Issue 4 I May 2021

Listed Issuer Regulation Newsletter

Highlights

- Issuers meeting financial reporting obligations amid the Covid-19 pandemic
- Guidance on lending transactions
- Confirmation on material loan arrangements of counterparties with connected persons when vetting notifiable transactions
- Highlights of listed issuers' spin-off activities

Issuers meeting financial reporting obligations amid the Covid-19 pandemic

31 March was the deadline for releasing preliminary financial results for more than 1,800 issuers with a December financial year-end. This reporting period we saw a high level of compliance with the Rules' financial reporting deadlines.

Meeting financial reporting deadlines

- Around 95% (1,756) of the issuers published their preliminary results agreed with auditors, compared to 80% (1,399) last year.
- Reduction in issuers applying the Covid-19 Guidance – 27 issuers were affected by Covid-19 and sought a timing relief under the **Guidance**[1]. These issuers published management accounts on or before 31 March and trading in their securities continued. Two issuers could not release any financial information due to Covid-19 and suspended trading.
- Number of trading suspension increased - 55 issuers did not publish their results with agreement from auditors for reasons other than Covid-19 and suspended their securities trading. The reasons for the delay included requiring additional time to resolve audit issues, awaiting confirmations from suppliers/customers, and identifying irregularities during the course of their audits. Since then, 16 issuers have published their results[2] and have resumed trading.

	Financial year	
Number of issuers (excluding long suspended issuers)	**2020**	**2019**
Issuers with December year-end	1,851	1,792
Annual results announcement		
Published results agreed with auditors by 31 March	**1,756**	**1,399**
Published management accounts under the Guidance and continued securities trading	27	384
Trading suspended pending publication of results agreed with auditors	**68[3]**	**9**

[1] The Guidance was issued jointly by the Exchange and the Securities and Futures Commission (SFC) on 16 March 2020 to address issuers delaying the publication of preliminary results due to Covid-19.

[2] As at 16 May 2021

[3] Included 11 issuers which had been suspended due to other reasons before their results became due.

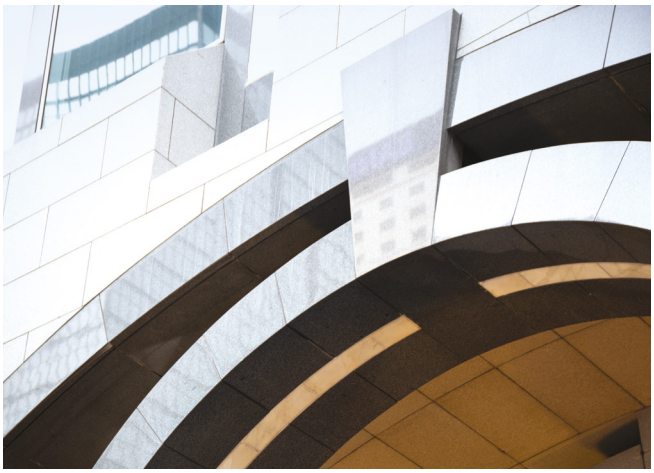
Auditors' opinions on published accounts

In September 2019, we introduced new Rules[4] requiring a trading suspension for an issuer that publishes a preliminary results announcement when its auditor has issued or will issue a disclaimer or adverse opinion on its financial statements (other than one relating solely to going concern or the issue was resolved). This is the first year of application for December year-end issuers.

- Most issuers obtained clean audit opinions - Around 95% of the issuers that had published their results for the year ended 31 December 2020 received an unmodified audit opinion.
- We are pleased that many issuers have taken substantive steps to address the audit qualifications in last year's accounts.
  - 46 issuers received a disclaimer or adverse audit opinion, a large majority of which were related solely to going concerns. Only four issuers had issues relating to matters other than solely going concerns and suspended trading under the new Rules.
  - 21 issuers received disclaimer or adverse audit opinion for the first time. This is a material reduction compared to last year's 37 cases.

As some issuers have yet to release their results, there may be more cases involving disclaimer or adverse opinions for the December 2020 financial year.

Issuers should timely publish financial statements which fairly present their financial positions and performance and free from material misstatements. This information is necessary for shareholders and investors to properly appraise the issuers, and to make informed investment decisions.



