Sept and Oct 2023 Legal and Regulatory Update

Top stories

HKEX Guidance

(A) HKEX published Guidance Letter (GL 116- 23) on Disclosure of the basis of consideration and business valuations in notifiable transactions.

Valuation in transactions and directors' duties is a recurring theme of regulators. It was addressed in HKEX's recent Enforcement Bulletin. *(See our May/June 23 update)*

*(Background: in a **"notifiable transaction"**, issuers are required to disclose the **basis for the consideration** and the terms of the transaction. Under FAQ Series 7 No. 21, where the valuation of a target is a **primary factor** in forming the basis for the consideration or other material terms, **disclosure of the valuation** would need to be made in the announcement/circular.*

***SFC** also published guidance on directors' duties in transactions: (2017) a Guidance note on directors' duties in the context of valuations in corporate transactions, (2019) Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals).*

The Guidance Letter sets out (i) disclosure gaps identified and **guidance on recommended disclosure**, (ii) guidance on disclosure of the **basis of consideration** where **no independent valuation** is disclosed.

It provides useful and detailed guidance, illustrated by examples. A summary of the key components is set out below.

What you should know/do:

Disclosure of business valuation

- **General**
  - Valuation report should contain information in line with generally accepted valuation standards *(e.g. The International Valuation Standards) (Para 8, P.3)*
  - Noted **"overly general and simplistic" disclosure** in some cases, particularly re: valuation methods, key inputs and assumptions used in the valuations
- **Valuation approaches and methods** *(Para 10, P.3)*
  - E.g. use of **"discounted cash flows" method** to value a start-up target company
  - Should explain how it is **appropriate** in the absence of a historical track record to substantiate the forecasts

- **More than one valuation method** is used: disclose valuer's process in analysing the values derived from different valuation approaches and how they contribute to the final appraised value

- **Key inputs and assumptions** *(Para 14 , P.4)*
  - Explain **"with detail and in specific terms"**
  - **"Market approach valuation"** *(Para 15, P.4)* : criteria used to select comparable companies
  - E.g. **generic description**: comparables selected as **"mostly" or "mainly"** engaged in certain businesses *(without quantitative benchmark such as % of revenue attributable to the industry,etc.)*
  - Addresses **income approach** *(Para 17, P.5)*, **cost approach** *(Para 20, P.7)*, **asset-based approach** *(Para 21, P.7)*

Transactions where no independent valuation is disclosed *(Para 22, P.7)*

- **Adequate explanation** of the **basis** for determining the consideration
- *(Illustrated by examples)* **sufficient** and **objective** information with **quantitative inputs and analysis**

(B) HKEX published its latest Enforcement Bulletin, focusing on directors' duties towards "conflicts of interest".

HKEX reminds directors that the **obligation to avoid conflicts** is **fundamental,** going hand in hand with the obligation **"to act in the best interest of the company".**

*(Background: **directors' duties under Listing Rule 3.08 are wide-ranging. For instance, their fiduciary duties** are "at least commensurate with HK law". There is also an express reference to "act for proper purpose", "**avoid actual and POTENTIAL conflicts of interest and duty**").*

It is noteworthy that conflicts go beyond "actual or obvious conflicts". The **threshold is very low**, hence catches "**potential** for conflict and even if the **risk** might seem **indirect, low or remote**" . If a director has **any doubt,** he/she should **declare and discuss** among directors.

HKEX also provides some **conflicts scenarios**, and useful **guidance on conflict management**. The need for **adequate and effective internal controls and risk management** is stressed**.**

What you should know/do:

Conflicts scenarios include

- **Competing business**

- **Controlling shareholder's interest *(e.g. interest of founding family)***
- **Director serving 2 companies**

Conflict management

- **Declaration of interest**
  - Upon joining the board
  - Update
  - Keep records
- **Policy and practices**
  - **Conflict management, anti-corruption and bribery, whistle blowing**
  - **Implementation**
  - **Directors to have easy access to policies**
- **Segregation of powers**
- **Professional advice**

Also in this issue

Regulators

(i) *(Connected transactions at subsidiary level)* **HKEX censures China Fortune Holdings Limited, imposes a Director Unsuitability Statement against a former executive director, censures/criticises named former directors *(including independent directors)*** .
(Announcement; Statement of Disciplinary Action)

Between 2014-9, the company entered into a number of connected transactions via its subsidiaries, and failed to comply with Listing Rule disclosure and procedural requirements.

The company's **internal controls and supervision over its subsidiaries** were found to be seriously deficient. It had **previously been warned by HKEX** for a breach of Listing Rules relating to connected transactions.

HKEX rejected the defence that the directors were **not involved in the day-to-day operation of subsidiaries** and relied on information provided to the board to exercise supervision over them.

