Skadden

Hong Kong Regulatory Update

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This update provides an overview of key regulatory developments in the past three months relevant to companies listed, or planning to list, on The Stock Exchange of Hong Kong Limited (**HKEx**), and their advisers. In particular, it covers amendments to the Rules Governing the Listing of Securities on HKEx (**Listing Rules**) as well as announcements, guidance and enforcement-related news from HKEx and the Securities and Futures Commission (**SFC**). Other recent market developments may also be included. We do not intend to cover all updates that may be relevant, but we welcome feedback, so please contact us if you would like to see analysis of other topics in the future.

HKEx Introduces New Rules on Book-Building and Placing Activities

HKEx has amended the Listing Rules to codify the SFC's new requirements on book-building and placing activities under the Code of Conduct for Persons Licensed by or Registered with the SFC (covered in our February 2022 Hong Kong Regulatory Update). The new rules apply to all primary and secondary listings involving book-building activities through a placing tranche. They take effect on 5 August 2022 and apply to all listing applications submitted on or after that date. The new rules introduce some significant changes to the way in which investment banks are engaged in IPO and placing transactions, including the banks' roles and responsibilities, engagement letters and fee arrangements.

Under the amendments, investment banks conducting book-building or placing activities will be engaged in one of the following capacities:

- A **capital market intermediary (CMI)** is any entity licensed or registered under the Securities and Futures Ordinance (**SFO**) that conducts activities such as book-building and placing. A **syndicate CMI** is a CMI directly engaged by the issuer. Any SFC-licensed investment bank acting as an underwriter in the transaction will be a CMI.
- An **overall coordinator (OC)** is a syndicate CMI responsible for overall management of the book-building process (a role traditionally referred to as "bookrunner").
- A **syndicate non-CMI distributor** is an entity that is not licensed or registered under the SFO and conducts book-building and placing activities outside Hong Kong and that is directly engaged by the issuer. This role will encompass the overseas entities of underwriters.
- A **syndicate member** is either a syndicate CMI or a syndicate non-CMI distributor.

The key amendments to the Listing Rules include:

- **Engagement of OC and sponsor-OC**: The issuer must engage at least one sponsor-OC at least two months before filing its listing application. The sponsor-OC must be an independent sponsor. On the date of the filing of the listing application, the issuer must publish an announcement disclosing the names of all OCs. All OCs must be engaged no later than two weeks after the filing.

- **Reporting of fee arrangements**:
  - Issuers must enter into written engagement agreements with each OC/CMI at the time of engagement. The engagement agreement must specify (i) the fee arrangement (including the fixed fees payable as a percentage of the total fees payable to all syndicate CMIs) and (ii) the time schedule for payment.
  - The sponsor-OC must submit the following information to HKEx at least four full business days before the listing hearing: (i) the fixed fees payable to each OC and (ii) the total fees (as a percentage of gross proceeds raised) and the ratio of fixed and discretionary fees payable to all syndicate CMIs.
  - The prospectus must disclose (i) the total fees payable to the sponsors and (ii) the total fees (as a percentage of gross proceeds raised) and the ratio of fixed and maximum potential discretionary fees payable to all syndicate members.
  - Before the listing date, the issuer must determine and communicate to each syndicate CMI (i) the finalized absolute amount of discretionary fees actually payable and (ii) the time schedule for payment and must confirm to HKEx that such communications have been made.
- **Furnishing of information to syndicate members**: At least four full business days before the listing hearing, the issuer must provide each syndicate member with a complete list of (i) its directors and existing shareholders, (ii) their respective close associates and (iii) persons acting as nominees for them for share subscription. This is likely to be an onerous obligation for issuers with large and/or complex shareholder registers.

SFC Proposes Amendments to SFO To Strengthen Enforcement

The SFC has launched a consultation on enforcement-related amendments to the Securities and Futures Ordinance. The amendments are intended to ensure the SFC has adequate regulatory power to protect investors and safeguard the quality of Hong Kong's financial markets. Highlights of the proposed amendments include:

