October 2017 Legal and Regulatory Update

Top stories

HKEX reviewed 2016 annual reports

HKEX published "Analysis of Corporate Governance Practice Disclosure in 2016 Annual Reports", reviewing issuers' compliance with the Corporate Governance Code and Corporate Governance Report (together as "the Code"). (Click: full report, press release). This follows previous reviews in 2015 (for 2014 annual reports), and 2016 (for March and June 2015 year-end reports).

What you should know:

- The findings are similar to the last reviews; high rate of compliance with the Corporate Governance Code Provisions ("CPs"), which are subject to the "comply or explain" regime

- Five (and similar) areas with the lowest compliance rate, including separation of the roles of chairman and chief executive; attendance by chairman and board committee chairs at annual general meetings

- (**New CP C.2.4, effective 1 Jan 16) risk management and internal control**
  (para 25-6 of report)
  - all issuers claimed to have included a "narrative statement", disclosing how they complied with the new requirements
  - HKEX found that **only 53% actually complied**; e.g. **omissions in disclosing "the process and features of risk management/internal controls systems"**; the procedures on **handling inside information**

- HKEX observations on some **"corporate governance concerns"** (para 37):
  - **independence of independent non-executive directors** ("INEDs")
  - **"over-boarding"** of certain INEDs
  - slower- than-global growth in **board diversity**

- (CP A.5.1) **nomination committee** — in light of the above concerns on INEDs, HKEX urged issuers that do not have a nomination committee to "re-consider their position". Those with nomination committees should consider the committee's role in addressing these concerns (para 37)

- (CP A.5.6) board diversity ─ HK is lagging in terms of ratio of women directors; and some issuers have not disclosed their diversity policy (paras 38-41)
- As noted in previous reviews, HKEX expects issuers to give "considered reasons" for deviations, which should be "informative and clear" (para 8)
- Read our legal updates on previous reviews (Click: Nov 15 ; May 16 ; Sept 16).

What you should do/watch out for:

- **Non-compliance of CPs without giving "considered reasons" amounts to a breach** of Listing Rules!
- HKEX observations on these "corporate governance concerns" set the scene for its **Nov 17 consultation on amendments to the Code**. We shall provide further updates.
- E.g. The need for a diversity policy is proposed to be made a Listing Rule, instead of being subject to "comply or explain"
- As you **start preparing your 2017 annual reports**, you should take into consideration the identified improvement areas, including internal controls and risk management

Also in this issue

(i) **HKEX published 4 Listing Decisions**, two relating to the theme of attempted "takeovers" circumventing Listing Rule requirements ("sufficiency of operations" after "disposals"/ "reverse take-overs"; LD 112, 113) (Click: our March 16 legal update on this theme). LD 114 relates to HKEX's commencing de-listing of an issuer ("no longer suitable for listing"), after two years of trading suspension.

LD 111 is noteworthy, and HKEX exercised its **"deeming power"** as regards **"connected transactions".**

What you should know:

- Issue: HKEX's power to "deem" a person to be a "connected person" (Rules 14A.19 and 14A.20)

- Background: Company A (listed issuer) proposes to enter into a transaction with Company B which is engaged in payment services. P holds over 50% of Company A's shares

- Company B's relationship with P
  - Established by P to operate its payment service business
  - P disposed of its interests in Company B and re-structured it as a PRC "domestic corporation" to meet regulatory requirements
  - Under profit sharing agreements between P and Company B, P is entitled to 38% of Company B's pre-tax income

- HKEX exercised its power and deemed Company B to be a "connected person" of Company A

- Rejected submissions that the transaction was conducted "in the ordinary course of business" of Company A on an "arm's length basis"; there is "no intention to circumvent the rules, and no incentives to manipulate the rates paid by Company A" ─ as P has a greater stake in Company A (over 50%), as compared with its 38% profit sharing in Company B

- Rationale:
  - Purpose of the "connected transactions" rules is to guard against **"the transfer of benefits by persons who are able to exercise significant influence over the issuer"**
  - In exercising the deeming provision, HKEX considers all relevant facts; focusing on the **"substance rather than form"** of the arrangements
  - Noted the close association between P and Company B
  - P is able to exercise significant influence over Company A. Its profit-sharing arrangements with Company B could effect a transfer of benefits from Company A to itself
  - "Arm's length basis", "no circumvention and incentive for rate manipulation" are not the relevant tests in this case. They are not the only circumstances for exercising the "deeming" power

What you should watch out for:

- "Connected transactions" rules are subject to very stringent enforcement and interpretation in practice

(ii) **HKEX updated its Guidance Letter on issues related to "controlling shareholder" and related Listing Rules implications (HKEX GL-89-16).** (Click: our Nov 16 legal update)

There are **no substantive changes**. HKEX added information on the rationale of the "ownership continuity and control" Listing Rule requirement, particularly from new listing applications perspectives.

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