HKEX's announcement states that the board of directors must ensure that **active reporting procedures and mechanisms** are in place to enable them to properly oversee the activities of a listed issuer's **subsidiaries**.

What you should know/do:

Internal controls: failure in directors' duties

- **No meaningful steps** taken to ensure **procedures/mechanism for reporting material information** about the **subsidiaries to the board**
- **HKEX's warning** should have prompted a reasonable director **to identify inadequacies in relevant internal controls** and **take active remedial actions**
- **Limited actions:** only commissioned an **internal controls review** in 2020**, internal procedures only updated** in 2021

(ii) HKEX published FAQ including on mandatory electronic dissemination of corporate communication, effective 31 Dec.

(Background: for a summary of the new regime, see our May/June 23 legal update).

*It is noteworthy that issuers are subject to requirements of the laws and regulations applicable to them. For **issuers incorporated in HK, HK Companies Ordinance does not currently permit shareholders' consent to be "implied" for receiving communications by electronic means).***

The useful FAQs give a list of items which constitute **"Actionable Corporate Communications"** whereby an issuer must still send to securities holders **individually** in **electronic form**, or *(where email details not provided)* by **hard copy**. E.g. provisional allotment letter in connection with a rights issue. *(Para 13, P.11)*

It also addresses practical situations, e.g. where electronic contact details provided by a securities holder are non-functional.

(iii) HKEX published a consultation paper on proposed rule amendments to introduce a new **treasury shares** regime. **It also published a Guidance Letter** setting out the **framework** for granting a **waiver** to allow an issuer to conduct an **automatic share buy-back programme** on the exchange and to continue the programme throughout the **"restricted period"** *(i.e. while in possession of undisclosed inside information and during the one month prior to release of financial results).* (Press release)

The proposed rule amendments and the Guidance Letter seek to give issuers greater flexibility in managing their capital structure through share buy-backs and resales of treasury shares.

Under the **proposed treasury shares system**, the requirement to cancel repurchased shares will be removed. Issuers may hold repurchased shares in treasury **subject to the laws of their places of incorporation and their constitutional documents**. **Safeguards** will be built for maintaining a fair market, mitigating the risk of stock market manipulation and insider dealing.

E.g. a 30-day moratorium period to restrict a resale of treasury shares. The consultation period will end on 27 Dec 2023.

The new **Guidance Letter** highlights the criteria that HKEX will apply when **assessing an issuer's share buy-back programme and waiver application**, including the issuer's size and liquidity of its shares and the mechanisms in place to guard against trading with undisclosed inside information and potential price manipulation.

(iv) SFC published consultation conclusions on proposed amendments to the Codes on Takeovers and Mergers and Share Buy-backs. (Press release, Consultation Conclusions)

SFC **will proceed** with the proposed amendments, which **mainly codify existing practices** of the Takeovers Executive and **clarify** the Codes where necessary. For instance, SFC will codify its current practice and expand the **definition of "close relatives"** to include a person's grandparents, grandchildren, sibling's spouse or de facto spouse, children of siblings and the parents and siblings of the person's spouse or de facto spouse.

The expanded definition will result in a larger group of individuals **presumed to be acting in concert** with a person. However, the SFC will continue to consider **rebuttal applications** refuting concert party presumptions.

(v) AFRC

(A) 2023 Annual Compliance and Investigation Report (Press release, Report)

Our focus is on the impact for listed companies. It sets out **top 5 areas of potential financial reporting non-compliance:**

- **Impairment** assessment and **fair value measurement**
- Recognition and measurement of **financial instruments**
- **Fraudulent** financial reporting**/misappropriation of assets**
- **Going concern** assessment/reporting
- **Revenue** recognition

(B) AFRC has been monitoring late auditor resignations and published a paper titled "AFRC Addresses Concerns Surrounding Auditor Changes" ("the Paper") **and the Guidance Notes on Change of Auditors** ("the Guidance Notes"). (Press release)

AFRC stated in the press release that it also focused on whether auditors as well as **audit committees ("ACs")** fulfill their respective **responsibilities** in managing auditor changes.

In the Paper, identified **improvement areas** include (i) audit planning *(see our July/August update: AFRC's "Audit Focus" publication)*, (ii) unwillingness to resolve audit issues.

The **Guidance Notes** (Part 3, P.9) set out useful **guidance to ACs**. Situations include when **ACs** are (i) notified of an **"audit issue",** (ii) receive notice of an **auditor's resignation**. There is a cross reference to its *(Dec 2021)* Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors.

What you should know/do:

Example: "unresolved audit issues"

- ***(Based on discussion with auditor)*** **Understand nature and details of unresolved issues, potential impact on financial statements and audit opinion**
- **May consider hiring external consultants *(e.g. forensic accounting, legal)***
- **Should prevent management from requesting auditor to resign owing to unresolved audit issues**

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