- **Expanding the bases on which the SFC can take action against regulated persons under SFO Section 213**. Currently the SFC can only obtain court orders such as injunctions in a limited range of situations, and such bases do not specifically include breaches of SFC codes and guidelines even though such breaches may be serious enough to find a regulated person guilty of misconduct or unfit to remain a regulated person. To bridge this gap, the SFC proposes to include those serious breaches as a ground for obtaining Section 213 orders. The SFC also suggests introducing an additional order to restore transactions and thus protect those who have been adversely affected by the regulated person's conduct.
- **Clarifying the authorized scope for investment product advertisements**. A recent ruling by Hong Kong's Court of Final Appeal has potentially expanded the scope of exemptions under the SFO, which may allow unauthorized investment offers or solicitations to the public. This may induce unsophisticated retail investors to purchase overly risky or complex products. The SFC suggests that investment advertisements intended for professional investors should not be distributed to the general public, but only to persons who have been identified by an intermediary as professional investors through appropriate know-your-client procedures.
- **Broadening the territorial scope of insider dealing**. The SFC proposes regulating (a) any insider dealings with Hong Kong-listed securities or their derivatives, regardless of where they occur, and (b) any insider dealings with overseas-listed securities or their derivatives in Hong Kong.

The consultation period ends on 12 August 2022.

HKEx Deems Immaterial Acquisition To Be Reverse Takeover Based on Expected Future Revenues of Target

In a recent listing decision, HKEx ruled that a listed company's proposed acquisition of a start-up company with no material assets or revenues may nevertheless constitute a reverse takeover based on the target's expected significant future revenues and profits.

A company engaged in the hotel hospitality business — with assets comprising a hotel property and cash, and recording losses — proposed acquiring a majority interest in a newly established company to carry out a natural gas project in the People's Republic of China (PRC). Given that the target company had no material assets and no revenue, the acquisition constituted only a disclosable transaction for the listed company based on the relevant percentage ratios. However, based on the financial forecast of the target, it was expected to record substantial amounts of revenue and profits in the coming years (projected to be over 20 times that of the listed company) after construction of the gas project was completed and gas sales commenced.

In applying its "principle-based test" for a reverse takeover set out in Listing Rule 14.06B, HKEx ruled that the acquisition should be deemed a reverse takeover.

In making this ruling, HKEx noted that the target company would be significantly larger than the existing business of the company in terms of future revenue and profits. Additionally, the target company's business was different from and unrelated to the listed company's existing business, leading to a fundamental change in the company's principal business. Finally, the target company did not have a track record before the acquisition and could not meet the new listing requirements.

As a result of the HKEx ruling, the company terminated the acquisition.

HKEx Permits Highly Dilutive Share Issuance in "Exceptional Circumstances"

A listed company experiencing financial difficulties proposed to repay part of its overdue indebtedness by issuing new shares to the founder and largest shareholder to raise funds and to certain creditors to settle the amounts owed to them. The issuance was subject to independent shareholder approval. Following the issuance, the founder's shareholding would increase from 10% to over 50%. The theoretical dilution effect of the share issuance was over 25% and thus required the approval of HKEx under Listing Rule 7.27B.

The company argued that the significant dilution to shareholder value was exceptional and justified in the circumstances, given that: (a) the company and its subsidiaries did not have sufficient funds to repay overdue indebtedness, as their business performance and financial position had deteriorated over the previous two years due to the change in market conditions and the outbreak of COVID-19; (b) the issue formed part of the company's rescue plan — its creditors had conditionally agreed with the principal terms of an arrangement to settle the remaining indebtedness and the company was also in discussion with a financing company for a loan facility to support its business operations; and (c) the company had exhausted all other avenues of potential fundraising.

HKEx recognized the circumstances as exceptional, determined the proposed issuance to be in the interest of the company and its shareholders as a whole and therefore permitted the company to proceed with the proposed share issuance.

HKEx Rules on Director Suitability in Bribery Cases

In a recent listing decision, HKEx elaborated on the impact of the directors of a listing applicant being involved in bribery cases. HKEx regards such cases as instances of "integrity noncompliance." Depending on the circumstances, the relevant persons may be regarded as unsuitable to act as a director of a listed company, or the suitability for listing of the company itself may be impacted.

In the first case, an individual serving as a chairman, executive director and controlling shareholder of a listing applicant paid bribes to a PRC government official. While the chairman was not prosecuted, the official was convicted of receiving bribes from the chairman, and the chairman was a witness in the case. HKEx held that not only was the chairman not suitable to be a director of a listed company, but also, given that as controlling shareholder he is capable of continuing to exert substantial influence over the operations and management of the company, that the company itself was not suitable for listing. This would be the case even if the chairman were to resign as a director and from all management roles of the company.

