January 2020 Legal and Regulatory Update

Top stories

HKEX review: annual reports disclosure

HKEX published a **report** on its review of issuers' **annual reports for financial year ended between Jan to Dec 2018**. (Click: press release; full report; our Jan 19 legal update for the last review)

This covers: (i) review of disclosure in annual reports to **monitor rule compliance**; (ii) **financial statements review**. 13 areas were covered.

Regarding **"Business review in MD&A"**, it reviewed issuers in some **highly regulated industries** in the PRC (pharmaceutical; education). Issuers should **clearly disclose risk areas** such as **major regulatory or governmental policy changes**, and an assessment on the **impact** on **business operations** and previously **announced business plans**. Where applicable, impact on **financial performances** during the financial year.

HKEX also reminded that **effective 1 October 2019**, there are **additional disclosure requirements for annual reports**, e.g. **significant securities investments**; updates on **results of performance guarantees** (by vendors) **under acquisitions**.

As regards "**annual review of continuing connected transactions**" by independent directors ("INEDs"), HKEX sent questionnaires to 40 issuers about their internal control procedures and review of these transactions by INEDs. The report gave **useful examples of good practices**, including additional monitoring procedures adopted by some INEDs.

What you should know:

- **"Business review" in MD&A** (para 51)
  - **Focus:** issuers in **highly regulated industries** should disclose **risks in major regulatory/government policy changes**
  - **Reminder: new disclosure in annual reports**

    (i) **securities investment** : **5%** or above of a company's total assets

    (ii) outcome of a **performance guarantee** of an acquisition target

    (iii) detailed summary of rule changes: items 15-20, Appendix 1 (P.65), HKEX Consultation Conclusions on backdoor listing, continuing listing criteria and other rule amendments

- **"Continuing connected transactions"**
  - **Additional and ongoing monitoring procedures for INED annual review** (para 48)
    - (i) periodic meetings with audit committee, management and internal auditors to review the transactions/related internal controls
    - (ii) quarterly management reports (status of transactions; annual caps utilisation)
    - (iii) review updated lists of connected persons

What you should do:

- Your forthcoming **annual results announcement/annual reports** — note new disclosure requirements; HKEX specific recommendations summarised above
- Your forthcoming **annual INED review of CCTs** — consider additional monitoring procedures above

Hot Trends

- How your board can drive transformative action on climate change (EY)

9 questions boards should ask themselves + management!

These include:

- Assessing climate disruptions
- Targets setting
- Value created by climate leadership?
- The "big picture" — strategy and business model

Read more **Hot! Practical!**

Other Stories

Regulators

(i) New HKEX case on directors' duties in acquisitions

Directors' duties is an **enforcement focus** of both HKEX and SFC.

(Background: SFC's **Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals;** read our July 19 legal update; HKEX's **Enforcement Newsletter**; read our August 19 legal update).

HKEX's Listing Committee criticized named (including former) executive directors ("EDs") and former independent directors ("INEDs) of Asia Resources Holdings Limited (the "Company"), for breach of **Rule 3.08(f)** by failing to **exercise sufficient skill, care and diligence** in respect of an **acquisition**. (Click: Press release)

It involved an acquisition of a water mine business in 2017, at a cash consideration of $244 million. The target was engaged in the exploitation, production and sales of spring water in Hunan. It had **no track record** and had not commenced business. The bottled water business was a **new business** to the Company, and **none of the relevant directors had relevant experience**.

What you should know:

Lack of proper due diligence

- *Failure to verify documents supplied by vendor*
  - **E.g. feasibility study** produced by the vendor recommended a service life of 5 years for the mine
  - **Valuation** was based upon a service life of 10 years
- *Excessive reliance on valuation report*
  - **No independent judgment**
  - No evidence of steps taken to assess its "reasonableness"; or assumptions
  - No record of such discussion at board meeting approving the transaction
  - Valuation based on a production (quantity of water) guarantee by the vendor
  - Exceeded the maximum amount allowed under mining permit
  - "Market approach" valuation; comparable transactions selected were very different from the target
  - No explanation as to suitability, or appropriateness of discount rates applied
- *Failed to procure sufficient professional advice*
  - Short expiry of mining permit
  - No PRC legal opinion as to ability to renew
  - Only verbal comfort from relevant PRC authorities

What you should watch out for/do:

- **Sharpened focus on "individual accountability"**: investigation not only looked into where the transaction went wrong**,** but also **how/why it was approved by the board**
- **Directors' duties of care, skills, and diligence** in approving transactions — high standards expected
- **Board process** in **approving transactions** — engagement of professional advisers
- **Internal controls** — review **your company's policies and procedures** re: engaging independent valuer/other advisors

(ii) HKEX published a consultation paper on a proposal to allow corporate entities to benefit from the weighted voting rights regime, subject to conditions and additional investor safeguards. (Click: press release; full paper)

This does not fall within our area of focus. The press release sets out a detailed summary of conditions.

These include the fact that the corporate entity must either be an innovative company itself or have business experience/track records in innovative companies. There is a time-defined **"sunset clause"** of not more than 10 years, renewable for successive periods not exceeding 5 years with independent shareholder approval.

Legislation

The Competition Commission commenced proceedings in the Competition Tribunal against an **IT** service provider and its director, for their participation in **"cartel"** conduct regarding Ocean Park's 2017 bidding exercise for the procurement of IT services. (Click: press release)

The Commission alleges that such service provider and a co-bidder exchanged competitively sensitive information on their intended quotations, seeking to coordinate which company was going to win.

"Cartels" (infringing the **"First Conduct" rule)** is a current **enforcement focus.** (Click: our May 19 legal update; on the first two decisions delivered on "cartels").

This case was brought to the attention of the Commission by a co-bidder, hence the Commission's **first enforcement case** resulting from a successful **"leniency application".**

The press release highlighted the **Commission's initial focus on "encouraging compliance**" — it's also being **the first "infringement notice" case.**

The Commission may issue such a notice, offering **not to bring legal proceedings** on **condition** that the person makes a **commitment to comply with the requirements** of the notice. In this case, the defendant declined this, whilst another service provider accepted such offer.

What you should watch out for/do:

- **"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**
- 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

February 2020