	Financial year	
Number of issuers (excluding long suspended issuers)	**2020**	**2019**
Issuers with December year-end	1,851	1,792
Audit opinion		
Unmodified	**1,700**	**1,675**
Qualified	**44**	**43**
Disclaimer or adverse	**46**	**57**
• Relating solely to going concerns	37	34
• Relating to issues resolved	5	4
• Relating to unresolved issues (other than solely going concerns)	4	19
• First time disclaimer or adverse opinion	21	37
• Repeated disclaimer or adverse opinion	25	20

As at 16 May 2021

[4] MB Rules 13.50A and 13.50B/GEM Rules 17.49B and 17.49C

Guidance on lending transactions

In our last review of issuers' annual reports (see **report** published in January 2021), we highlighted a small number of issuers reporting material impairments on their loans and receivables. We continued to identify these cases during the recent financial reporting season.

Example of money lending cases that raised concerns:

Company A (a system service provider) granted loans to nine business partners allegedly to enhance its business networks and capture business opportunities in the Mainland. Before granting the loans, Company A neither performed credit risk assessments on the borrowers nor obtained any collateral. Ultimately, Company A failed to get any real benefits out of such lending and the borrowers defaulted.

Company B (a gaming operator) lent money to six independent parties. The loans were granted mostly interest-free or at a rate substantially lower than Company B's cost of capital, raising a question on the commercial merit of such lending. About 70% of these loans were unrecoverable shortly after they were made.

Company C (a money lender and financial services provider) granted unsecured loans to 18 individual borrowers, allegedly under its business expansion initiative. Such material lending raised the size of its loan receivables by six times within one year. Over 90% of these loans were unrecoverable in the following year. Company C had not performed adequate due diligence on, or obtained collaterals from, the borrowers.

Company D (a manufacturer) entered into a cross-guarantee arrangement with a third party to guarantee each other's banking facilities. The size of the guarantee provided by Company D was six times larger than that provided by the third party. No financial due diligence was conducted on the third party's financial condition. Subsequently, the third party defaulted on its bank loans.

Some issuers failed to release their results after their auditors identified issues in their lending transactions, such as a lack of business rationale or commercial substance, excessive lending in size compared to the scale of the issuer's business operation, or defaults in repayment or full impairments shortly after the grant of the loans. The problems suggested a lack of proper internal control, management expertise, or oversight and raised questions about whether the directors had properly discharged their fiduciary duties.

Material lending transactions will remain a focus area in our current year's review of issuers' annual reports and on-going disclosure. We take this opportunity to highlight relevant Listing Rules and directors' obligations:

Listing Rules disclosures and compliance obligations	Lending transactions may take a variety of forms, such as loans, advance payments and deposits. They may constitute: • "Financial assistance" regulated by Chapters 14 and 14A of the Rules on notifiable transactions and connected transactions. Issuers should ensure timely disclosure and, if necessary, obtain shareholders' approval • "Advances to entities" under the Rules 13.13 to 13.15[5]. Issuers should be mindful of their ongoing disclosure obligations where these advances cross the materiality thresholds.
Financial reporting	Issuers should develop appropriate and supportable estimates to assess the recoverability of the loans to support the impairment assessment under the relevant accounting standard. Issuers should make adequate disclosures on their material lending transactions in the management discussion and analysis section of their annual reports. For example, issuers should disclose: • Major terms of the loans, including the total outstanding loan receivables or advances, maturity profile, interest rates, collateral and/or guarantee obtained • Discussion on the loan provisions and impairments, if any, the bases of impairment assessment on the loans, and valuations or other evidence to support the impairment assessment • Where the loans are granted outside the issuers' ordinary course of business, the reasons for granting such loans and how they meet the issuers' business strategies
Proper and adequate internal control system	Issuers and their audit committees should ensure that they have effective internal control systems to assess and manage their credit risk exposure and to monitor the recoverability of the relevant loans and adequacy of the collaterals.
Directors' responsibilities	Directors should critically assess the commercial rationale for entering into loan transactions, if the terms are fair and reasonable, and whether the use of issuers' fund is in the ordinary and usual course of business of the issuers and in their best interest.

We will continue to monitor material loan transactions (including any related material impairments) and directors' oversight of these loan transactions. We will take enforcement actions as and when necessary and where required, collaborate with the SFC and other regulatory authorities on identified corporate misconducts and misleading disclosures to protect shareholders and preserve market integrity.