In the second case, a director of a company served as a witness in the trial of his colleague (a fellow director) accused of paying bribes to a PRC government official. Neither the director nor his colleague were charged or convicted. The incident occurred six years prior to the listing application, and the colleague involved had subsequently resigned from the board. Nonetheless, HKEx ruled that the director was not suitable to act as a director because he was aware of the bribery committed by his colleague and had not expressed disagreement or taken action in response.

Notably, in both cases, neither of the directors were prosecuted or convicted.

HKEx emphasized that it considers bribery a serious issue, and even when a director is not prosecuted or convicted in the relevant bribery case, the presence of bribery circumstances raises concerns about a director's character, integrity and ability to fulfill a director's duties to act honestly, in good faith and for a proper purpose.

HKEx Rejects Listing Application Due to Extreme Reliance

In a recent listing decision, HKEx rejected the listing application of a company on suitability grounds because the company had what HKEx regarded as "extreme" reliance on certain parties. Material reliance on another party may threaten a new applicant's business sustainability if the relationship with such party is likely to materially adversely change. In this case, the applicant operated a medical specialist practice in which a doctor and his wife were the sole resident medical specialists and generated over 90% of the company's revenue. To address the reliance concerns, the company had hired an additional medical specialist in the final year of the track record period, but even after this hire, the doctor continued to generate over 70% of the company's revenue. The company further proposed to hire eight new specialists and open four new clinics within three years after listing. However, HKEx determined that such business expansion plans were uncertain and the company was not suitable for HKEx listing.

HKEx found that the "extreme" level of reliance could not be overcome by disclosure in the prospectus because any material change in the relationship with the primary doctor would have material adverse impact on the company. HKEx ruled that the company failed to demonstrate that it would be able to effectively mitigate its exposure to any material adverse changes to or termination of its relationship with the primary doctor on the basis that (i) the past and future success of the medical practice depended on the doctor's experience, skill and expertise, which is unique and critical, and the personal reputation and trust with patients that he and his wife built over years may not be transferrable to other doctors or replicated in other clinics; and (ii) the proposed plans to reduce reliance on the doctor were preliminary and would not be materialized before listing. HKEx also questioned the feasibility of the proposed plans. For example, the company took four to six years to operate the existing two clinics successfully, and whether qualified specialists fit for the practice could be identified and whether sufficient market demand would support additional clinics were uncertain.

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HKEx Rejects Listing Application Due to Prolonged Deterioration of Business Performance

HKEx conducts a substantive review of the business and prospects of listing applicants, and will reject listing applications if it considers the business unsustainable or to have poor financial prospects. In a recent case, HKEx deemed a company with deteriorating business performance to be unsuitable for listing.

The company owned and operated hospitals focused on providing basic health care services to residents in local communities in China. During the original track record period submitted in the company's first listing application, the company's business and financial performance had deteriorated due to regulatory breaches, relocation of a hospital resulting from land title defects, and the outbreak of COVID-19, which adversely affected the performance of the company's core business. The company subsequently submitted a renewed listing application, arguing that its business had improved due to revenue generated from new business lines. However, HKEx ruled that the company had failed to demonstrate how its expansion plans and proposed use of proceeds would improve its business and financial performance.

HKEx rejected the listing application in this case on suitability grounds, taking into account the following factors: (i) the prolonged deterioration in financial performance of the core business; (ii) lack of specific strategies or plans to improve the core business or deal with the risks of potential relocation due to land title concerns; (iii) a limited track record of the new business lines, which contributed only 10% of the revenue, and a lack of basis for the projected revenue increase; and (iv) failure to demonstrate how expansion plans and proposed use of proceeds could improve the company's business and financial performance.

New Rulings on Biotech Core Product Eligibility

Biotech companies seeking to list on HKEx under Chapter 18A of the Listing Rules must have at least one "core product" that (i) has completed Phase 1 clinical trials (clinical trials on human subjects categorized as Phase 1 clinical trials by the a regulatory authority recognized by HKEx), and (ii) for which the relevant competent authority approves commencement of Phase 2 (or later) clinical trials. HKEx has recognized the U.S. Food and Drug Administration, the European Medicines Agency (**EMA**) and PRC's National Medical Products Administration (**NMPA**) for these purposes, and may, at its discretion, recognize other national or supranational authorities as a competent authority in individual cases.

