

# May 18 Legal and Regulatory Update

## Top stories

### Another new case on “disclosure of inside information”

#### SFC proceedings against Magic Holdings for “disclosure of inside information” breaches

(Click: [press release](#); [Market Misconduct Tribunal Notice](#))

#### *What you should know:*

- Nature: **delay** in disclosure; founders sold equity stake to L’Oreal (“L”) leading to general offer
- Action against **company**, 3 founders/EDs, ED and Company Secretary, 4 Directors
- Chronology: alleged “**inside information**” (\*) and **leakages**:
  - \*(Mar 2013) founders’ meeting with L: preliminary agreement reached re: sale, price not agreed
  - (April) **Loss of “safe harbour” (“incomplete negotiation or proposals”) given leakages** — road show (fund manager enquired as to sale to L); a supplier asked Company Secretary as to sale; email from analyst as to possible sale
  - \*(Mid Apr) founders’ video conference with L: agreement on deal approach
  - \*(Late Apr) founders’ meeting with L: minimum offer price agreed
  - \*(May) L sent preliminary proposal; then forwarded to all directors
  - (Late May) board meeting held granting due diligence to L
  - (June-July) due diligence, further negotiation on price
  - (Aug) company made announcement
- **Officers** failed to take reasonable measures to ensure proper safeguards for timely disclosure

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

- “Disclosure of inside information” **remains a key area that listed companies should monitor**
- Significance to maintain **confidentiality** and hence any available “**Safe Harbour**”

## Also in this issue

### Regulators

#### (i) SFC Regulatory Bulletin: Listed Corporations (Click: [full report](#); [press release](#))

It highlights various case studies on SFC actions to tackle **market misconduct** in the 9 months ended 31 Mar 18. SFC's "**early intervention**" approach in serious corporate cases and IPO applications was stressed.

We focus on the post-IPO cases, and noted the principal themes of **transaction valuations** (see below), **highly dilutive capital raising** (e.g. deeply discounted share issuance).

**SFC tools** used in the cases are also noteworthy — including exercising its **power to require production of books and records** under specified circumstances (**s.179**, Securities and Futures Ordinance); "**Letter of mindedness to object**" ("**LOM**").

#### *What you should know:*

Cases on **valuation issues** are noteworthy:

- **Post-IPO case 4 (P. 5): valuation in acquisitions**
  - (i) Issuer acquired minority stake in a broker, and announced proposed acquisition of remaining interest
  - (ii) SFC issued "**s.179 enquiries**"
  - (iii) SFC found a "**series of transactions**" designed to **justify artificially high valuation** for target
  - (iv) Target's net profit mainly attributable to non-recurring items; key customers related to the issuer
  - (v) Seller of target provided loans to individuals for exercising recently-granted options in the issuer
  - (vi) **SFC issued a LOM** setting out its concerns on impact of transactions on public shareholders
  - (vii) Issuer terminated the deal
- **Post-IPO case 6 (P. 6): valuation in warrants issuance**
  - (i) Issuer proposed to issue unlisted **warrants at a deep discount**, over **14% of its enlarged share capital**; failed to explain **reasons** of issuing at deep discount
  - (ii) Board did **not obtain independent valuation**

- (iii) SFC was concerned that **the board might not have obtained sufficient information** to determine whether the issue **price** was **fair and reasonable and in the interest of the shareholders**

*What you should do/watch out for:*

- SFC focus on **“fair and reasonable valuation” in transactions**, and the otherwise adverse impact on public shareholders
- Higher expectations on **boards’ role in valuations**, including the need to obtain **independent valuation reports**

**(ii) HKEX published a report on its review of issuers’ first ESG reporting**

This review analyzed disclosure by 400 randomly selected issuers, after implementation of the ESG Guide. (Click here: [press release](#), [full report](#))

Overall, the level of compliance with the ESG Guide was high, but the quality of reporting varied. There was some “excellent reporting”, both in terms of detail and clarity, while at the other end, some ESG reports appeared to show a “box-ticking” approach.

