



Hong Kong

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## SFC OUTLINES REGULATORY APPROACH TO CORPORATE MISCONDUCT IN LATEST REGULATORY BULLETIN

The Securities and Futures Commission (**SFC**) outlined its proactive regulatory approach to tackling corporate misconduct in the second issue<sup>1</sup> of the SFC Regulatory Bulletin: Listed Corporations (**Regulatory Bulletin**) published on 23 May 2018. The Regulatory Bulletin gives details of the SFC's exercise of its powers under the Securities and Futures (Stock Market Listing) Rules (**SMLR**) in order to fulfil its statutory obligation of investor protection in the nine months ended 31 March 2018.

### SFC Powers under the Securities and Futures (Stock Market Listing) Rules

The SFC can object to a listing application under section 6(2) of the SMLR if it considers that:

- a) the application does not satisfy section 3 of the SMLR due to:
  - i) non-compliance with the Listing Rules (except where a waiver has been obtained);
  - ii) non-compliance with applicable law; or
  - iii) the omission of particulars or information necessary for investors to make an informed assessment of the applicant's activities, assets, liabilities and financial position at

the time of the application, and of its profits and losses and the rights attached to the securities;

- b) the application is false or misleading as to a material fact or due to the omission of a material fact;
- c) the applicant has failed to comply with a request for further information made by the SFC under section 6(1) SMLR (i.e. a request made by the SFC within 10 business days of the applicant filing the listing application or of the applicant providing any information requested by the SFC) or supplied information to the SFC that is false or misleading in any material particular; or
- d) a listing of the securities would not be in the interest of the investing public.

Section 179(1) of the Securities and Futures Ordinance allow the SFC to commence inquiries and request records if it believes that:

- a) the corporation's business aims to: (i) defraud creditors, (ii) is fraudulent or unlawful, or (iii) is oppressive to its shareholders;
- b) the corporation was formed with a fraudulent or unlawful purpose;

<sup>1</sup> <http://www.sfc.hk/web/EN/files/ER/PDF/SFC%20Regulatory%20Bulletin/SFC%20Regulatory%20Bulletin%20May%2018%20Eng.pdf>

- c) persons involved in the corporation's listing engaged in defalcation, fraud, misfeasance or other misconduct in relation to such process;
- d) persons managing the corporation engaged in defalcation, fraud, misfeasance or other misconduct towards it or its shareholders; or
- e) full information with regards to relevant affairs of the corporation has not been provided to its shareholders.

The Bulletin sets out 10 case studies that demonstrate the SFC's proactive approach to regulation.

### Case Study 1 – IPO

A letter of mindedness to object (**LOM**) was issued to a listing applicant due to the SFC's concerns as to the accuracy and completeness of the information in the materials submitted.

The relevant applicant had a considerable amount of revenue settled by third-party payers who were not its customers. The SFC found that some of these payers had relationships or connections to the applicant or its controlling shareholder, thereby disproving claims made in the listing application that the payers were independent third parties. The submissions also contained material inconsistencies regarding these payments.

Examples given included (i) that the applicant's remittances to third-party payers were recorded as advances to the controlling shareholder, and (ii) the applicant making an advance to a third-party payer who made a payment to the applicant on behalf of the customer.

The SFC's principal concerns in issuing the LOM was the lack of clarity regarding whether the sales proceeds received via third-party payers were provided by the applicant's customers and the genuineness of the underlying sales. No response was provided by the applicant and the application lapsed.

### Case study 2 – IPO

The listing applicant had relocated its major operations after the track record period causing a significant change to its cost structure. No audited financial information reflecting the applicant's operations after the relocation was available to demonstrate the sustainability of its revenue and profit margins in the new circumstances. The SFC issued an LOM because

of its concerns that the historical financial information provided did not provide a fair and reasonable basis for investors to assess the applicant's future prospects.

The SFC subsequently objected to the listing application as it considered that the application failed to include the information necessary to enable investors to make an informed assessment of the applicant's activities, assets and liabilities and financial position as well as of the rights attaching to the securities. It also appeared to the SFC that it would not be in the interest of the investing public for the applicant's shares to be listed.