In a recent case, a biotech listing applicant under Chapter 18A had conducted Phase 1 clinical trials on its core product in Australia under the supervision of Australia's Therapeutic Goods Administration (**TGA**), which is not recognized as a competent authority for the purpose of Chapter 18A. Subsequently, the company obtained approval from each of the two recognized competent authorities under Chapter 18A, namely the EMA and NMPA, to commence Phase 2/3 clinical trials.

HKEx ruled that the product meets the eligibility requirements for a core product for the purposes of Chapter 18A, given that both EMA and NMPA had reviewed and accepted the Australian Phase 1 clinical trials in approving the Phase 2/3 trials. HKEx emphasized that this decision is case-specific, and should not be construed to mean that (i) a clinical trial conducted in Australia is generally accepted as regulated by a competent authority, and/or (ii) the TGA is generally accepted as a competent authority under Chapter 18A.

HKEx Launches Board Diversity Repository and Enhances ESG Academy

HKEx has a strong commitment to promoting board diversity and excellence in environmental, social and governance (**ESG**) reporting for listed companies. In April 2022, the exchange launched a new repository to provide information on board diversity and an ESG Academy to improve issuers' ESG practices.

- **Board Diversity & Inclusion in Focus:** HKEx will no longer permit listed companies to have a single-gender board. New listing applicants must have a diverse board, while existing listed companies must take action to establish a diverse board. HKEx has launched a new "Board Diversity & Inclusion in Focus" database to provide data regarding each issuer's board of directors by age, gender and years of tenure. This centralized platform helps investors and other stakeholders keep informed of a company's policy and approach to good governance and board diversity. Users can also choose a particular industry sector to assess a company's performance against its peers.
- **ESG in Practice:** HKEx introduced new "ESG in Practice" guidance material, aiming to provide timely, useful information to the market. It underlines HKEx's latest ESG regulatory developments and features exemplary models of ESG practices at companies.

HKEx will continue to review its ESG framework, prioritizing board governance and climate-related disclosures (including further alignment with the recommendations of the Task Force on Climate-Related Financial Disclosures and adoption of the new standards to be developed by the International Sustainability Standards Board under the International Financial Reporting Standards), and will provide any further guidance to the market as appropriate.

Amendments to Guidance Letter 25-11 on the Preliminary Results Announcement and Annual Report Requirements for New Listing Applicants

Listed companies are required to publish their final results announcements no later than three months after the end of the fiscal year under the Listing Rules. Main Board listing applicants issuing their prospectuses in the third month after the latest year-end will often obtain a waiver from the relevant Listing Rules requirement such that the audited financial results of the company for the latest fiscal year immediately preceding the issuance of the prospectus can be omitted, provided (i) listing takes place within three months after the latest year-end and (ii) the prospectus includes financial information for the latest fiscal year that was reviewed by auditors and a commentary on the results for the year that follows the content requirements for a preliminary results announcement.

Under the revised GL25-11, a company that obtains this waiver is not required to publish a preliminary results announcement and an annual report after its listing provided that the prospectus contains the financial information required to be published in annual results announcements and reports for the relevant year and that the company will not breach its constitutional documents by failing to publish such announcement or report.

Enforcement Matters

HKEx Takes Disciplinary Action Against Directors for Breach of Directors' Duties in Operating a Money-Lending Business

Two executive directors of CIL Holdings Limited (**CIL**) were responsible for CIL's money-lending business. CIL recorded substantial impairments in its annual results in relation to outstanding loans that it had granted. Due to an absence of documentation, CIL's auditors were unable to obtain sufficient audit evidence to determine whether the allowance for impairment losses was appropriate, and issued a qualified opinion identifying the following internal control deficiencies: (i) key financial information for assessing the creditworthiness of each borrower, including income proof and tax returns, could not be located; (ii) the mortgage deeds were not executed for certain loans requiring pledges of properties; (iii) certain matured loans were not repaid and pledged properties could not be foreclosed because proper mortgage deeds were not executed; and (iv) title deeds for the properties owned by borrowers for the mortgage had not been obtained. This revealed that the directors had failed to follow the credit and internal control policies of CIL, which in any event failed to include procedures for loan and interest repayment defaults.

In May 2022, HKEx criticized the conduct of the directors, which resulted adversely in CIL's ability to recover the outstanding loans. The directors were found to have breached their directors' duties and ordered to attend relevant legal and regulatory training.