**“Best practices”** adopted, and **improvement areas** highlighted by HKEX are summarized below.

*What you should know/do:*

**For planning your next ESG report:**

- **“Best practices” commended by HKEX** include (P.3, para 5):
  - (i) Comprehensive description of **policies**
  - (ii) Set out information on **laws and regulations** that have a significant impact
  - (iii) Gave **“considered explanations”** under the “Comply or Explain” provisions
  - (iv) Conducted **materiality assessment** by going through the **stakeholder engagement** process; produced a **materiality matrix**
- HKEX stressed the importance to follow the Guide’s **“ESG strategy and reporting”** section (under “Overall Approach” of the Guide) and **“Reporting Principles”**
  - While not mandatory nor subject to “Comply or Explain”, such information is “expected from stakeholders” (P.3, para 7)

- **Improvement areas** highlighted (P.4, para 8):
  - (i) State the issuer's or the **board's commitment** to ESG, **management approach** and explain **how they relate to its business**
  - (ii) The **board's** evaluation and determination of **ESG risks** and how it ensures that appropriate and effective **ESG risk management/ internal control systems** are in place
  - (iii) The process of **stakeholder engagement** which is central to materiality assessment and as a channel to engage and communicate with stakeholders
- HKEX stressed again, that it is a Listing Rule requirement to report on the “**Comply or Explain**” provisions. **Non-compliance without giving considered reasons amounts to a breach** of the Listing Rule. (P.4, para 9)

(iii) **HKEX censured Boer Power Holdings: unauthorized loans triggering other breaches** ([Press release](#)).

These arrangements were made by an executive director without board knowledge. The undisclosed loans also led to **misleading annual reports**. This case also shows the importance of maintaining **a clear division of responsibilities within the board and management**, to ensure a balance of power and authority without concentration in any one individual. The issuer, as well as some executive directors were censured.

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

- The group factored RMB1.403 billion of trade receivables due from 200 customers to various banks. As a result, the customers would settle the factored amount directly with the Banks
- Customers in financial difficulties
- (2013-4) **ED** procured the group (**without board knowledge**) to make partial settlement to the banks on behalf of the customers
- Unauthorized loans: undocumented loans; in the form of interest-free and unsecured loans to the customers repayable on demand
- Financed by bank loans; own operating cash
- **ED controlled the Group's bank accounts, chops/seals and books and records**
- The Board did not discover the loans and the financing arrangements until March 2016

- **Breaches:** relevant years’ **annual reports** were incomplete, inaccurate, misleading; failed to disclose the loans and their financing
- **Breaches:** **inadequate internal controls and risk management systems**

(iv) HKEX published FAQs relating to issuers’ continuing obligations.

[Updated FAQ Series 1](#) (#49) clarified the calculation of “**market capitalization**” (“consideration test” under “**Five Tests**”, **Chapter 14** of Listing Rules) **for H share issuers with A/B shares listed on PRC stock exchange.**

A [new FAQ](#) clarified the **interpretation of “pledging of shares” by controlling shareholders (Chapter 13 of Listing Rules).**

*What you should know:*

#### **Updated FAQ Series 1**

- Clarified the calculation of “**market capitalization**”, if the issuer has unlisted shares or shares listed in other markets (**e.g. H Share PRC issuers with A and B Shares**)
- This follows **Listing Decision [LD 83-1](#)**. The issuer has both H and A Shares, with the H Shares trading at a deep discount to the price of A Shares. Calculation under the current method (based on market value of the H Shares only) produced anomalous results
- **Market capitalization** should be calculated with reference to the total issued share capital of the issuer
- For an **H Share issuer with A and/or B Shares** listed on a PRC stock exchange, the market value of A and/or B Shares is calculated based on the average closing price of the respective shares for the 5 days preceding the date of the transaction
- For an H-issuer with unlisted shares, the market value of unlisted shares is extrapolated from the market value of the H shares for the 5 days preceding the date of the transaction

#### **New FAQ re: interpretation of “pledges of shares” by controlling shareholders**

- Such concept is **broadly construed**
- **Any arrangement, in any form and however named will be caught** — where the company’s controlling shareholder **effectively uses all or part of its interest in**

**company shares to, directly or indirectly, secure the company's debts, or to secure guarantees or other support of Company**

- E.g. deposit of share certificates by controlling shareholders.

**(v) HKEX published consultation conclusions** on (1) [Capital Raisings by Listed Issuers](#) and (2) [Delisting and other Rule Amendments](#). (For details of proposals, click our [Sept 17 legal update](#)).

The **proposals were adopted**, with minor clarification/drafting changes.

The first consultation seeks to address potential abuses related to **large scale deeply discounted capital raising activities**, including rights issues, open offers, specific mandate placings. E.g. prohibition of capital raisings with a **material value dilution (25% or more within a rolling 12-month period when aggregated)**. The proposals will become **effective from 3 July 2018**.

The second consultation aims to improve the effectiveness of the delisting framework and address the issue of **prolonged suspension of trading** in listed securities. The proposals, including **automatic delisting** for issuers where share trading has been **suspended** continuously for **18 months**, will be **effective from 1 August 2018**.

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