Hong Kong Corporate Finance Update

Davis Polk

Welcome to 2016 – Key Dates

For the Hong Kong corporate finance community, the year 2016 opened with this list of key events:

New Law/Regulation	Impact Date	Key Points
Contracts (Rights of Third Parties) Ordinance	Effective on 1 January 2016	The common law "privity of contract" principle will be modified so that parties to a contract may give enforceable rights to a third party. It is possible to exclude or modify third parties' rights by express agreement, but certain basic safeguards are provided by the law to third parties who have been given such rights.
Listing Rules – risk management and internal controls provisions in the Corporate Governance Code/ Corporate Governance Report provisions of the Listing Rules	Effective for accounting periods beginning on or after 1 January 2016	Enhanced procedural and disclosure requirements on risk management and internal control aspects of corporate governance
Listing Rules – additional financial disclosure requirements for Hong Kong listed companies	Effective for accounting periods ending on or after 31 December 2015	Reporting by non-Hong Kong-incorporated companies will be largely brought in line with Hong Kong-incorporated companies in terms of CO financial reporting requirements (including business review, directors' material interests and other mandatory contents in the directors' reports).
Listing Rules – environmental, social and governance reporting requirements	Coming into effect in two phases – rule amendments, upgrade of general disclosure requirements and recommended disclosures will be effective for financial years commencing on or after 1 January 2016; upgrade of the key performance indicators will be effective for financial years commencing on or after 1 January 2017	Enhanced annual reporting requirements on environmental, social and governance matters, including a rewrite of current rules and upgrading some of them from recommended disclosure level to "comply or explain" level

See page 7 for a list of defined terms used in this paper.

If you would like to discuss any of the topics in this update, please contact a contributor, Bonnie Chan, Paul Chow, Antony Dapiran, Martin Rogers or James Wadham, listed on the back page or your regular Davis Polk contact.

Stock Exchange tightens various aspects of backdoor listings

Regulation on distributions that amount to delisting of assets

In December 2015, the Stock Exchange amended its Listing Decision HKEx-LD75-4 regarding some of the Listing Rules implications of a distribution in specie, in particular where the distribution amounts, in effect, to a delisting of relevant assets.

In this decision, first issued in October 2009, the parent company ("Parent") of a listed company ("Listco") requested the directors of Listco to put forward for Listco shareholders' consideration a distribution in specie of all the shares in a subsidiary of Listco ("Target") to Listco's shareholders on a pro rata basis. Parent would then acquire all the remaining shares in Target by a voluntary general offer. This exercise was to facilitate the disposal by Parent of all its interest in Listco to a third party ("Investor"). After the transfer of Listco shares from Parent to Investor, Investor would make a mandatory general offer under the Takeovers Code. A disposal by Listco of its interest in Target would have constituted a VSD under Chapter 14 of the Listing Rules.

The Stock Exchange states that payment of dividends to shareholders does not normally fall within Chapter 14 (which governs notifiable transactions). Chapter 14A, which governs connected transactions, likewise does not normally apply to a pro rata dividend. However, the Stock Exchange may impose additional requirements under the "fair treatment" principle in Listing Rule 2.04 and in this case, the distribution was to facilitate the Parent's transaction.

At the time of the listing decision, the Stock Exchange was satisfied that the distribution in specie need not comply with Chapter 14 or 14A and no additional requirements were imposed. However, this was on the basis of various safeguards proposed by Listco, including the holding of a special general meeting for shareholders to consider the distribution, disclosure in a VSD-standard circular, and the appointment of an independent financial adviser. It would seem that these safeguards were not too far removed from full compliance with the Listing Rules requirements.

On this reissue of the Listing Decision, the Stock Exchange has given additional guidance:

- There have been a number of cases in 2015 where listed companies distributed significant portions of their businesses in specie. This is tantamount to a delisting of assets. Therefore shareholders should be afforded the same protection as a withdrawal of listing under Chapter 6 of the Listing Rules.
- Where a disposal of assets amounts to a VSD, the distribution would also be subject to the Chapter 6 requirements in addition to the safeguards mentioned above, namely:
  - voting requirements – 75% of disinterested shareholders voting for and not more than 10% voting against the resolution
  - cash alternative – shareholders (other than executive and non-executive directors, chief executive officers and controlling shareholders) should be offered a reasonable cash alternative or other reasonable alternative for the distributed assets
- Listed companies should consult the Stock Exchange at the earliest opportunity.

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Cash injections and large scale fund-raising for greenfield operations

Under Listing Rules 14.82 – 14.84, a company (apart from a securities brokerage) whose assets consist wholly or substantially of cash or short-dated securities is normally regarded as unsuitable for listing and trading in its securities will be suspended.

