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Key Regulatory Updates for Hong Kong Listed Companies — January/February 2024

The updates include a report from the Stock Exchange of Hong Kong Limited on review of issuers' annual reports, a summary of private reprimands, and disciplinary actions.

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Other Reports/Newsletters by the Stock Exchange

1. Review of Issuers' Annual Reports 2023 (January 2024)

The Stock Exchange published a report on the findings and recommendations of its annual review of issuers' annual reports for the 2022 financial year end (the Report).

As part of its review, the Stock Exchange made the following recommendations to issuers:

- **Financial reporting and related controls**
 - With respect to internal control weaknesses, management should establish a policy to identify emerging risks, develop risk-mitigating controls, and continuously review the control effectiveness to facilitate timely and accurate financial reporting. The audit committees are responsible for overseeing the whole process.
 - Issuers should timely agree on audit fees and audit plans with the auditors.
 - When new auditors are appointed, issuers should be mindful of the additional time needed to develop the audit plan. Management should monitor the audit progress and seek help from the audit committee when necessary.
 - The Stock Exchange encouraged issuers to take the following steps:

- Confirm in the corporate governance reports that the management has reviewed the issuers' risk management and internal control systems and that the board considers the systems to be effective and adequate.
- To support that confirmation, disclose the scope of review and details of significant areas of concern identified, including principal risks, internal control deficiencies, and remedial measures implemented.
- **Material lending transactions by money lenders**
 - Money lenders should enhance their disclosures on customer profile, concentration risks, and internal controls.
 - Non-money lenders should disclose their reasons for lending. Issuers should also implement appropriate internal controls.
- **Material lending transactions outside the issuers' ordinary and usual course of business**
 - In conducting money lending transactions, directors should assess the commercial rationale and whether the use of corporate funds for lending is in line with the issuer's overall business strategy and direction; and whether the terms of the lending are fair and reasonable and in shareholders' interests.
 - Directors and audit committees should ensure that issuers have effective risk management and internal control systems to monitor lending transactions (please refer to Appendix I of the Report for examples of issuers' control measures).
 - Issuers are reminded that money lending is a form of "financial assistance" which, depending on its materiality and counterparties, might constitute a notifiable and/or connected transaction.
- **Newly listed issuers**
 - Such issuers are reminded of their listing obligations regarding accountability and transparency to shareholders.
 - Directors should ensure the issuers have effective infrastructure and controls which can enable them to timely identify material corporate developments and make disclosures promptly.
 - Issuers should be mindful of the Listing Rule implications on different types of transactions, such as subscription for wealth management products or provision of loans to other parties.
- **Financial statement disclosure under accounting standards**
 - **Material intangible assets:** Issuers should timely revisit and update the financial budgets and assumptions used in the impairment testing, which should reflect the management's best estimates and available market information as of the reporting date.
 - **Material Level 3 financial assets:** Remind issuers' directors of their fiduciary duties and duties of skill, care, and diligence that they must exercise their own judgment to assess the reasonableness of the valuation techniques and underlying unobservable inputs and should not

overly rely on valuers. They should obtain sufficient and timely information from investees (such as latest financial data, updates on operations and business plans, and recent share transactions) for measuring fair values and provide robust disclosure on Level 3 measurement.

- **Revenue:** Issuers should continuously enhance the quality of their disclosure and provide tailored information based on their own circumstances. In particular, the implications of their specific business models or arrangements should be clearly explained in their accounting judgments, estimates, and policies.
- **Credit risk disclosure on trade receivables:** The disclosure requirements on credit risk and ECL assessment are more objective-based. Issuers should carefully consider their circumstances and determine (1) how much detail to disclose; (2) how much emphasis to place on different aspects of the disclosure requirements; (3) the appropriate level of aggregation or disaggregation; and (4) whether shareholders and investors need additional explanations to evaluate the quantitative information disclosed.
- **Key audit matters and financial statement disclosure:** Issuers should pay particular attention to the clarity of their financial disclosure for those areas covered by key audit matters (KAMs) to assist investors in better understanding the risky areas. Issuers and their audit committees should communicate with their auditors about the audit plan and areas of audit focus well in advance of the financial year-end and use their best endeavours to address in a timely manner the issues that the auditors raise.

For further details, please refer to the [Report](#).

2. Summaries of Private Reprimands (January 2024)

The Stock Exchange has published summaries of private reprimands which have been issued. These cases involved three executive directors (EDs), one non-executive director (NED), five independent non-executive directors (INEDs), and one company. Although these reprimands are private in nature, they form part of the parties' compliance records that the Stock Exchange will take into account if the parties commit further Listing Rule breaches.

