There would be another consequence of this proposal. It would increase the pressure on auditors, from the directors who hire them, not to issue a disclaimer of opinion, as it would be like issuing a (suspended) corporate death sentence. This pressure would sometimes result in a milder "qualified opinion" just to retain or win the audit business, and that would be against the interest of investors who deserve to know what the auditor really thinks rather than what it is paid to think. So by linking the audit reports to the listing status, the proposal works against the principles of an informed, disclosure-based market.

## Squeeze-outs

For some controlling shareholders, the prospect of a mandatory suspension and delisting would be music to their ears. It would put them in a position to buy out the minority shareholders, now deprived of a market for their shares and the disclosures required by the Listing Rules, at a knock-down price. The controller would avoid the normal delisting approvals needed under Rule 2.2 of the [Takeovers Code](#), even if the company is still regarded as a "public company" by the SFC.

## HKEX's conflict of interest

Finally, let's not ignore the financial interest that HKEX has in these proposals. It makes the vast majority of its monopolistic profit on the trading, clearing and settlement fees of larger listed companies in HK and the derivatives linked to them. From HKEX's perspective, small troubled companies are loss-makers, because they consume a disproportionate amount of regulatory staff-

hours relative to the overall fees they generate. Ranked by size, on the Main Board at the end of September, 344 companies (18% of 1881) accounted for 90% of the [market value](#). Including GEM and Secondary listings, 362 companies (16% of 2268) accounted for 90% of the [market value](#). Their proportion of turnover and transaction fees is even greater than 90% because the market-value figure includes many large H-share issuers, most of which have nearly 100% free float (the mainland A-shares not being counted towards market value).

The regulatory staff-hours consumed by small companies in financial or other difficulties can be dispensed with if they are quickly delisted rather than rehabilitated, thereby boosting profits for HKEX and its shareholders, including the Government. Put simply, it is cheaper to kill the patients than to cure them.

Since the [Expert Group Report](#) of 2003, the Exchange and the Government have refused to address the inherent conflict of interest in being a for-profit regulator, by transferring Listing regulation to the SFC. Even a half-baked proposal (which we [supported](#) as a step in the right direction) to transfer regulatory reform to a 50:50 committee between HKEX and SFC was [shot down](#).

The Exchange remains a statutory monopoly stock market and HKEX remains exempt from the Competition Ordinance, so there are no alternative exchanges and no competition to drive down exchange fees. If there were, then HKEX and the other exchanges could make commercial decisions on which stocks to trade, and the actual listing would be a matter for the SFC, as it is for the UK's Financial Conduct Authority and the USA's Securities and Exchange Commission, separating the listing regulation from the trading venues. That would be the smart approach - but then HK was never the [Smart City](#) that it claims to be.

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If HKEX proceeds with an ill-conceived Listing Rule change, companies with disclaimed audit reports for 2019 will be suspended and likely delisted, victimising minority shareholders. We now list those with disclaimed audits up to 30-Jun-2018 which would be affected if the rule applied today. Make your submission to stop this nonsense!

## 41 endangered stocks

**17 November 2018**

In our article [HKEX: shoot patients to prevent illness](#) (30-Sep-2018) we opposed HKEX's proposed changes to the Listing Rules which would allow it to suspend and subsequently delist companies which receive a disclaimed audit opinion. Our reasons are in the first article, so we won't repeat them here. The deadline for submissions to HKEX on the proposals is soon, 30-Nov-2018.

Together, these 2 articles constitute our submission. You can make your submission using the [questionnaire here](#) or simply by dropping an email to [response@hkex.com.hk](mailto:response@hkex.com.hk).

We noted in the first article that HKEX failed to include a list of companies that would have been affected if the policy was already in effect. We invited readers to find them. A number of readers sent us contributions to the following list, which we have enhanced and verified - a special shoutout to the team over at [Gekko Lab](#), which got most of it right.

We exclude stocks which are already in long-term suspension. If the proposed rule is adopted and the companies don't obtain (perhaps by opinion-shopping) a non-disclaimed audit report for their financial year commencing on or after 1-Jan-2019, then they will be suspended. That means we could see the first casualties by 31-Mar-2020 when the 2019 results are due.

