May 2021 Legal and Regulatory Update

Top stories: new HKEX disciplinary regime

HKEX published consultation conclusions in relation to proposed changes in its disciplinary regime. (Press release; full document: *summary on P.2*)

The thresholds for some actions are lowered, and **new measures** are introduced. There is an emphasis on **misconduct by individuals**, including **directors and *(new)* "senior management"** of listed issuers and subsidiaries.

For instance, as regards **public statement** that retention of office by a director is **"prejudicial to the interests of investors"** ("PII statements"), **"wilful" or "persistent" failure** to discharge responsibilities is no longer required. The **scope** of PII statements is expanded, to cover **director OR senior management.**

A **NEW "director unsuitability statements"** against individuals is also introduced.

Follow-up actions *(e.g. denial of market facilities)*, and **disclosure** are also enhanced.

The revisions will become effective on **3 July 2021**.

What you should know/do:

Key changes

- **Lower thresholds**

  *(No longer requires: **"wilful" or "persistent"** failure to discharge responsibilities)*

  - **PII statements**
  - **Denying an issuer's access to facilities of the market**

- **Expand scope of restrictions under PII statements**
  - The individual's occupying the position of **director OR senior management**
  - Of a **named listed issuer** OR any of its **subsidiaries**

- **(New) "director unsuitability statements" against individuals**
  - That, in HKEX's opinion, the director is "**unsuitable**" to be a director or member of senior management of a listed company
  - **"Serious or repeated failures"** requirement

- **Enhance follow-on actions**
  - Where **individuals subject to PII statements continue** as director/senior management of a named issuer/subsidiaries
  - E.g. denial of access to market facilities to the named issuer
- **Enhance disclosure**
  - Directors/senior management subject to public sanctions
  - **Disclose** in issuer's **announcements/communications** and/or **annual reports**
- **(New) secondary liability for Rule breaches**
  - "Caused by **action** or **omission** or **knowingly participated** in a contravention of the Listing Rules"
  - **"Relevant persons"** broadly defined
  - E.g. **"senior management", substantial shareholders**
  - E.g. guarantors of an issuer for its issue of debt securities
- Definition of **"senior management"**
  - Named positions of **CEO, CFO, COO, company secretary,** and **supervisor** OR
  - **Performs managerial functions** under the directors' immediate authority OR
  - Referred to as **senior management** in issuer's **corporate communications**
- **Introduce explicit Rule provisions**
  - When **responding to HKEX enquiries/investigations**
  - **Obligation** to provide accurate, complete and up-to-date information and explanation

Also in this issue

Regulators

(i) HKEX's latest Listed Issuer Regulation Newsletter covers **various themes relevant to listed issuers,** e.g. **guidance on lending transactions** *(summarized below)*.

As regards **"notifiable transaction" announcements**, HKEX previously reminded issuers to disclose **significant relationships between counterparties** to the transactions *(and ultimate beneficial owners)* and the issuer's **connected persons**. E.g. a connected person may provide **loans** to the counterparty funding the transaction. This is relevant in assessing if the counterparty should be **deemed a "connected person"**.

The newsletter explains that **HKEX may require** issuers to provide a **confirmation** on any **material loan arrangements** between **the counterparty** and **connected persons**.

HKEX also observed that despite Covid 19, issuers demonstrated a high level of compliance with their financial reporting obligations. Highlights of listed issuers' spin-off activities are also addressed.

What you should know/do:

Guidance on loan transactions

- Lending transactions which raise concerns
  - Lack of **business rationale/ commercial substance**
  - **Excessive lending** in size compared to scale of issuer's business operation
  - **Defaults in repayment or full impairments** shortly after grant of the loans
- **Example**: gaming operator lent money to six independent parties
  - Mostly **interest-free** or at a rate **substantially lower** than its cost of capital
  - Raises question of **commercial merit**
  - 70% of **loans unrecoverable** shortly after being made
- **Financial reporting**
  - Appropriate and supportable estimates **to assess loans recoverability to support "impairment" assessment**
  - **Disclosure on material lending transactions in annual report *("MD+A" section)***
    - (i) major terms *(total outstanding loan receivables, maturity profile, interest rates, collateral/ guarantee)*
    - (ii) discussion on **provisions and impairments**, **bases** of impairment assessment, valuations / other supporting evidence
    - (iii) *(outside ordinary course of business)* reasons for granting such loans and how they meet business strategies
- **Proper and adequate internal controls**
  - Assess and manage credit exposure
  - Monitor recoverability of loans
  - Monitor adequacy of collaterals
- Improper **discharge of directors' fiduciary duties**
  - Should critically assess commercial rationale

– Terms are fair and reasonable

– Use of issuers' fund in the ordinary and usual course of business and in best interest of company

(ii) 3 HKEX Listing Decisions on directors' duties

The cases reflect directors' duties in different context: **loans, acquisitions**, and **joint ventures** ("JVs")

Listing Rules requirements

Rule 3.08: the **board of directors** is **collectively** responsible for its **management and operations**, and the **directors are collectively and individually** responsible for ensuring Listing Rule **compliance.**

Every director must apply **such degree of skill, care and diligence** as may reasonably be expected of a person of his knowledge and experience and holding his office; act honestly and in good faith **in the interests of the issuer**.