The Stock Exchange notes that recently there has been an increase in listed companies proposing large scale fund-raisings where investors would inject large amounts of cash into the company. A new Guidance Letter HKEx-GL84-15 was issued in December 2015 to address the concerns. Here is a summary of the guidance given:

- There is no prescribed quantitative threshold in the Listing Rules for the concept of the company's assets consisting "substantially" of cash. The cash to assets ratio is not conclusive and the circumstances of the company's business and financial position must be taken into account. However, in paragraph 9 of the Guidance Letter, the Stock Exchange offers a rule of thumb that a company with less than half (50%) of its assets being cash as a result of a fund-raising would not normally be regarded to have assets consisting wholly or substantially of cash.
- The recent fundraising exercises that have caused regulatory concerns have some common features:
  - The size of the exercise was very significant to the company and bore little or no correlation with the needs of its existing principal business.
  - The funds raised would be used in "greenfield" operations (often the business carried on by the investor(s)) with no relation to the company's existing business.
  - The investor(s) would obtain control or de facto control of the company and would intend to manage the new business.
  - The new funds raised will be used to operate the new business which would be substantially larger than the original business.

In these cases, the Stock Exchange considers that the proposed fund-raising would cause the company to be treated as a cash company, and the facts and circumstances suggest an attempt to list a new business that may not otherwise have met the new listing requirements.

- It is not acceptable for companies to address the cash company concerns by providing further details about business plans and/or signing agreements to commit the use of the proceeds of the fund-raising. The "cash company" assessment is made based on the cash balance as a result of the fund-raising at the date of completion of that exercise. The company cannot rely on the future or intended use of proceeds (even with a legally binding agreement for investing the money) to alleviate the cash company concerns. Once the company has become a "cash company" on this basis, the Stock Exchange is required to evaluate the business plans (including the intended use of proceeds) as if it were a new listing application.
- If the Stock Exchange considers that any fund-raising, acquisition or other corporate action of the company in the future, together with the current fund-raising, are a means to list a new business that is not otherwise suitable for listing, or otherwise to circumvent the new listing requirements, additional requirements or conditions would be imposed on such future arrangement(s).

Exceptionally, the Stock Exchange provided two case studies at the end of the Guidance Letter to illustrate the principles. The market is reminded that listed company announcements relating to cash companies are required under Rule 13.52(2)(c) to be pre-vetted by the Stock Exchange and companies are encouraged to consult the regulator at the earliest possible opportunity for guidance.

Regulatory scrutiny on backdoor listings

It is interesting to read the guidelines discussed above together with an earlier Guidance Letter, HKEx-GL78-14 on reverse takeover requirements, issued in May 2014. That Guidance Letter spells out how the Stock Exchange applies the principles and bright line tests in the Listing Rules regarding acquisitions that potentially amount to reverse takeovers. We can see an emerging trend of a stepping up of regulations on the creation of listed "shells" and backdoor listings. Listings that are not achieved in one of the usual ways (e.g., IPO, listing by introduction, etc.), while not strictly prohibited in Hong Kong, are under close regulatory scrutiny.

Stock Exchange issues consultation conclusions on ESG reporting

In September 2015, the Stock Exchange consulted the market on a general rewrite and upgrading of the reporting requirements in the Listing Rules regarding environmental, social and governance matters. The proposals include numerous rewrites and upgrading (from "recommended disclosure" to "comply or explain") of current requirements (most notably, the key performance indicators or KPIs).

The Consultation Conclusions were published on 21 December 2015. The revised ESG Reportng Guide will comprise two levels of disclosure – recommend disclosures and "comply or explain" disclosures. A revised Appendix 27 will show in a tabular form how each disclosure rule has changed. The requirements will be brought into line with the CO requirements on directors' reports (in particular, business reviews). For the implementation dates, please see the "Key Dates" table above.

Stock Exchange publishes new guidance letter on trading halts

In December 2015, the Stock Exchange published a Guidance Letter HKEx-GL83-15 on trading halts/suspensions. Here is a summary of the key messages:

- Listed companies should plan affairs so as to avoid a trading halt or keep it as short as possible and trading should be resumed as soon as practicable following an announcement.
- Announcements containing inside information can only be published outside trading hours. Significant agreements should be signed outside, not during, trading hours.
- Where a transaction involves complex issues or where pre-vetting is required, the company should seek early consultation/ clearance from the Stock Exchange. This should take place before, not after, the signing of an agreement.
- Disclosure in announcements should be in plain language and easy to understand.
- Where there are developments during the trading halt (e.g., the terms of the agreement being changed), the company must not let the trading halt continue and wait for the outcome of negotiations. It must publish the announcement and resume trading as soon as possible.
- The Stock Exchange reminds the market that, to use the "incomplete transaction" safe harbour in Part XIVA of the SFO, there must be measures to preserve confidentiality (e.g., use of non-disclosure agreement and a code name for the project). The Stock Exchange will agree to a trading halt only if there is reasonable concern about the leakage of inside information or if there is practical difficulty in maintaining confidentiality.

