HKEx Issues 8th Listed Issuer Regulation Newsletter

The Hong Kong Stock Exchange (**HKEx**) published its 8th Listed Issuer Regulation Newsletter (the **HKEx Newsletter**) in June 2023, with reminders relating to audits and financial reporting, compliance with the new HKEx Listing Rules on share schemes and the disclosure of business valuations in transactions.

Auditing, Financial Reporting and related Internal Control Matters

The HKEx reminded issuers of the importance of timely publication of quality financial reports, noting that it had continued to identify late changes in auditors, including issuers which changed auditors within 4 months of their audit deadline. The HKEx identified the following issues in its review of issuers' announcements on change of auditors:

- issuers appointed new auditors in an attempt to expedite the audit process, notwithstanding that audit issues had been identified by the outgoing auditors. However, issuers' initial announcements failed to explain why the change of auditors would expedite the audit process or resolve the audit issues. Announcements also failed to disclose the role of the audit committees and their actions in relation to the audit process or the auditor change; and

- disagreements over audit fees were one of the main reasons for late auditor resignation. The HKEx noted that issuers' audit committees should monitor the timing of the issuers' audit fee discussions to minimise the chances of a late change of auditor; and

- audit modifications and delays in financial reporting were often the result of issuers' inability to provide the necessary records, insufficient audit evidence and information being available to auditors, and irregularities in transactions uncovered by auditors.

The HKEx urged issuers and their audit committees to actively manage the audit process, understand the nature and root causes of outstanding issues, agree on plans and timelines to resolve issues, monitor progress, and intervene when necessary. The HKEx also stated that audit committees' actions in relation to auditor change and the effectiveness of issuers' internal control systems will be their main focus in terms of monitoring issuers' HKEx Listing Rules compliance this year. It advised issuers to identify any deficiencies in their internal controls and ensure that appropriate remedial measures are taken to strengthen their internal control systems.

Compliance with new HKEx Listing Rules on Share Schemes

As regards the new HKEx Listing Rules on share schemes which took effect on 1 January 2023, the HKEx reminded issuers of the minimum 12-month vesting period for the grant of options or awards under Main Board Listing Rule 17.03F and GEM Listing Rule 23.03F. However, it noted that grants will be exempt from the 12-month vesting period requirement where they are made to employee participants in specific circumstances set out in the scheme document. FAQ No.092-2022 sets out examples of circumstances which the HKEx will consider justifiable, including grants of “make-whole” awards to new joiners to replace the forfeited awards, grants to a participant whose employment ended due to death or disability or an “out of control event”, grants with performance-based vesting conditions instead of time-based vesting criteria.

The HKEx observed that some circumstances cited by issuers for shorter vesting periods were too generic, such as “*any circumstances as the board considers appropriate at the time of grant*” and “*circumstances to recognise the past performance of the employees*”.[1] It commented that the former lacked “*specific criterion to assess a shorter vesting period*”, while the latter did not support the purpose of share schemes, which is “*to incentivise the grantees to contribute to the long term growth of the issuer*”.

As regards performance targets, Main Board Listing Rule 17.03(7) and GEM Listing Rule 23.03(7) require a scheme document to provide a description (which can be qualitative) of the performance targets attached to the options or awards to be granted, or a negative statement. The HKEx again noted that some performance targets in scheme documents were too generic and failed to set out the criteria for assessing whether the performance target would be met. One such example would be “the vesting of the options granted is subject to satisfactory performance of the employee participant”.

Disclosure of Business Valuations in Transactions

Main Board Listing Rule 14.58(5) and GEM Listing Rule 19.58(6) require issuers to disclose the basis for the consideration and terms of a notifiable transaction, and question no. 21 of the HKEx’s Frequently Asked Question Series 7 requires that disclosure of the target company valuation should be included in the announcement and circular relating to the transaction where the target company valuation is a main factor in determining the basis for the consideration or other material terms of the notifiable transaction.