The case highlights that directors are expected to establish and maintain adequate and effective internal control procedures and exercise skill, care and diligence to safeguard the issuer's interests. Particular care is required in relation to transactions involving substantial outflows or commitments of money. Directors should ensure proper records and documentation are kept.

HKEx Enforces Disciplinary Action for Lack of Internal Controls

The former director of the Hsin Chong Group Holdings Limited (**Hsin Chong**), Zhou Wei, approved two transactions with his related companies regarding a sale and leaseback arrangement with no commercial rationale — a leaseback from Hsin Chong at an aggregate rental of RMB203.5 million (despite the purchase price of RMB500 million) with an obligation for Hsin Chong to sell at RMB100 after the lease term. Both transactions were subsequently terminated with the sums paid out being treated as loans to related companies of Mr. Zhou, which remained outstanding at the publishing of the latest annual report. Mr. Zhou was the sole approver of these transactions, without notifying the board or disclosing his conflicts of interests. These transactions were only discovered by the company's auditors in the course of preparing the annual results and were raised as an audit issue subject to disclaimer opinions. The publication of the annual results and report were delayed by 18 and 17 days, respectively.

In April 2022, HKEx censured Hsin Chong and Mr. Zhou for lack of internal controls related to financial reporting, Listing Rules compliance for notifiable and connected transactions, approval of transactions and avoiding conflicts of interest. Other former directors were criticized because they failed to obtain the company's compliance with the Listing Rules and did not actively safeguard the company's financial assets.

Investors' interests can be easily threatened if internal control deficiencies exist, especially concerning disclosure of notifiable and connected transactions. Directors are responsible for developing risk management systems and being actively involved in operations to ensure Listing Rules compliance and safeguard the company's financial assets.

Failure To Announce Connected Transactions Leads to HKEx Censure

Prosper One International Holdings Company Limited (**Prosper One**) underwent a change in control and introduced a new business segment in 2017. The company started conducting connected transactions with that business segment, but neither reviewed nor updated its internal controls. In the following three financial years, the company failed to comply with the Listing Rules requirements governing notifiable and connected transactions for transactions worth over HK$800 million, the majority of which were in the new business segment. In July 2019, the company belatedly announced many of these transactions and admitted its failure to comply with the relevant Listing Rules requirements. However, further transactions involving similar breaches occurred thereafter.

In May 2022, HKEx censured Prosper One and its directors, including both executive directors and independent nonexecutive directors, for failures to ensure that Prosper One maintained adequate and effective internal controls appropriate for the new business, and failing to take steps to cause Prosper One to announce the transactions and seek shareholder approval. HKEx ordered the directors to complete legal and regulatory training and to review the company's internal controls.

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Listed companies must be diligent about announcing their notifiable transactions, including connected transactions, as soon as possible. Directors of listed companies in Hong Kong must take steps to ensure that the company's internal control system is up-to-date and effective, including an annual review. Significant changes in the company, including the commencement of new business, should prompt an immediate review.

HKEx Takes Disciplinary Actions Over Multiple Listing Rules Breaches

Between January 2017 and December 2018, Wuzhou International Holdings Limited (**Wuzhou International**) carried out nine transactions involving an acquisition and various disposals of equity interests in its subsidiaries for a consideration with an aggregate value of over RMB1.1 billion. Of these transactions, eight constituted disclosable transactions and one amounted to a very substantial disposal. However, Wuzhou International failed to comply with requirements to promptly announce these notifiable transactions, publish circulars and/or obtain shareholders' approval, reflecting material deficiencies in the company's internal and risk management systems.

In May 2022, HKEx censured Wuzhou International for its delayed announcement of notifiable transactions and deficiencies in its internal control and risk management systems, including: (i) lack of a mechanism and/or written procedures for identification, reporting and execution of notifiable transactions; (ii) lack of a system or control requiring progress of negotiations and/or developments of transactions to be promptly reported to the board; and (iii) lack of internal procedures or systems regarding transfer of shares and assets. HKEx highlighted that these deficiencies may lead to directors entering into material, notifiable transactions or disposals of the company's interests in its subsidiaries without the board being aware and in breach of Listing Rules requirements.