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- It is critically important for authorised representatives of listed companies to be contactable at all times and in a position to answer queries from the Stock Exchange regarding any unusual price/trading movements or news in the media that may be of potential concern.
- When listed companies are engaged in confidential business negotiations, they should monitor their share price and volume movements and media coverage to ensure the confidentiality measures they have adopted remain effective.
- Listed companies should have properly delegated authority to relevant persons to allow timely release of information to the Stock Exchange and to the public, including authority for the authorised representatives to request a trading halt pending an announcement.
- Where there are specific market rumours, speculations or negative publicity, a listed company's directors must assess whether a disclosure obligation has arisen. While the company is not generally expected to respond to market comments, if any such comment has or may have an effect on share price or trading volume, there may be risks of a false market developing and the company may have to make a clarification announcement. It is important for companies to monitor actively their share price and relevant news coverage.
- Companies that are listed both in Hong Kong and in another market must ensure as far as practicable simultaneous dissemination in different markets. If this is impracticable, they should ensure that the information is disseminated before the market opens in Hong Kong. For PRC-incorporated companies with both A and H shares listed, trading halt requests should be made and information should be disclosed in both the Hong Kong and PRC markets simultaneously. As far as practicable, trading resumption should take place on both markets at the same time.
- The Listing Rules require listed companies to make an announcement promptly after a trading halt, giving a reason for such halt (e.g., "Trading in the shares has been halted pending the release of an announcement containing inside information …"). To make such announcements meaningful, the company should disclose a fair amount of details – e.g., "Trading in the shares has been halted pending the release of an announcement regarding a further issuance of equity securities amounting to 5% of the Company's issued shares which will constitute a connected transaction under the Listing Rules and inside information under the SFO …".
- Where the announcement takes a long time to prepare, the company should publish periodic updates or holding announcements.
- The Stock Exchange reminds the market that disclosure obligations under Part XIVA of the SFO are statutory obligations that apply irrespective of suspension or continuation of trading. In other words, from a legal perspective, a trading halt is not a safe harbour from the general obligation to disclose inside information as soon as practicable.
- A request for trading halt should be made in writing before 9:00 a.m. for a halt in the morning session and before 1:00 p.m. for a halt in the afternoon session. In the majority of cases, trading will resume from the next immediate trading window following publication of the relevant information and/or fulfillment of conditions imposed by the Stock Exchange.

The Guidance Letter contains two "decision trees" to illustrate the process of allowing trading to continue versus imposing a trading halt.

Stock Exchange accepts State of Nevada and India for Hong Kong listing

In September 2015 the Stock Exchange issued a new Country Guide on the State of Nevada of the United States, thereby giving Nevada the status of an "Acceptable Jurisdiction" under the 2013 Joint Policy Statement Regarding Listing of Overseas Companies. This was followed in November by the Country Guide on India, giving India the same status.

Continuing obligations of Hong Kong debt-listed issuers

On 6 November 2015, the Stock Exchange issued new guidance on the continuing obligations for guarantors and issuers for debt securities listed under Chapter 37 of the Listing Rules. Some highlights:

- A reminder that issuers and guarantors of listed debt have continuing obligations to announce inside information to the public:
  - The disclosure obligation covers: any information that is necessary to avoid a false market in its listed securities; information which the issuer is required to disclose under relevant legal provisions; information which may have a material effect on the guarantor's ability to meet its guarantee obligations; public disclosures made on another stock exchange; and aggregated redemptions or cancellations of debt securities exceeding 10% and every subsequent 5% of an issue.

Issuers and guarantors of listed debt have continuing obligations to announce inside information.

  - Where the issuer or guarantor has equity securities also listed on the Stock Exchange and inside information has been published on the equity counter (i.e. using the equity stock code) of the Stock Exchange, it should assess whether the information has an impact on its debt securities and if so, the information should be published also on the debt counter.

- Where trading in an issuer's equity and debt securities is simultaneously suspended or resumed, the relevant announcement should be published on both the equity and debt counters.
- Announcements relevant to debt must be submitted through the e-submission system operated by the Stock Exchange.