When vetting issuers’ transaction announcements, the HKEx focuses on transactions where it has concerns as to whether the transaction terms (including the consideration) are fair and reasonable for the issuer and its shareholders as a whole. It observed that the disclosure in these announcements is often excessively general and lacks the necessary information. Specifically, the disclosure relating to valuation methods, assumptions and inputs are often insufficient to allow investors to understand how the valuation methods and assumptions, the reasons for their adoption, and how the valuation was determined. To address this, the HKEx highlighted the following general principles for the disclosure of valuations:

- Selection of valuation methods - issuers should describe the chosen valuation models and explain why they are appropriate for the transactions or target companies. For instance:
    - when using the discounted cash flows (**DCF**) method for valuing a start-up target company, issuers should explain why this method is suitable in the absence of a historical track record to substantiate the forecasts;
    - if the market approach is used to value a target company in a novel or innovative industry, issuers should explain why the market approach is appropriate in the absence of similar or comparable companies; and
    - if multiple valuation methods are used, issuers should disclose the process in analysing the values derived from different valuation methods and how they contribute to the appraised value; and
- Valuation assumptions and inputs, issuers should:
    - provide detailed explanations of, and explain in specific terms, the assumptions and adopted valuation inputs; and
    - in the event the valuation assumptions and/or inputs significantly differ from the target company’s historical information or parameters of comparable companies, the issuer should further justify the fairness and reasonableness of using the particular assumptions and/or inputs. For example:
        - in a DCF valuation with projected revenue based on significant growth compared with the target company’s historical trend, the issuer should disclose the basis of projections and explain why they are fair and reasonable; and
        - in a market approach valuation, issuers should disclose the criteria and process for selecting comparable companies and explain why the chosen market comparables are appropriate in

the circumstances. If the multiples of comparable companies vary widely, the issuer should explain the rationale for including or excluding outliers and how the multiple for valuation was derived.

HKEx's Application of Technology

The HKEx notes that it has continued to apply technology to its regulatory functions and daily operations. Since the last Listed Issuer Regulation Newsletter in December, the HKEx has:

- continued to utilise its AI model, JURA, which has been used to review disclosures in issuers' ESG reports and to vet issuers' transaction and fundraising announcements. The HKEx has extended JURA to review annual results announcements and highlight red flags and potential breaches of the HKEx Listing rules that require immediate attention (e.g. those requiring an immediate suspension of trading or a clarification to the market). JURA is also used to perform financial analysis and identify material fluctuations;

- expanded the HKEx Listing Division's internal case management and workflow system; and

- been developing an issuer platform for issuers to make private submissions on cases and filings of changes to corporate standing data and director information, and to act as a replacement for current emails and e-Forms.

JURA will be used this year to review disclosures in issuers' ESG reports and to vet issuers' documents including their transaction and fundraising announcements.

HKEx's Other Recent Publications

Since the publication of its last listed issuer regulation newsletter, the HKEx has published:

- three guidance letters:

  - revised guidance letter GL113-22 for special purpose acquisition companies with, or seeking, a listing on the HKEx;

  - new guidance letter GL115-23 for Specialist Technology Companies applying to list on the HKEx; and

  - new guidance letter GL79-14 on the documentary requirements and administrative matters for listed collective investment schemes issuers;

- a consultation paper on the Enhancement of Climate-related Disclosures under the ESG Framework (see HKEX Consults on Mandatory Climate Disclosures in ESG Reports);

- the consultation conclusion on Specialist Technology Companies (see Charltons' newsletter HKEX Publishes Consultation Conclusions on New Listing Regime for Specialist Technology Companies);

- revised disciplinary procedures of the Listing Committee and the Listing Review Committee, addressing the arrangement of the Chairman of the Disciplinary Committee and the handling of potential conflicts of interest;

- a revised Guide on General Meetings relating to the holding of virtual or hybrid general meetings in light of recent amendments to Hong Kong's Companies Ordinance;

- new FAQ 118-2023 on the impact on listed issuers' issue of securities of the PRC's new filing requirements for overseas listings and securities offering by Mainland companies; and

- the Revised Listing e-Forms and Guidelines for announcements and trading arrangement; directors and supervisors; authorised representatives and company secretaries; blackout periods; listing applications for securities; and meeting notifications.

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[1] Unless otherwise stated, all quotations are from the 8th Listed Issuer Newsletter

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