SFC
證監會

CORPORATE REGULATION NEWSLETTER

ISSUE NO. 1
JULY 2014

An SFC newsletter to inform market participants about matters concerning disclosures by listing applicants and listed companies

Welcome to the first edition of the SFC's *Corporate Regulation Newsletter*. This series of newsletters will highlight specific issues related to disclosures by listing applicants and listed companies.

Proper disclosure gives investors confidence that they understand the companies they invest in. Investors are less likely to discount company valuations when they are confident that management provides proper disclosure to the market and maintains good corporate governance standards. This, in turn, should reduce the cost of capital for companies, enhance investor confidence and increase shareholder value.

In this edition, we set out the role of the new Corporate Regulation team, formed as part of the SFC's renewed emphasis on corporate behaviour. We also focus on specific areas where listed companies can improve their level of engagement with the market and the SFC. We include some specific guidance to companies on matters that they have raised with us or that we have identified in the course of our work. Finally, we raise two issues of concern identified in listing applications.

We hope that this newsletter will be of use to companies, sponsors, market practitioners and others interested in listed company disclosures. We would be grateful for your comments and feedback, including suggestions for topics you would like us to address in the future. Please send your comments to: CRnews@sfc.hk.

We look forward to hearing from you.

Highlights

- Renewed emphasis on corporate behaviour
- Disclosure matters
- Duty to submit quality listing applications

Renewed emphasis on corporate behaviour

In December 2013, a dedicated Corporate Regulation team was set up with the overarching aim of protecting members of the public who invest in listed companies and ensuring that the right information is disclosed to investors at the right time. The new team will be using the information-gathering powers conferred to the SFC under Section 179(1)(e)[1] of the Securities and Futures Ordinance (SFO).

The high-level objectives of this initiative are:

1. To increase the level of compliance culture within listed companies and to improve general corporate behaviour.

2. To identify corporate misconduct within the scope of the SFO, particularly:
   (a) Behaviour that is prejudicial to the interests of shareholders
   (b) Non-disclosure of inside information in a timely manner
   (c) Disclosure of false or misleading information

3. To ensure that the listing of a security is not against the public interest or the interest of the investing public. In particular, to ensure that disclosure in prospectuses is sufficient to enable investors to make informed assessments regarding the listed company and the securities.

Two existing functions were rolled into the new team: corporate disclosure, which deals with the daily review of announcements under the statutory inside information disclosure regime; and dual filing, which reviews listing documents and considers public interest issues.

Bringing these functions under one umbrella allows for a holistic approach to the regulation of listed companies. Now one team deals with companies throughout the course of the entire listing process, beginning with the application, through oversight of continuing obligations, and on until the time of delisting.

Corporate regulation: principal work streams and focus

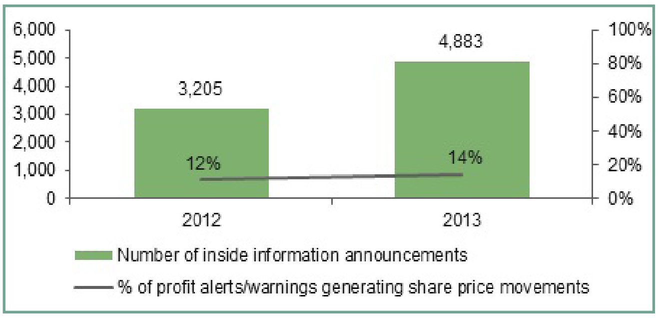
Daily review of announcements	■ focus on delayed disclosure of inside information ■ determine whether material facts are missing or require clarification ■ look into the circumstances surrounding transactions to determine any possible detriment to investors
In-depth reviews	■ analyse annual reports and other information released over the past two years by listed companies selected using a risk-based approach ■ monitor analyst reports and news articles
Thematic reviews	■ triggered when there appears to be an issue affecting more than one company ■ focus on market patterns, activities or behaviour, carried out by a group of listed companies, that raise potential concerns
Review of listing application documents	■ performed in conjunction with The Stock Exchange of Hong Kong Limited (SEHK) ■ under the dual filing system, the SFC comments on issues relevant to investors' assessments of a company's business and financial position; SEHK focuses on compliance with Listing Rules
Public interest considerations	■ while public interest is generally considered before a listing, certain transactions may also be a cause for consideration ■ where it appears to us that the listing of a company is not in the interest of investors or the public, we would consider exercising our power to object to it

[1] Namely, the power to require production of records and documents concerning listed companies.