- An issuer in the form of a body corporate must provide the Stock Exchange with annual accounts and interim reports. Issuers are encouraged to submit these documents electronically (by attachment to email or by providing a link to the website).
- An issuer is required to appoint two authorised representatives. Generally, they should be either two directors or a director and a company secretary of the issuer. Any change of their contact details must be notified to the Stock Exchange using the relevant form.

Hong Kong company winding-up reforms

In October 2015, a Companies (Winding Up and Miscellaneous Provisions) (Amendment) Bill 2015 was gazetted and introduced to the Legislative Council. This is not yet law and will be subject to potentially lengthy legislative debates.

The 300-page Bill focuses on the winding up provisions of Hong Kong's company legislation and aims to enhance creditor protection and improve the winding up process. Here are some highlights of the key proposals:

- **Giving Hong Kong courts powers to set aside transactions at an undervalue with a five-year look-back period:** The court may set aside transactions entered into by a company within five years before the commencement of its winding-up, where the company has received no consideration or a consideration which is significantly less than the value of the subject of the transaction at the relevant time. This is currently part of Hong Kong's personal bankruptcy regime, but does not exist in our company legislation.
- **Rationalising the fraudulent/unfair preference provisions:** The current mode of incorporating by reference the personal bankruptcy provisions in relation to fraudulent or unfair preference will be replaced by provisions rewritten into company legislation, with a view to smoothing out a number of technical anomalies that exist today. (Broadly speaking, fraudulent or unfair preference refers to acts that put a particular creditor in a better position in the event of the debtor's banktruptcy than he otherwise would have been.)
- **Providing for liabilities of directors and members:** Directors and members may be liable to contribute to the assets of a company where the company is wound up within one year after a redemption or buyback of shares out of capital.
- **Tightening up regulation of liquidators:** The powers and duties of provisional liquidators will be set out more clearly, including the extent to which they may be liable for misfeasance or breach of duty. There will be deterrents against touting for appointment and tighter controls will be put in place to reduce conflicts of interest and to enhance transparency in the appointment process of liquidators.
- **Streamlining the winding up process:** The proposals include reforms on the powers and processes of the committee of inspection, and introducing more court-free procedures to save costs and time.

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Winding up of foreign company on the just and equitable ground

In November 2015, the Hong Kong Court of Final Appeal delivered a landmark decision, Kam Leung Sui Kwan v. Kam Kwan Lai & Ors FACV 4/2015, regarding the winding up of a non-Hong Kong-incorporated company under Hong Kong law on the just and equitable ground. The case clarifies a number of uncertainties and potentially makes Hong Kong a more accessible forum for shareholders (especially of family-controlled private enterprises) who have been unfairly treated or forced into a passive position over the company's affairs to seek redress before a Hong Kong court.

The case arose from a dispute over the management of the famous restaurant Yung Kee, formerly owned by two brothers, one of whom alleged unfairly prejudicial behaviour on the part of the other. The proceedings were brought by the estate of the aggrieved brother against the allegedly "oppressive" one, and the bone of contention was whether the Hong Kong courts would take jurisdiction over a winding-up petition, given that the company which was the subject of the dispute was incorporated in the British Virgin Islands

Apart from a "surprise element" (in accepting jurisdiction over a foreign company under the just and equitable winding up provision in what is now s.327(3)(c) of the CO, the highest court overturned the decisions of both the Court of First Instance and the Court of Appeal), a number of notable points were made by the Court of Final Appeal in its judgment:

- In the case of a shareholder's winding up petition, the presence of the other shareholders within the jurisdiction is an extremely weighty factor in establishing the sufficiency of the connection between the company and Hong Kong. In fact, this will usually be the most important single factor in the equation.

- There is no reason why a "more stringent" connection should be required in the case of a shareholder's (as opposed to a creditor's) winding up petition. However, the factors relevant to establishing the "connection" are different in the two cases because of the nature of the dispute and purpose of the relief sought are different in each case. In a creditor's petition, the creditor wants his debts repaid and the presence in Hong Kong of significant assets for distribution will usually suffice. In contrast, in a shareholder's petition the company is the subject of the dispute rather than a party to it and the presence of other shareholders (apart from the petitioner) is an extremely weighty factor for the question of connection. The purpose of shareholders' winding-up proceedings is not to have a debt repaid but to release the petitioner's investment in the company, which is likely to involve a detailed examination of the management of the company's affairs.

For a more detailed analysis of the case, please see the briefing "Hong Kong Court of Final Appeal Explains Sufficient Connection to Wind Up a Foreign Company on the Just and Equitable Ground" by Davis Polk & Wardwell.