It's worth noting that in HKEX's own survey, there were 43 companies (not in long-term suspension) with disclaimed audit opinions in 2017, of which 24 had received disclaimers for 2 or more consecutive years. So the average prospects for a company getting off the endangered list in 2019 are not great. Without further ado, the current 41 endangered stocks that we can identify with a disclaimed audit opinion in the latest financial year are:

Stock code	Name	Auditor	Year YY-MM
0030	<a href="#">Ban Loong Hldgs Ltd</a>	HLB	18-03
0061	<a href="#">Green Leader Hldgs Grp Ltd</a>	Crowe	17-12
0065	<a href="#">Grand Ocean Advanced Resources Co Ltd</a>	BDO	17-12
0110	<a href="#">China Fortune Hldgs Ltd</a>	BDO	17-12
0186	<a href="#">Nimble Hldgs Co Ltd</a>	Moore Stephens	18-03
0228	<a href="#">China Energy Development Hldgs Ltd</a>	BDO	17-12
0351	<a href="#">Asia Energy Logistics Grp Ltd</a>	BDO	17-12
0353	<a href="#">Energy International Investments Hldgs Ltd</a>	BDO	17-12
0399	<a href="#">Innovative Pharmaceutical Biotech Ltd</a>	BDO	18-03
0632	<a href="#">Pearl Oriental Oil Ltd</a>	Cheng & Cheng	17-12
0651	<a href="#">China Ocean Industry Grp Ltd</a>	Asian Alliance	17-12
0673	<a href="#">China Health Grp Ltd</a>	Elite	18-03
0702	<a href="#">Sino Oil and Gas Hldgs Ltd</a>	BDO	17-12
0809	<a href="#">Global Bio-Chem Technology Grp Co Ltd</a>	Mazars	17-12
0845	<a href="#">Glorious Property Hldgs Ltd</a>	PwC	17-12
0858	<a href="#">Extrawell Pharmaceutical Hldgs Ltd</a>	BDO	18-03
0875	<a href="#">China Finance Investment Hldgs Ltd</a>	Elite	17-12
0918	<a href="#">State Energy Grp International Assets Hldgs Ltd</a>	Cheng & Cheng	18-03
0948	<a href="#">Alpha Professional Hldgs Ltd</a>	Crowe	18-03
0959	<a href="#">Amax International Hldgs Ltd</a>	Elite	18-03

1007	<a href="#">Longhui International Hldgs Ltd**</a>	HLB	17-12
1068	<a href="#">China Yurun Food Grp Ltd</a>	Moore Stephens	17-12
1101	<a href="#">China Huarong Energy Co Ltd</a>	PwC	17-12
1103	<a href="#">Shanghai Dasheng Agriculture Finance Technology Co Ltd</a>	BDO	17-12
1106	<a href="#">Sino Haijing Hldgs Ltd</a>	Mazars	17-12
1192	<a href="#">Titan Petrochemicals Grp Ltd</a>	Elite	17-12
1227	<a href="#">National Investments Fund Ltd</a>	HLB	17-12
1393	<a href="#">Hidili Industry International Development Ltd</a>	Zhonghui	17-12
1400	<a href="#">Moody Technology Hldgs Ltd</a>	Zhonghui	17-12
2700	<a href="#">Green International Hldgs Ltd</a>	HLB	17-12
3889	<a href="#">Global Sweeteners Hldgs Ltd</a>	Mazars	17-12
3963	<a href="#">China Rongzhong Financial Hldgs Co Ltd</a>	BDO	18-03
8026	<a href="#">China Brilliant Global Ltd</a>	HLB	18-03
8029	<a href="#">Sun International Grp Ltd*</a>	Andes Glacier	18-03
8090	<a href="#">China Assurance Finance Grp Ltd</a>	BDO	17-12
8132	<a href="#">China Oil Gangran Energy Grp Hldgs Ltd</a>	HLM	18-03
8153	<a href="#">Code Agriculture (Hldgs) Ltd</a>	Elite	18-03
8202	<a href="#">Inno-Tech Hldgs Ltd</a>	Elite	18-06
8271	<a href="#">Global Digital Creations Hldgs Ltd</a>	Deloitte	17-12
8272	<a href="#">Chinese Food and Beverage Grp Ltd</a>	Asian Alliance	17-12
8331	<a href="#">HangKan Grp Ltd</a>	Elite	17-12

\* Sun International Group Ltd (8029) was the only one to achieve the accolade of "adverse opinion" - that is, the auditors didn't just disclaim their opinion, but [opined](#) that the financial statements *do not* give a true and fair view.

\*\* Longhui (formerly Daqing Dairy) has recently completed a Reverse Takeover and new listing application, so it may leave the list when its 2018 results are published.

Click the names to find their past financial statements back to 2002. If we have missed any companies on the endangered list, [let us know](#).

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