Disclosure matters

After Part XIVA of the SFO came into effect on 1 January 2013, a listed company has a statutory obligation to make an announcement when it has information that would have a material effect on the price of its shares[2]. Subsequently, the number of inside information announcements increased by 52% in 2013. This is encouraging and suggests that the market is benefitting from greater corporate disclosure and more transparency.

Number of inside information announcements and percentage of profit alerts/warnings generating market movements



Of the inside information announcements issued in 2013, the number that were profit alerts and warnings increased by 16% over the previous year. Profit alerts and warnings are normally published to alert investors to a significant change in the expected profitability of the listed company for the current period. By definition, we would generally expect them to be price-sensitive. However, only about 14% of these alerts and warnings resulted in share price movements in 2013. It seems surprising that there is so little reaction to what would be expected to be price sensitive announcements.

In some cases, limited liquidity in a listed company's shares might account for the lack of price movement. But as trading in low liquidity stocks often peaks around announcements, or other news such as analyst reports, this can only be a partial explanation.

Of greater concern is that the lack of clarity in many profit alerts explains why they fail to move prices. To remedy this, we encourage companies to make more meaningful disclosures. The outcome should be to give investors more confidence about investing in the company's shares.

Specific figures

Many profit alerts and warnings do not disclose associated numbers or any clear sense of materiality. They merely state that there will be a "substantially" or "significantly" greater profit or loss. Without specific figures, investors have difficulty realistically assessing the effects of an announcement on the value of the company.

Similarly, many profit alerts and warnings list a number of items that explain the reasons for the change in expected financial results, but omit specific figures. We encourage listed companies to provide specific amounts wherever possible. In particular, the financial impact of a completed transaction, such as a gain or loss from the sale of property or listed investments, is often easily ascertained to a reasonable degree of certainty and should be disclosed as soon as practicable when it is inside information.

[2] Under section 307B(1) of the SFO, a listed company must disclose inside information to the public as soon as reasonably practicable, unless one of the exemptions in section 307D applies.

Recently, we encouraged one listed company to make a further announcement to disclose the amount of a loss-making item mentioned in its profit warning. The company provided the figure to us but was hesitant to make a further announcement based on an unaudited figure. As expected, when the final audited results were announced the relevant number was unchanged.

We would like to make it clear that the law does not require inside information to be audited before it is disclosed. If appropriate financial reporting procedures have been maintained and management accounts were prepared with due care, then inside information arising from the periodic review of management accounts should be disclosed.

Timeliness

We expect listed companies to maintain periodic financial reporting procedures so that key financial and operating data are identified and disclosed in a structured and timely manner.

When there appears to be a delay in disclosing inside information, we may write to the listed company to ask questions. Where it appears that more should have been done to disclose the information in a timely manner, we may issue a guidance letter to encourage the listed company to comply in the future. In the most egregious cases we will consider all available options, including referral to our Enforcement Division for potential action.

We take particular note of profit alerts and warnings that are issued just days before final results announcements. This is almost three months after the close of the year, and it would be of concern if this were the first opportunity for the board to gain an understanding of the results for the year and decide that profits were substantially different from expectations. Under properly functioning financial reporting procedures, the board of directors should review the management accounts on a monthly or at least a quarterly basis and it should know about any change in profitability shortly after the period-end.

Fostering a disclosure culture

We are starting to see profit alerts and warnings with the enhancements that we encourage in our communications with listed companies. Some announcements now disclose a range for the expected profit or a percentage increase or decrease in the expected profit from the prior year. Some listed companies have begun to quantify specific factors contributing to the profit or loss as well. While currently few in number, such announcements are a welcome development. We hope other listed companies will provide similar details in their own announcements.

Duty to submit quality listing applications

Anecdotal evidence suggests that the new sponsor regime[3] has changed the way sponsors conduct the due diligence process. It appears that they do more background work prior to signing the sponsor agreement and are more careful about selecting the deals for which they act as sponsor. Except for 10 returned applications , the application proofs under the new sponsor regime have generally covered the key aspects of the listing applicants' businesses. However, in some cases the quality of disclosure remains an issue.