HKEx issued a statement of prejudice to investors' interests against the two former executive directors of Wuzhou International, who entered into eight of these transactions without either informing or obtaining approvals from the board of directors. They also failed to protect the company's interest in one disposal involving RMB350 million by allowing the registration of the purchaser as the shareholder to proceed without receiving any consideration. In addition, HKEx criticized all the company's directors for failing to discharge their fiduciary duties to exercise reasonable skill, care and diligence to obtain the company's Listing Rules compliance.

Listed companies must promptly announce their notifiable transactions in accordance with the Listing Rules. Failure to comply with the Listing Rules will often reveal underlying internal control and risk management system deficiencies and breaches of directors' fiduciary duties to promptly identify and address such deficiencies.

HKEx Orders Disciplinary Action for Inaccurate Prospectus Disclosure and Breach of Lock-Up Undertaking

CR Construction Group Holdings Limited's (**CR**) listing prospectus disclosed that Zhejiang State-owned Capital Operation Company Limited (**ZSC**) would be a controlling shareholder of CR upon its listing, and was accordingly subject to the relevant lock-up restrictions against disposing its interest in CR. Later during the listing application process, ZSC was taking steps to carry out a reorganization that would result in a reduction in ZSC's effective interest in CR, but the relevant directors who were aware of the reorganization did not make sure CR disclosed the reorganization in the prospectus.

In May 2022, HKEx found that: (i) CR breached its obligations because the information contained in the prospectus was not accurate and complete in all material respects and/or misleading or deceptive; (ii) all relevant directors breached their undertaking to use their best efforts to cause CR to comply with the Listing Rules because they were aware of the reorganization when the prospectus was prepared and issued but the reorganization was never disclosed to the independent nonexecutive directors of CR in a timely manner; and (iii) ZSC breached its undertaking to observe the Listing Rules because the company carried out a series of transactions to implement the reorganization without consulting HKEx to first obtain clearance. Each of the directors were ordered to attend regulatory and legal training.

Prospective investors of listed issuers should receive accurate and complete information. Therefore, directors must use their best efforts to ensure the information contained in listing documents is accurate and complete in all material respects. Additionally, controlling shareholders must comply fully with the disposal restrictions under the Listing Rules.

SFC Criticizes Directors for Breaches of the Takeovers Code

An offer period commenced for Steering Holdings Limited (**Steering**) on 13 May 2021 when an announcement was published by the offeror company. The offeror, Ng Kin Siu, was an executive director at the time and his aggregate shareholding interest (together with parties acting in concert with him) increased from 4.62% to 53.62%. The shares acquired by Mr. Ng were from CMBC Capital Finance Limited (**CMBC**), which enforced its security over the share pledge given by Gentle Soar Limited (**Gentle Soar**), the controlling shareholder of Steering that was controlled by Gao Yunhong, a nonexecutive director. Mr. Ng and all independent nonexecutive directors were later removed from Steering's board, leaving only Mr. Gao and Xuelian Feng on the board. Steering then announced a dispute between Gentle Soar, CMBC and Mr. Ng regarding enforcement of the security by CMBC and transfer of the related shares to Mr. Ng and that legal proceedings had been instigated. Between 27 May 2021 and 1 June 2021, Ms. Feng disposed of certain listed securities held by a wholly owned subsidiary of Steering, and the new board approved the disposal. Given that the disposal constituted a disclosable transaction, it constituted a material disposal and therefore a "frustrating action" that could inhibit the offer for the purpose of Rule 4 of the Takeovers Code. However, Steering neither obtained shareholders' approval nor sought a waiver from the SFC in relation to the requirement to obtain shareholders' approval for the disposal. The disposal was therefore in breach of Rule 4 of the Takeovers Code. As Mr. Gao and Ms. Feng remained directors of Steering throughout the relevant period and were substantially involved in the disposal, the SFC commenced disciplinary action against them in April 2022. Mr. Gao and Ms. Feng admitted that their breach was due to an oversight and misunderstanding of Rule 4 of the Takeovers Code and accepted the SFC's disciplinary action.

Rule 4 of the Takeovers Code is a fundamental rule that prevents an offeree company from taking any action that could inhibit an offer or denying its shareholders the opportunity to decide on the merits of an offer.

