

# July 2019 Legal and Regulatory Update

## Top stories

### SFC Statement on director duties in acquisitions/disposals

SFC published a [Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals](#).

Broadly, this statement is a follow-up on SFC's **Guidance Note on directors' duties in the context of valuations in corporate transactions** (for details: our [May 17 legal update](#)). The statement gave **useful examples on recurring types of misconduct**, typically involving **unfair valuations**.

SFC reminds **directors** of their **duty** to ensure that forecast/estimate used in a transaction was compiled with due care; underlying assumptions are fair, reasonable, and represent management's best judgment/estimate, considering all relevant information.

Directors should carefully consider **the need to engage an independent valuer**, even if not required under the Listing Rules — in light of the board's time, resources, and expertise to perform the necessary work without the assistance of a valuer. **Failure to do so risks a finding of misconduct**.

However, directors are also reminded that **obtaining an independent valuation would not reduce directors' duties of care, skill, and diligence**.

#### *What you should know:*

Useful examples of recurring "misconduct":

- **Lack of independent valuation**
  - E.g. issuers **simply announced without further explanation**, that there were **arm's length negotiations**, taking into account **vaguely described factors**
- **Lack of independent judgment and accountability**
  - Independent valuation obtained
  - Directors simply **relied on valuation without performing due diligence or other work**
  - E.g. valuers simply carried out **"mathematical computations" on vendors' forecasts; failed to exercise independent judgment**
  - E.g. **"cherry-picked" comparables to justify a pre-determined estimate**

- **Quality of earnings**
  - Due diligence on forecasts, assumptions, business plans not performed
  - E.g. **risk factors** (historic losses; sudden increases in sales; unjustifiably high margins when compared with peers; suspect non-recurring items; unsustainable sources of revenue)
  - E.g. failed to explain paying a hefty premium to enter a new industry with low barriers; instead of starting the business itself at a lower cost
- **Fair presentation of comparables**
  - E.g. “**cheery picked**” **companies** with higher trading multiples and disregarded those with poor performance
  - E.g. chosen comparables had longer and more profitable track records; without making adjustment
- **Impact on financial position of issuer**
  - E.g. substantial additional funds for **acquisition cost**, and **capital investment** to meet the forecasts or sustain the business
- **Compensation**
  - Upfront payment of price, with **vendor guarantee** (if profit forecasts not met)
  - E.g. no verification of ability of vendor to pay; funds not held in escrow
  - E.g. vendor guaranteed amount substantially lower than acquisition price
- **Suspicious connected parties**
  - Noteworthy: degree of association not necessarily confined to “Connected Persons” under Listing Rules
  - Undisclosed “**relationships, arrangements, understandings** that cause them **to act (or refrain from acting)** in a **co-ordinated manner** to the **detriment of the issuer and its shareholders...** or **distortion of the market for its shares**”
  - E.g. sales growth driven by a handful of customers; subsequently found to be related with issuer’s directors

*What you should watch out for/do:*

- **Board process in approving transactions** — should seriously consider engaging a valuer
- **Directors’ duties of care, skills, and diligence** in approving transactions — more rigour expected

- **Internal controls** — embed principles of the **SFC Guide** and **SFC Statement** in your **company’s policies and procedures**.
- The need to engage a valuer; interpretations of “connected parties” **not confined to Listing Rules**
- **Our further observations: valuation is an important, but not the sole consideration** of the board in approving transactions. Other factors like risks, strategic fit, alternative investment options are also relevant for **directors’ duties**

## Other Stories

### Regulators

**HKEX published its consultation conclusions** on backdoor listing, continuing listing criteria and other Rule amendments (Click: [HKEX press release](#); [SFC press release](#), [consultation conclusions](#)).

It will implement the consultation proposals, with modifications, **effective on 1 October 2019**. There will be a **transitional period of 12 months** from the effective date, for the continuing listing criteria.

HKEX also publishes (i) **3 new guidance letters** on the application of the amended Rules: Guidance on application of the reverse takeover rules ([HKEX-GL104-19](#)), Guidance on large scale issues of securities ([HKEX-GL105-19](#)), and Guidance on sufficiency of operations ([HKEX-GL106-19](#)), and (ii) a [FAQ](#) (057-2019) on the notifiable transaction requirements relating to securities transactions.

As noted in our previous updates, there have been concerns on “**shell companies**” in recent years. The proposals are not intended to restrict issuers from legitimate business expansion or diversification.

#### *What you should watch out for/do:*

“Shell companies” do not fall within our focus area. A detailed summary of the proposed Rule amendments is set out in the HKEX press release.

(Background on the consultation; Click: our [June 18 legal update](#))

### Legislation

**The Competition Commission commenced proceedings in the Competition Tribunal** against six **decoration contractors** and three **individuals** for “**market sharing**” (i.e. allocated

customers) and “**price fixing**” activities in 2017, regarding renovation services at a public rental housing estate in Kwun Tong. (i.e. “**cartel actions**”, in contravention of **First Conduct Rule**). (Click: [press release](#)).

This is another case on “**cartels**”; also the third one on renovation services at public rental housing estates. (Click: our [May 19 legal update](#); on the first two decisions delivered on “cartels”).

This case involves bringing action **against individuals** (seeking **penalties; director disqualification order**).

***What you should know/watch out for:***

- “**First Conduct Rule**” means — parties acting together with an **agreement**, and/or engaged in a **concerted practice**, whose **object or effect** is “to prevent, restrict or distort” competition in Hong Kong
- Reinforces that “**cartel actions**” i.e. **price fixing, market sharing, and bid-rigging**, is a **priority enforcement area**
- This case stemmed from a **public complaint**. The Commission encourages the public to report suspected cartel practices
- All companies must steer clear of cartel practices. Those **already involved** in such practices should consider approaching the Commission for **leniency**

**Published by Practising Governance Limited**

**August 2019**