### Case study 3 – IPO

An LOM was issued to an applicant due to concerns about the high shareholding concentration. According to the applicant's share allotment information, its issued share capital would only be held by a few shareholders upon listing, even though the total number of shareholders was to exceed 100 as specified by GEM Listing Rule 11.23. The applicant deferred its listing, and after it relaunched its offer a wider spread of shareholders was attained.

### Case study 4 – IPO

An LOM was issued to an applicant due to the SFC's concerns that the historical financial information in its listing prospectus might not be representative of the applicant's business in future, since the company underwent a significant change in its business strategy. Closer to the end of its track record period, a portion of working capital that was greater than the applicant's turnover in the preceding financial year was allocated to a new business segment with differing risk and reward profiles and with different liquidity and capital requirements. The applicant provided no response to the SFC and withdrew its listing application.

### Case study 5 – Post-IPO

The SFC issued letters of concern in response to a company's proposed placing to raise funds under a general mandate and a share options grant to unknown grantees. Together, the placing and the share options amounted to a significant proportion of the company's share capital, and both came after a rights issue conducted by the company in the first half of 2017. A significant discount to the company's net asset value of more than 80% was made, and the SFC did not obtain a reasonable justification for that discount or for the imminent fund raising.

An inquiry under section 179 was commenced by the SFC into the details of placing, share options and the use of funds from the earlier rights issue. Subsequently, the company terminated both the share options and the placing.

### Case study 6 – Post-IPO

The SFC commenced section 179 inquiries due to concerns that an acquisition proposed by the company was aimed at listing a company by circumventing the listing rules. The acquisition was to be conducted by means of a convertible bond issue and a placing at a price discount of more than 60% of the market price, with the conversion shares representing 57% of the enlarged issued share capital.

After commencing its inquiries, the SFC found that the company to be acquired was in fact loss-making, had not commenced operations, and did not have a satisfactory justification for the placing at the proposed price discount nor for the given projection of its growth.

After the SFC issued its letter of concern about the acquisition and placing, the company announced the lapse of the acquisition and termination of the placing.

### Case study 7 – Post-IPO

The SFC issued a letter of concern to the issuer that proposed a rights issue and a convertible note issue at a significant discount to the market price which cumulatively would have resulted in a dilution of more than 50%. Since 2015, the company had conducted two fund raisings that were highly dilutive. In response, the company restructured the planned transactions to decrease dilution impact, set a more moderate discount and halted its issue of convertible bonds.

### Case study 8 – Post-IPO

Section 179 inquiries were commenced by the SFC in relation to a company's minority equity interest acquired in a broker and a proposed acquisition of the remaining interest that was to follow. The company granted a small number of individuals with options, and each individual exercised their option through loans provided by the seller. The SFC formed the view that the transactions might have been designed to overvalue the broker, as the broker's recorded net profit consisted mainly of non-recurring items, and its key customers were subsidiaries of the seller or parties associated with it.

The SFC issued an LOM and the company terminated the acquisition.

### Case study 9 - Post-IPO

Section 179 inquiries were commenced by the SFC with regards to a company's settlement deed designed to repay an outstanding loan by issuing new shares and convertible bonds at prices deeply discounted to the corresponding market prices. The impact of the settlement deed would have been material since the new shares and convertible bonds would have represented 35% of the enlarged share capital and the combined value was to be higher than the debt to be repaid. The SFC issued a letter of concern as it considered that the settlement deed might result in the unfair treatment of the company's shareholders. In response, the company announced the lapse of the settlement deed and that alternative funding was being sought.

### Case study 10 – Post-IPO

A letter of concern was issued by the SFC in response to the company's proposed issue of unlisted warrants. A discount of roughly 14% of the company's enlarged share capital was proposed, however, the company did not provide a satisfactory explanation for the discount. No independent valuation of the planned warrant issue was provided to the board. The SFC's letter of concern stressed its concern that insufficient information was provided to the directors for determining whether the issue price of the warrants was fair and reasonable. The company announced the termination of the warrant subscription.

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**Hong Kong Office**

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

**Tel:** + (852) 2905 7888

**Fax:** + (852) 2854 9596

[www.charltonslaw.com](http://www.charltonslaw.com)