[5] GEM Rules 17.15 to 17.17

Confirmation on material loan arrangements of counterparties with connected persons when vetting notifiable transactions

In the December 2020 issue, we reminded issuers to disclose in notifiable transaction announcements any significant relationships between the counterparties to the transactions (and their ultimate beneficial owners) on one hand, and the issuers' connected persons on the other. This may include material financing arrangements such as loans to or from a connected person provided prior to the transaction, or in the course of funding the target of the transaction. This information may be relevant for the Exchange to assess whether to deem the counterparty to be a connected person of the issuer under Chapter 14A[6], or for investors to assess the transaction as a whole.

This information may also assist the SFC in regulating listing matters. As the statutory regulator, the SFC engages in targeted, early intervention to perform its statutory functions in relation to post-IPO matters, and regulates directly listing matters that fall within the scope of the SMLR[7] or the SFO[8]. For example, if following its investigations, the SFC has serious concerns that the affairs of a listed company are being conducted in a fraudulent manner, it may direct the Exchange to suspend dealings in the securities of the company under section 8(1) of the SMLR, and take steps to bring proceedings under section 214 of the SFO.

As part of the collaborative effort between the Exchange and the SFC to jointly monitor issuers and identify regulatory issues, we and the SFC have agreed that the Exchange may require issuers to provide a confirmation on any material loan arrangements between the counterparty and the connected persons of the issuer.

What confirmation is required?

The issuer will confirm whether, to the best of the directors' knowledge and after reasonable enquiry, there is or has been any material loan arrangement in the last 12 months between the counterparty of the transaction and its ultimate beneficial owners who can exert influence on the transaction on one hand, and the issuer, its connected persons at the issuer's level, and/or any connected person at the subsidiary level (to the extent that such subsidiary/ subsidiaries is/are involved in the transaction) on the other.

The counterparty and its ultimate beneficial owners who can exert influence on the transaction generally include the person(s) who negotiated the transaction with the issuer, and the ultimate beneficial owners holding 30% or more of the voting power of the counterparty. A counterparty that is an entity will also provide a confirmation from its directors and legal representatives.

When is such confirmation required?

We will request this confirmation based on pre-defined criteria applicable to the transaction and the issuer. An issuer will be requested (under Rule 2.12A[9]) to provide this confirmation to the Exchange as part of our commenting process on the issuer's announcement.

[6] Rule 14A.19/GEM Rule 20.17
[7] Securities and Futures (Stock Market Listing) Rules
[8] Securities and Futures Ordinance
[9] GEM Rule 17.55A

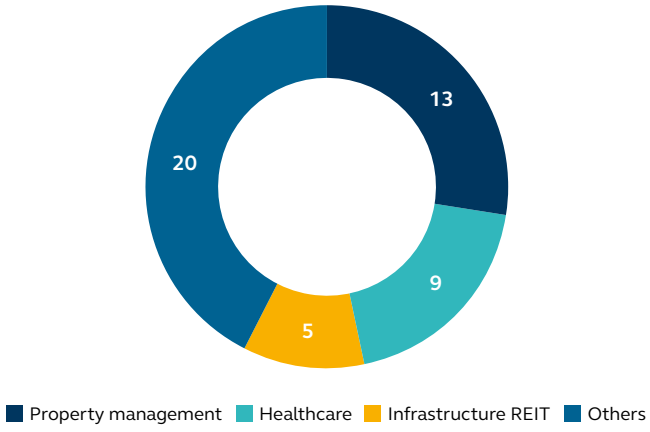
Highlights of listed issuers' spin-off activities

The number of spin-off transactions has increased substantially in last year. These spin-offs are predominantly listed on the Exchange and the PRC exchanges, with a majority of spun-off companies (spincos) engaged in the property management and healthcare businesses:

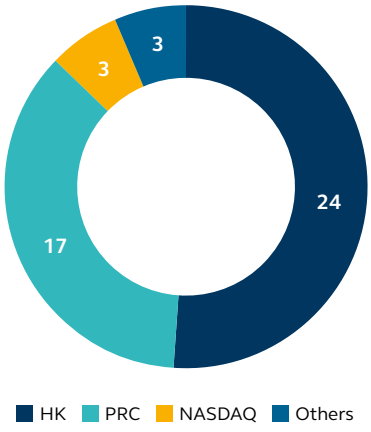
	2017	2018	2019	2020	Q1 2021
Number of spin-off applications approved	16	19	14	**37**	**10**

