

June 25 Legal and Regulatory Update

Top stories

HKEX's latest Listing Regulation and Enforcement Newsletter

HKEX addresses various themes, including **convertible bond offerings with concurrent share buyback; issuers undertaking securities trading and financial investment activities; non-compliance in material transactions.** ([HKEX Newsletter](#))

(Note: other themes include: promoting capital efficiency through treasury shares; new company re-domiciliation regime; USM; new corporate governance requirements; putting adequate resources on financial reporting. These have been addressed in our previous updates).

Our focus is on the 3 themes highlighted above.

Firstly, convertible bonds (“CBs”) offerings with concurrent share buyback.

HKEX is mindful of the emerging demand from issuers and investors for transactions with **innovative fundraising structures**. It will continue to carefully evaluate these structures and strike an appropriate **balance between protecting investors’ interests and providing flexibility** to facilitate legitimate transactions when applying the Listing Rules.

It cited some examples of **recent waivers** granted, in the context of **CBs with concurrent share buyback, equity-linked securities with a “call-spread” arrangement comprising warrants**.

Secondly, HKEX noted an increasing trend of **issuers undertaking frequent and/or substantial securities trading and financial investment activities** outside their principal businesses.

HKEX's **key concerns** (*including **governance and disclosure***), as well as **recommendations** are set out in our **Appendix 1**.

Thirdly, non-compliance in material transactions.

HKEX investigates **conduct giving rise to breaches of the Rules** and observed that the **root causes** stem from **deficiencies in internal controls**. **Repeated breaches** also suggest that prior remedial actions may have been ineffective.

Where such a Rule breach occurs, HKEX will (*in addition to **disciplinary actions***) normally require the issuer to **review and enhance its internal control policies and procedures.**(*For details, see table on P.8*)

HKEX's recommended on-going measures are set out in our **Appendix 2**.

Also in this issue

Regulators

(i) SFC obtains landmark court decision for a “shadow director” and 2 executive directors (“EDs”) of Combest Holdings to make \$192 m compensation to shareholders ([Press release](#), [Judgment](#))

(Under s. 214 of the Securities and Futures Ordinance) The court order was granted following a settlement secured by the SFC, for the trio to pay the sum to an administrator jointly appointed by SFC and the company as special dividends to independent public shareholders.

Background: **EDs acted upon the shadow director’s directions and instructions** to operate and manage the affairs of the company. During various times between 2016-9, they together orchestrated the acquisition of subsidiary groups (*substantially overvalued by \$229m*); payments of fictitious loan interests and fees to entities related to the shadow director (*\$64 m*); grossly inflated company revenue artificially generated by entities related to the shadow director.

It is noteworthy that the “**shadow director**” was made subject to the compensation order as well.

(ii) HKEX censures New Century Healthcare Holding and 3 executive directors (“EDs”); criticises members of audit committee. ([Announcement](#); [Statement of disciplinary action](#))

Background: this case concerns transactions with connected person by the company.

In 2016, the company entered into a framework agreement for the provision of hospital consulting services to its connected person (*related to former Chairman and CEO*).

Between 2016 - 21, a substantial amount of service fees remained unsettled. EDs repeatedly allowed delay in payment by the connected person, **without reporting** latter’s deteriorating financial condition and certain agreed repayment plans **to the board**. Such information was **not disclosed to independent shareholders** when their approval for renewing the framework agreement was sought.

The audit committee was aware of the situation throughout the years. Apart from expressing concerns to the board and asking it to monitor and strengthen the receivables collection process, **it did not take further or adequate action to safeguard the company’s interests**. Nor did it **procure the company to disclose** the situation in the shareholder circular or otherwise to the market in a timely manner.

What you should watch out for

Audit committee

HKEX key message:

- Audit committee members serve an important role in the board's oversight of a listed issuer's **risk management and internal controls**. They are expected to cast an eye over the issuer's business decisions and transactions. In particular, they should take the lead where a potential conflict of interest arises, rather than just relying on the responsible directors or representations of executive management. They should also ensure accuracy and completeness of information in corporate communications.

Specific failures

- Question/seek more information on the financial condition of the connected person
- Raise further enquiries/follow up on the progress of the repayment plans
- Procure the board to take adequate steps to collect the receivables and safeguard company interests

(iii) SFC published consultation conclusions on the limits for three types of fees that an approved securities registrar may charge investors under the USM regime. ([Press release](#); [Consultation conclusions](#)) (*Background on consultation: our [Feb 25 Update](#)*).

SFC will proceed to incorporate the fee limits in the ASR code. It also updated its dedicated [USM webpage](#). (*For **details of the final limits**, see **Annex 2** of the consultation conclusions paper*)

In the coming months, it will continue to collaborate with HKEX and the Federation of Share Registrars to raise stakeholders' awareness and enhance understanding of the new regime.

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Appendix 1

Key Concerns

(i) Lack of governance

- Issuers claiming stock purchases as **long-term strategic investments**
 - But engaged in **frequent buying and selling** without achieving material benefits over time
- Issuers cited **treasury management** to utilise **idle funds**
 - But ultimately “parked” these temporary funds at **illiquid and risky investment vehicles**
- Issuers asserted that activities aimed to **enhance shareholders’ value**
 - But many incurred **investment losses**

(ii) Disclosure is overly limited and generic

(iii) HKEX’s recommendations

- Directors should **critically evaluate** whether investment activities are a **proper use of shareholders’ funds**, and whether they align with **shareholders’ investment expectations** and the issuer’s **direction and strategy**
- Issuers holding a **substantial amount of cash in excess of the operation needs from their principal businesses** and/or **investing heavily in securities** are strongly encouraged to **formulate and execute a dividend policy** to enhance shareholders’ return, with **detailed disclosure** in line with the new Rules
- Issuers considering securities trading as a **business** must ensure they have adequate **expertise, infrastructure, and control mechanisms**
- **Improve disclosure** in financial reports and other regulatory filings by giving a detailed account of the **investment policy and objectives, risk management and control measures** and **approval and oversight mechanisms**

Appendix 2

To ensure compliance, issuers must consider the following **ongoing measures**:

- **Robust policies and procedures**
- **Adequate resourced compliance function**
 - capable staff who can exercise sound judgment and timely escalate issues to senior management
- **Oversight by directors and senior management**
- **Regular training**
 - for senior management and relevant personnel to enhance their understanding of the Rules and compliance requirements
- **Seek professional advice**