(A) ***[Loans]*** **decision on Dongyue Limited and named directors** (*executive, non-executive, independent*) (Press release; Statement of Disciplinary Action)

This involves **misappropriations** by the company's **financial controller**, who was responsible for the **wealth management business**. Transactions involving loans/deposits around RMB 1.5b were entered into over 1.5 years. The amount remains unrepaid or has been forfeited. Significant **internal control deficiencies** in the wealth management business was found.

The **directors** had failed to implement **effective risk management and internal control** procedures to **supervise the financial controller** or **safeguard the company's assets**. **Placing trust in senior members of staff is not a substitute** for a proper internal control framework.

What you should know/do:

Internal controls deficiencies + failure in directors' duties *include*

- No **specific internal control procedures** re: wealth management business
- **Financial controller** given a freehand re: treasury function enabling him to conduct the problematic loans
- **Monthly management reports**
  - No separate item for wealth management business
  - No evidence that any relevant director made meaningful enquiries

  - No attempt by any director to change the level of details

- **Wealth management reports** supplied to CFO only, and on an ad hoc basis
- No requirement for CFO/directors to **review** the above **reports in detail**
- Despite **auditor's red flags**, directors did not review the relevant processes/ procedures or follow through

Audit Committee

- **Never met with internal audit** team to discuss issues raised by them/ wealth management business

(B) *[Acquisitions]* case on named former directors (*executive, non-executive, independent*) of Huiyin *Holdings* Group Limited (Press release; Statement of Disciplinary Action)

In 2016, the company sought to acquire 2 companies. However, issues arose and directors failed to establish adequate internal controls to ensure that **relevant documentation re: the acquisition** was obtained/ retained *(e.g. personal guarantee by vendor)*. Auditor issued **disclaimer**. There was a subsequent impairment *(over $100 m)*, and significant loss for the company.

The **directors** failed to establish adequate **internal controls** in the company to **obtain / retain the relevant documentation** in respect of the acquisitions.

What you should know/do:

Internal controls deficiencies + failure in directors' duties *include*

- **Disclaimer** was due to unavailability of relevant books/records, or appropriate evidence to verify the ownership of the subsidiaries
- **Company could not explain** various issues which reflect its internal controls inadequacies
- No formal procedures to **take control** over the newly acquired subsidiaries

(C) *[JV]* Decision on Tech Pro Technology Development Limited and named former directors (*executive, independent*) (Press release; Statement of Disciplinary Action)

The company acquired a 50% interest in a JV, whose principal business was to lease a property from a lessor and sub-lease it to tenants. It appointed 2 directors as representatives on the JV board.

Directors failed to take adequate steps or implement **effective risk management and internal controls** to **monitor the operations** of the JV or **safeguard its assets**. There was an **over-reliance on JV partner**.

This created an environment for irregularities. E.g. JV partner continued to collect a substantial part of rent on behalf of JV. The outstanding amount due from JV partner was very substantial. JV was unaware of a major lawsuit by the lessor resulting in the loss of its sub-leasing right, a substantial asset.

What you should know/do:

Internal controls deficiencies + failure in directors' duties *include*

Executive directors

- E.g. no protective measures in place for monitoring JV's business and operations
  - JV partner was able to continue the historical rental collection arrangement
- E.g. very substantial outstanding amount from JV partner; no risk management measures
- E.g. inadequate checks and balances re: JV's operations and cash flows

Representatives on JV board

- E.g. lack of involvement in JV's management and operations
- E.g. lack of action to address the JV partner's dominance for a prolonged period

Audit Committee members

- E.g. neither the company's management nor audit committee members adequately addressed the company's obvious lack of control over the cashflows of the JV

(iii) HKEX published new FAQs relating to notifiable/connected transactions.

- FAQ 073-2021
  - **Calculation of "5 tests"**: proposed loan to substantial shareholder; percentage ratio based on stand-alone loan amount OR after setting off loan owed by company
- FAQ 074-2021
  - **"Aggregation" principle** —acquisition of wealth management products from bank

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