2020 and Q1 2021

Spinco's principal activities



Spinco's listing exchange



The following are some general observations and guidance on our administration of Practice Note 15 (PN15):

PN15 principle	One business cannot support two listings. Accordingly, PN15 requires: • each of the remaining group and spinco to independently meet the new listing requirements of the exchange of its listing; • a clear delineation between the businesses of the remaining group and spinco; and • spinco to function independently of the issuer.
Remaining group must meet the minimum market capitalisation and profit requirements	To demonstrate that the remaining group can meet the minimum market capitalization requirement, issuers should note that: • We would take into account only the value of the business and assets attributable to the remaining group. For example, we disregarded the value of certain non-operating assets as they were not used to support the principal business of the remaining group in a case (see LD125-2020). • When providing a valuation to support the remaining group's market capitalization, the issuer should demonstrate that the valuation methodologies adopted are appropriate to the industry and business of the remaining group, and the underlying assumptions are reasonable. Normally more than one valuation methodology should be used to support the valuation. In exceptional circumstances, we have disregarded a valuation of an entity's underlying business or assets as it was not reflective of its market capitalization (see LD124-2020). To support the minimum profit requirement, the issuer should submit pro forma financial information of the remaining group that has been reviewed by the auditors and adjusted to exclude profits generated outside its ordinary and usual course of business. • For example, profits from discontinued operations or activities which were not a principal segment of the remaining group would not be counted. Generally, the assessment criteria is consistent with our assessment of new applicants' compliance with Rule 8.05.
Clear business delineation and spinco's independence	• There should be a clear delineation between the businesses of the remaining group and spinco, and spinco should function independently from the issuer. Guidance letter GL68-13 provides guidance in circumstances where there may be material reliance or mutual dependency between spinco and the remaining group (e.g. spin-offs of property management companies). • In some spin-off cases the issuer may grant a non-competition undertaking to spinco to clarify the businesses of the two groups after spinco's listing. While such undertakings might more clearly set out the businesses of the two groups going forward, the issuer would nevertheless need to demonstrate a clear delineation between the current operations of the remaining group and spinco. The issuer would also need to consider why granting the undertaking is in the interest of the issuer and its shareholders.
Assured entitlement	Issuers should have due regard to the interests of their existing shareholders by providing them with assured entitlement to spinco shares unless there are legal restrictions in doing so, for example, spinco is to be listed on a PRC exchange where non-PRC investors are prohibited from acquiring spinco's A shares. A general waiver from the assured entitlement requirement is available in such case (see LD104-2017).
Administrative matters related to spin-off on the Exchange	Where spinco is to be listed on the Exchange, it must meet the new listing requirements under the Rules, and demonstrate clear delineation and independence from the issuer. These are common requirements for both the PN15 approval for the issuer and the listing application of spinco, and are generally considered at the time of the PN15 application by both the Listed Issuer Regulation and the IPO Vetting departments in co-operation. Issuers should be prepared to make appropriate submission to address these issues from both the issuer's and spinco's perspectives (See GL 69-13).

Recent publications

We have recently published the following new guidance materials:

- Listing Decision LD129-2020 on granting options to a discretionary trust under a share option scheme (September 2020)
- E-learning module on equity fundraisings (13 January 2021)
- FAQs (No. 073-2021 to 074-2021) on the notifiable and connected transaction requirements relating to loan transactions and acquisitions of wealth management products (21 May 2021)

We have also recently published the following consultation papers and conclusions on our proposals to enhance our listing regime:

- Consultation paper on **Listing Regime for Overseas Issuers** (31 March 2021) on proposed streamlined requirements for overseas issuers, expansion of secondary listing regime for certain overseas issuers and provision of greater flexibility for issuers seeking dual-primary listings
- Consultation paper on **Review of Corporate Governance Code and Related Listing Rules** (16 April 2021) on proposed enhancement of issuers' corporate governance standards specifically in the areas of corporate culture, director independence, diversity and ESG[10] disclosures and standards
- Consultation conclusions on (1) **The Main Board Profit Requirement** and (2) **Review of Listing Rules Relating to Disciplinary Powers and Sanctions** (20 May 2021) with a view to enhancing market quality and promoting investor protections

[10] Environmental, Social and Governance

We welcome your feedback.
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