July 17 Legal and Regulatory Update

Top stories

SFC intervenes at early stage in serious corporate cases

The first SFC Regulatory Bulletin: Listed Corporations (Click: full report; press release)

This series of bulletins provides guidance on how the SFC performs some functions under the regulatory framework, in relation to listed corporations and listing.

The first issue explains that given changing market conditions and risks, SFC is taking steps to intervene in serious cases at an early stage to fulfil its statutory objectives — including to protect the investing public and to suppress illegal, dishonourable and improper market practices. **Some examples of SFC actions in 1H 2017** are given.

Apart from raising objection to IPO applications, **SFC may direct HKEX to suspend trading in a listed company's shares.** SFC may also require a listed corporation and other persons to produce any books and records under the relevant rules.

What you should know/watch out for:

Our focus is on listed corporations:

- Four examples of "early SFC intervention" were given, including where share trading had been suspended. Two cases relate to "highly dilutive fundraising". (Background: click our Dec 16 Legal Update)

- **Case 3 (P. 4): highly dilutive fund raising**
  - (i) Company completed two highly dilutive fundraisings within a year, proposing a third exercise
  - (ii) Not appear to have an urgent need for funding on each occasion
  - (iii) SFC investigated and found undisclosed connections between certain directors and some shareholders who voted to approve the exercises
  - (iv) Certain directors appeared to be connected with some persons who subsequently acquired shares from the underwriters
  - (v) SFC concerns: accuracy and completeness of disclosure made; impact of another fundraising on shareholders and investors
  - (vi) SFC directed suspension of share trading

- The other examples relate to forged bank balances, and "lack of open market" in the share trading (a very serious case of shareholding concentration)

Regulators

(i) **HKEX published its first Enforcement Newsletter,** covering 1H of 2017
(Click: full report; press release)

Apart from listing enforcement statistics (showing increasing enforcement actions generally), HKEX also highlighted disciplinary actions published. (Background: click our Feb 17 Legal Update for enforcement themes).

The "compliance highlights" section sets out **useful observations and guidance** in some areas**.**

What you should know/watch out for:

Two areas are particularly noteworthy:

- **Director understanding of share dealing restrictions**
  (i) Issue: breaches in share dealing restrictions re: share repurchases and directors' share dealing (Rule 10.06(2) or the Model Code), some directors claimed that they were not informed by the company secretary/ other staff about these restrictions

  (ii) HKEX reminder:
  - each director should be familiar with the dealing restrictions
  - issuers should have appropriate and effective internal control procedures on share repurchases and directors' dealings
  - directors and relevant staff should periodically attend appropriate training

- **Segregation of duties and powers**
  (i) Issue: possible **internal control** deficiencies, such as over-concentration of powers

  (ii) Example: one person was able to, without knowledge of the board, use the company chop and enter into notifiable transactions, or transfer money out of the issuer's account

  (iii) HKEX reminder:
  - possible over-reliance and/or over-concentration of powers on one director
  - issuer should have appropriate internal controls procedures reflecting segregation of duties and powers
  - collective responsibility of the board for Listing Rule compliance

(ii) HKEX published its 2016 financial statements review report, monitoring issuer compliance with disclosure requirements of Listing Rules, accounting standards, and the new Companies Ordinance. (Click: full report; press release)

HKEX's suggested improvement areas on the "**new auditors' reporting**" are particularly noteworthy. It also reminded issuers to get ready for implementing some new accounting standards. Other observations, like preparing management commentary that is "useful to investors", are similar to those noted in previous reviews. The special industry review theme is accounting by "retail and consumer goods companies".

The report has a useful executive summary.

What you should know:

We focus on findings relating to Listing Rules and "new auditors' reporting":

- Should provide management commentary that is "useful to investors" (**MD+A**, and **business review** should be clear, understandable, and "entity-specific")
- (Accounting standard) rigorous assessment of impairment
- (Accounting standard) disclosure of judgments and assumptions in determining control or significant influence
- Implementation of some soon-to-be-effective accounting standards (e.g. HKFRS 9 *"Financial Instruments"*, HKFRS 15 *"Revenue from Contracts with Customers"*, HKFRS 16 *"Leases"*) is not just an accounting exercise, and will have a significant impact on some issuers' information systems, internal controls and business
- "Segment reporting" in financial statements — should be consistent with information included in the **MD&A**
- (Accounting by) retail and consumer goods companies—useful observations regarding revenue recognition, inventories, leases, and segment reporting
- **"New auditors' reporting"**: inter-consistency and linkages
    - (i) (Under accounting standards) **"key audit matters"** ("KAM") disclosed in auditor report should be matters already disclosed elsewhere in the annual report
    - (ii) E.g. KAM include the most significant accounting judgment and estimates, such information should be disclosed in the **financial statements**
    - (iii) **Corporate governance report** should describe how the **audit committee** has met its responsibilities in reviewing significant financial reporting judgmental areas (CG Code Provision C.3.3(d), Listing Rules Appendix 14 para L(d)(iv))

(iv) Link appropriate disclosures by cross referencing to avoid duplication; corporate governance report and auditor report should focus on the responsibilities and work done by the audit Committee and auditors respectively

(v) **Audit committee** to have more in-depth discussions with the auditors regarding KAM, going concern issues and other significant events, and at an early stage to avoid surprises

What you should do/watch out for:

- **In preparing your future annual reports**, consider improvement areas like management commentary in MD+A and business review
- **"New auditors' reporting"** — to strengthen linkages with other reports (e.g. corporate governance report; audit committee report)
- **Audit committee's work** — particularly regarding interaction with the auditors, and responsibilities in reviewing significant financial reporting judgmental areas

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