Insufficient Oversight

- **Key Takeaway:** Directors should always be provided with information regularly regarding the issuer's business and financial position. If that information is not provided, directors must request it. Failure to follow up will itself likely be a breach of duty. Delegation must be managed carefully and with appropriate oversight. Unquestioning reliance on others is unlikely to be sufficient to discharge directors' duties.
- In one case, within a week of listing, the company entered into agreements to pay out more than half of the IPO proceeds to third parties. The relevant directors were not aware of the payments at the time they were made, but investigation revealed that they had not received any monthly financial or business updates. They also had not asked for those updates. The directors were reprimanded for their failure to apply a reasonable degree of care, skill, or diligence and to use their best endeavours to monitor the company's financial position.
- In another case, the Stock Exchange investigated a series of significant transactions under which funds were transferred from the listed issuer group to a company controlled by a director and his spouse. The board of the company was not notified of the fund transfers. The relevant director (an

ED) was reprimanded as he failed to participate in any of the group's affairs apart from attending board meetings. He failed to take an active interest in, and to make independent inquiries about, the group's business and operations.

- In a third case, the company entered into certain arrangements that circumvented the connected transactions rules. The relevant directors (two EDs) had delegated responsibility for those arrangements to another ED. They were reprimanded for their failure to ensure that the delegated duties were properly discharged. They did not proactively follow up with the delegatee, or provide clear directions on when matters should be reported back for further board consideration and approval.

Conflicts of Interest

- **Key Takeaway:** The threshold for conflicts of interest is very low; action may be required even if there is only a potential for conflict.
- In one case involving a placing, the listed issuer's placing agent had appointed a sub-placing agent which received more than 90% of the placing fees. The two EDs who controlled the sub-placing agent were reprimanded for, among other things, failure to avoid conflicts of interest.
- In another case, a listed issuer entered into an undisclosed arrangement which conferred benefits on a connected person. The listed issuer was found to be in breach of the disclosure and approval requirements for connected transactions and was reprimanded.

Duties With Respect to Internal Controls

- **Key Takeaway:** Directors are expected to take proactive steps and exercise independent judgement to ensure implementation of appropriate and effective internal controls.
- The company's subsidiary entered into an acquisition that should have been subject to shareholders' approval under the Listing Rules. The relevant directors had played no role in overseeing that aspect of the group's business. They were reprimanded for their unquestioning reliance on others, and also for lack of evidence that they took any meaningful steps to ensure the adequacy and effectiveness of the internal controls with respect to the business that had been acquired.

For further details, please refer to the [summaries](#).

Disciplinary Actions by the Stock Exchange for Failure to Comply With Disclosure Requirements

1. Stock Exchange's Disciplinary Action Against China Gas Industry Investment Holdings Co. Ltd. and a Former Director (February 2024)

Key Points: A company being listed must provide sufficient and accurate information to enable investors to make an informed assessment of the issuer and of the securities for which listing is sought. Applicants for listing and their directors must ensure that disclosures in the prospectus, including those relating to the use of funds, financial information, and risks are accurate and complete and not misleading. Directors must exercise skill, care, and diligence in proposing or entering transactions. Appropriate due diligence and risk assessment must be conducted. Directors must also ensure that significant transactions and risks are brought to the attention of the board.

The Stock Exchange criticised China Gas Industry Investment Holdings Co. Ltd. (Stock Code: 1940) and imposed a Prejudice to Investors' Interests statement against Mr David T Chen (Mr Chen), the company's former chairman and executive director.

Facts

- The company raised net proceeds of HK\$315.9 million through its initial public offering.
- Shortly before listing, the company used a significant proportion of its funds to provide three unsecured loans in the total principal amount of RMB118 million (the Loans) and subscribe for a loan note (together, the Transactions), which should have been disclosed in the company's prospectus.
- Mr Chen entered into the Transactions on the company's behalf without seeking the approval of the company's board of directors (the Board).
- During the audit for the year ended 31 December 2020, the company's former auditor noted that the Loans were all overdue and inquired about the Loans and requested the Board to commission an independent investigation.
- As a result, the company failed to timely publish and/or dispatch the following results and reports (the Results and Reports).
- The company subsequently made a full loss allowance on the Loan and loan note receivables.