ASIFMA statement and guidelines on powers of attorney in Hong Kong IPOs

On 22 September 2014, the ASIFMA issued a press release raising concerns about the growth of a practice in Hong Kong IPOs where less senior underwriting syndicate members (including joint bookrunners) are required to execute broad and irrevocable powers of attorney in favour of senior syndicate members very early in the listing process. In a number of cases, the senior managers are given wide powers to determine key terms of the transaction and to finalise documentation.

The ASIFMA stressed that such use of powers of attorney poses potential regulatory, risk management and corporate governance issues for givers of such powers. It noted that this practice is not customary in other capital markets of the world, and there are no unique features in the Hong Kong IPO process that call for it.

Nevertheless, the ASIFMA recognises the logistical benefits associated with the use of powers of attorney in the above scenario and has formed a working group to spearhead work in this area. A set of ASIFMA guidelines (in draft) has been released in connection with this initiative.

HKMA guidance on cyber security risk management

On 15 September 2015, the HKMA issued a circular to all authorised institutions setting out its expectations on cyber securities risk management controls that authorised institutions should adopt, including the following:

- **Risk ownership and management accountability:** Authorised institutions should establish clear ownership and management accountability of cyber risks and related risk management measures, and foster a strong security culture across all relevant users.
- **Periodic evaluations and monitoring:** The Board should request the senior management to evaluate the adequacy of the authorised institution's cyber security controls periodically, address any material gaps identified and implement upgrades or other compensating controls promptly. The HKMA has not prescribed a benchmark for conducting periodic evaluations, but listed six international benchmarks that authorised institutions may consider adopting.
- **Regular independent assessment and tests:** There should be sufficient cyber security expertise and resources within the responsible function(s) of an authorised institution to carry out ongoing checks and balances (including regular independent assessment and possibly penetration tests) against the abovementioned evaluations and monitoring, as well as contingency planning.
- **Industry collaboration and contingency planning:** Authorised institutions should explore opportunities of collaborating with other institutions and/or the Police in both sharing and gathering cyber threat intelligence.

The Board and senior management of authorised institutions are expected to play a proactive role in ensuring effective cyber security risk management in authorised institutions. Any control inadequacies need to be remedied with some concrete progress to be evidenced in the Board meetings in late 2015 and early 2016. The HKMA may request an authorised institution to submit specific deliverables for the HKMA to assess the output or progress of the work.

Suspension of dealings under s.8 of the Stock Market Listing Rules

In an extraordinary move and with neither of the regulators making any official announcement or comments, the SFC directed the Stock Exchange on 15 December 2015 to suspend all dealings in a named listed company under s.8 of the Stock Market Listing Rules. Although much of the surrounding circumstances remains undisclosed (public information being so far limited to a few basic facts set out in the company's regulatory announcements), the case has already aroused some lively media attention. The case involves allegations of fabricated financial results and potentially serious corporate wrongdoing.

Practitioners and other market participants are keeping their eyes peeled on s.8 of the Stock Market Listing Rules, a powerful if rarely used "weapon" in the regulator's arsenal. This section provides the SFC with broad powers to direct a suspension, including where it "appears" to the SFC that any prospectus, circular, announcement or statement contains materially false, incomplete or misleading information; or where it is in the interest of maintaining an orderly and fair market, or is in the public interest, to do so. Where a direction is given, the relevant listed company and/or the exchange company (the Stock Exchange in this case) may make representations in writing to the SFC. After considering such representations, the SFC may permit dealings in the securities to recommence or direct the exchange company to cancel the listing of the securities.

In the past, s.8 has been used only in exceptional circumstances where there is a very clear-cut and serious case for investigation. Its exceptional invocation in this case underpins what seems to be an ongoing trend in the SFC's enforcement efforts: the message is clear that the regulator will not hesitate to use innovative and forceful measures to keep the market in good order. Further developments are awaited in this continuing saga.

Defined terms:

ASIFMA	Asia Securities Industry & Financial Markets Association
CO	Companies Ordinance (Cap. 622 of the Laws of Hong Kong)
ESG	Environmental, social and governance
HKMA	Hong Kong Monetary Authority
IPO	Initial public offering
Listing Rules	The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
SFC	The Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)
Stock Exchange	The Stock Exchange of Hong Kong Limited
Stock Market Listing Rules	Securities and Futures (Stock Market Listing) Rules (Cap. 571V of the Laws of Hong Kong)
Takeovers Code	The Code on Takeovers and Mergers and Share Buy-backs
VSD	Very substantial disposal

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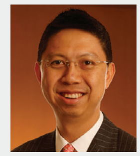

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