Listing applications received under new sponsor regime compared to previous period

	October 2012 – June 2013	October 2013 – June 2014
Applications received	105	132

No "one-size-fits-all" disclosure checklist

Each listing applicant is unique and there can never be a "one-size-fits-all" checklist for the preparation of meaningful disclosure in the listing document. An applicant and its sponsor should critically assess what constitutes meaningful disclosure in the applicant's context rather than taking a mechanical box-ticking approach. In particular, a sponsor is required to use all reasonable efforts to ensure that the listing document is prepared to the required standard and no relevant information has been omitted or withheld. Failure to complete all necessary assessments prior to submitting a listing application casts doubt on whether the sponsor has discharged its responsibilities under the Code of Conduct[5].

Risk disclosure

A listing document should provide comprehensive and balanced information to enable investors to assess the prospects and risks of the applicant. Risk disclosure should be tailored to the specific facts and circumstances and clearly state the possible consequences in the event the risk materialises. Where possible, it is also good practice to provide relevant quantitative information about risks to help investors assess the likelihood of occurrence and their possible consequences on the listing applicant.

Risk disclosure alone does not mitigate an applicant's exposure to underlying uncertainties. In the absence of effective mitigating measures, uncertainties might call into question whether the applicant is suitable for listing or whether the listing is in the public interest or in the interest of the investing public. These issues are fundamental to the applicant's compliance with the listing requirements and are unlikely to be satisfactorily addressed merely by additional risk disclosure.

For example, if an applicant's key operating assets are located in a jurisdiction where government expropriations have been recently reported and property rights and law enforcement are highly uncertain, it is questionable whether effective legal avenues are available to safeguard the applicant's interests in the key operating assets. This poses a significant risk that the applicant may not be able to sustain its business operations.

We would expect a sponsor to submit a listing application only after it has come to a reasonable opinion that the applicant fulfils the relevant listing requirements, including whether there exist any material uncertainties that might render the applicant unsuitable for listing under the Listing Rules.

3 Under the new sponsor regime effective 1 October 2013, a sponsor should come to a reasonable opinion at the time of submitting a listing application that the application proof is substantially complete except in relation to matters that by nature can only be dealt with at a later date.

4 These cases were returned by SEHK under the Listing Rules.

5 The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (revised in 2014).

Expert's opinion

When listing applicants engage experts to express independent opinions on technical matters, such as the legality of an applicant's business or the valuation of biological assets, sponsors are obliged to assess the reasonableness of the bases and assumptions on which the expert opinion is founded[6]. Sponsors should maintain professional scepticism and critically review expert opinions against all other known information.

Investors are likely to give less weight to expert opinions that are heavily qualified or based on flawed arguments. It is essential that listing documents disclose the bases of expert opinions on material issues, particularly when they are potentially controversial, as in cases where the interpretation of applicable rules and regulations is unclear. For example, if a listing applicant's shareholding structure is inconsistent with the provisions of a notice issued by a relevant government authority, we would expect the listing document to explain the inconsistency.

In the event a new expert is brought in who expresses an opinion on information in the listing document that is apparently and materially at odds with that of the outgoing expert, the sponsor ought to investigate the reasons for the change and not assume the new opinion is more reliable than the old one. We expect the sponsor to bring such matters to the regulators' attention. This is especially important if the matter covered by the expert opinion might affect the applicant's compliance with the listing requirements.

Sponsors are not expected to repeat an expert's work, but this does not mean that a sponsor may rely on expert opinions without any due diligence. In one recent case, the regulators' enquiries revealed that the legal opinion in the application proof had omitted a material breach and this ultimately led to a suspension of the vetting process.

6 Under the Code of Conduct a sponsor should, after performing the necessary due diligence, have no reasonable grounds to believe and should not believe that the information in the expert's opinion is untrue, misleading or contains any material omissions.

All issues of the *Corporate Regulation Newsletter* are available under 'Published resources – Industry-related publications – *Corporate Regulation Newsletter*'on the SFC website at www.sfc.hk.

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