HKEx Issues Disciplinary Action for Internal Control Deficiencies

Between 2016 and 2019, a subsidiary of Great Wall Terroir Holdings Limited (**Great Wall Terroir**) entered into service agreements with and provided advances and loans to the directors of a subsidiary and companies in which the subsidiary's directors held significant equity interest. These were notifiable and connected transactions, as the counterparties were associates of the subsidiary's directors and connected persons of Great Wall Terroir. These transactions were not publicly announced and were executed without the company's board of directors being explicitly informed. The company failed to comply with the reporting, announcement, shareholders' approval and annual disclosure requirements under the Listing Rules regarding notifiable and connected transactions.

In June 2022, HKEx ruled that the board failed to (i) adequately supervise the affairs of the subsidiary with the appropriate checks and balances to guard against possible abuse of powers and (ii) ensure that the subsidiary's management had the necessary Listing Rules knowledge to carry out their responsibility to inform the company of any notifiable and connected transactions. Despite discovering a breach of the Listing Rules, the board failed to improve the supervision of the subsidiary. The subsidiary's directors were able to subsequently make further undocumented advances.

HKEx censured Great Wall Terroir and the directors who were aware or should have been aware of the notifiable and connected transactions. HKEx ordered the directors to complete training on legal and regulatory issues and Listing Rules compliance.

A board of directors must ensure that a proper internal control and risk management framework extends to a company's subsidiaries. The board must also adequately supervise the affairs of subsidiaries. An appropriate oversight mechanism is an essential component of an effective internal control system.

HKEx Publishes Private Reprimands Against Directors

All directors including executive directors, nonexecutive directors and independent nonexecutive directors of listed companies in Hong Kong are required to proactively perform their directors' duties and cause the company to comply with the Listing Rules requirements. HKEx recently published the key contents of private reprimands the exchange has issued to directors for various Listing Rules breaches. The reprimands cover the following key areas:

- failure to provide accurate and complete information in all material respects in financial results and reports as a result of failing to ensure that bank reconciliation was performed;
- failure to comply with the relevant requirements under Chapter 13, 14 and 14A of the Listing Rules in relation to notifiable and connected transactions as a result of (i) inadequate and ineffective internal controls; (ii) in the case of independent nonexecutive directors, failure to conduct proper annual reviews of internal controls and to interact with auditors during the annual audit process; (iii) significant deficiencies in the internal controls of subsidiaries, including a lack of awareness of Listing Rules compliance among staff and a failure to comply with internal procedures; (iv) over-reliance on the internal audit function and failing to consider whether the company is adequately resourced (for example, with only one employee) or the quality of the audit work; (v) failure to understand that the board has a general responsibility for the internal controls of the company and that the directors are subject to such general responsibility even if they are appointed for marketing purposes; (vi) loopholes in the payment approval system and a failure to enforce policies to provide checks and balances on the approval authority of the executive directors; and
- failure to maintain and implement effective internal controls to ensure compliance with the arrangements the company claimed to have entered into to protect shareholders interests and inaccurate publication of announcements claiming the company has complied with the arrangements.

HKEx Orders Disciplinary Action for Internal Control Deficiencies

Between 2013 and 2015, a director of Mingfa Group (International) Company Limited (**Mingfa Group**) caused the company and its subsidiaries to enter into several agreements involving loans and disposals of assets that resulted in numerous fund transfers and the late publication of Mingfa Group's financial results. Many agreements involved counterparties that were the directors themselves (or their associates). These transactions constituted disclosable and connected transactions, but were executed without the company's full board of directors being informed. In addition, Mingfa Group failed to comply with the Listing Rules' announcement and/or shareholders' approval requirements.

In June 2022, HKEx ruled that all relevant directors who were aware of or involved in authorizing some of the agreements or fund transfers failed to (i) obtain the company's compliance with the Listing Rules, (ii) disclose or avoid conflicts of interest, (iii) ensure the staff was sufficiently trained and supervised to comply with the Listing Rules and (iv) ensure notifiable and connected transactions would require board's consideration and approval. HKEx emphasized that delegation does not absolve the directors from the duty to supervise the discharge of the delegated functions and that directors retain ultimate collective and individual responsibility for their duties.

HKEx censured Mingfa Group and all directors who were aware of the notifiable and connected transactions. The exchange ordered the censured directors to complete training on legal and regulatory issues and Listing Rules compliance. HKEx issued a statement designating the directors who willfully and persistently failed to discharge their responsibilities as prejudicial to investors' interests.

The case highlights the exchange's priority that directors must act honestly, for proper purpose and in good faith in the company's interests and must disclose and avoid conflicts of interest.