Findings of Breach

The Company

- Late financial reporting: The company was late in publishing and/or dispatching the Results and Reports.
- The company made inaccurate, incomplete, and misleading disclosures:
 - The company's provision of the Loans using a substantial proportion of its funds, the unsecured nature of the Loans, and their potential risks and impact on the company's financial position were material information necessary for the investors to make a properly informed assessment of the company.
 - The information in the prospectus was not accurate and complete in all material respects and was misleading.

Mr Chen

- Mr Chen failed to exercise due skill, care, and diligence in approving the Loans and with respect to the loan note subscription.
- He was unable to explain the commercial rationale for providing the unsecured Loans.
- He also failed to conduct sufficient due diligence and credit assessment on the borrowers and to exercise independent judgement in approving the loan terms.

- He did not use his best endeavours to procure the company's Listing Rule compliance in relation to the disclosure of the Transactions. In particular, he failed to seek the board's approval and to ensure that the board properly considered the Transactions and any disclosure obligations.

Conclusion

- The company and Mr Chen admitted their respective breaches and reached a settlement with the Listing Division.
- The Listing Committee decided to impose the sanctions as set out above.

For further details, please refer to the statement of disciplinary action in respect of the [company](#) and [Mr Chen](#).

2. Stock Exchange's Disciplinary Action Against Three Current Directors of Xinming China Holdings Limited (February 2024)

Key Points: Directors should ensure that transactions carried out by a listed issuer or its subsidiaries are compliant with internal control policies, and in any event that material issues are brought to the attention of the board for consideration and approval. A director of a listed issuer should also take active steps to manage actual or potential conflicts of interest, such as when acting in another capacity in a transaction involving the listed issuer.

The Stock Exchange censured Mr Chen Chengshou (Mr Chen), ED, chairman, and CEO of Xinming China Holdings Limited (Stock Code: 2699); Mr Feng Cizhao (Mr Feng), ED of the company; and Ms Gao Qiaoqin (Ms Gao), non-executive director of the company.

Facts

- Mr Chen — the controlling shareholder, ED, chairman and CEO, and one of the directors of the company's subsidiaries, Chongqing Xinming Property Company Limited (Chongqing Xinming) — offered to provide assistance to Chongqing Xinming by raising funds on its behalf through Xinming Group Limited (XGL), a company outside the group which was privately owned by himself and his wife, Ms Gao. XGL would act as a borrower of loans (the Loans) from certain private investors (the Lenders).
- In January 2017, as one of the conditions to extend the repayment period of the outstanding Loans, the Lenders demanded default annual interest of 24% on the Loans, to be charged retroactively. Chongqing Xinming did not agree with the payment of the default interest rate, and asked XGL to continue negotiating with the Lenders.
- Mr Chen, Mr Feng, and Ms Gao, who were all company board members, did not inform the rest of the board about the Loans or the Lenders' demand for default interest.

Findings of Breach

- The Listing Committee found that Mr Chen, Mr Feng, and Ms Gao breached Rule 3.08 and their undertakings by failing to exercise due skill, care, and diligence with respect to the Loans, and in the case of Mr Chen, by failing to avoid actual and potential conflicts of interest and duty:
 - The relevant directors entered into the Loans without bringing them to the board's attention for consideration and approval. They failed to ensure that the company's internal control policies had been followed, and that proper documentation was retained with respect to the Loans.

- Mr Chen failed to avoid a conflict of interest in his capacity as a director of the company and the owner of XGL. He did not inform the board about the Lender's demand for default interest, and agreed to pay the default interest without reporting to the board.

Conclusions

- The Listing Committee decided to impose the sanctions set out above.
- It was further directed that:
 - Mr Chen to attend 18 hours of training on regulatory and legal topics and Listing Rule compliance within 90 days; and
 - Mr Feng and Ms Gao to attend 15 hours of training within 90 days.

For further details, please refer to the [statement of disciplinary action](#).

Forms by the Stock Exchange

1. Revised Form

The Stock Exchange has revised [Form FF004 – Personal Details Form](#), a form that has to be submitted as soon as practicable after appointment of directors/supervisors of a listed issuer.

Conclusion

Issuers should take note of the observations and recommendations in the Report and follow the relevant guidance to ensure compliance in future annual reports and to improve transparency and accountability to investors.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[Cathy Yeung](#)

cathy.yeung@lw.com
+852.2912.2622
Hong Kong

[Terris Tang](#)

terris.tang@lw.com
+852.2912.2719
Hong Kong

[Mandy Wong](#)

mandy.wong@lw.com
+852.2912.2682
Hong Kong

[Ning Li](#)

ning.li@lw.com
+86.10.5965.7026
Beijing

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