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Welcome to the latest issue of KPMG China's Hong Kong Capital Markets Update. In this issue, we highlight the regulatory developments during the second quarter of 2013 with a focus on matters of importance to directors, management and other persons who are responsible for compliance with the Listing Rules. These include:

- New Guidance Letters and Listing Decisions for listing applicants in their preparation of listing applications.
- A series of Listing Decisions for listed issuers with respect to requirements on connected transactions, notifiable transactions, rights issues and reverse takeovers.
- Two consultation papers on connected transactions published by The Hong Kong Stock Exchange ('the Exchange') aiming to simplify the existing connected transaction rules.

On 23 July 2013, the Exchange published rule changes and a series of new and revised guidance letters to complement the new sponsor regulation that will come into effect on 1 October 2013. The new requirements will apply to listing applications filed on or after 1 October 2013. A separate issue of the Hong Kong Capital Markets Update highlighting these developments will follow.

# 1 Guidance for new listing applicants

## **Implications of instances of non-compliance, uncertainties over principal operations and deteriorating financial performance on the suitability of listing**

In [LD73-13](#) (May 2013), the Exchange considered that a listing applicant which operated retail stores **was not suitable for listing due to a number of uncertainties over its operations**. In particular, there was non-compliance identified with respect to the use of certain retail floors against the building's occupation permit for an extended period of time and the rectification work on some of those floors after the track record period was subject to approval by the authorities. Further, the listing applicant's financial performance had deteriorated significantly subsequent to the track record period.

The Exchange considered that where a substantial part of the company's profits were derived from operations that were in breach of law, casts doubts on whether the applicant's historical performance was a reasonable and fair basis for assessing whether the minimum profit requirement for listing had been met. Further, the deterioration in the listing applicant's results after the track record period also cast doubt on the reliability of the track record performance for meeting the minimum profit requirement. The pending outcome of the alteration work proposal added uncertainty over the company's future operations.

Having considered the cumulative effect of the above uncertainties on the company's future performance and that the uncertainties could not be adequately addressed by disclosure in the prospectus, the company was considered not suitable for listing.

### ***Our observations:***

Identification of all potential material non-compliance with laws and regulations and, more importantly, the rectification of material breaches identified are among the key steps to be taken at the very beginning of the IPO preparation process. Where there has been serious non-compliance, a listing applicant should be prepared to demonstrate compliance for a reasonable period of time before approval for listing will be granted. Listing applicants are also advised to carry out a comprehensive review of its internal controls at an early stage to identify areas of improvement, if any, and to address them before listing is sought, such that the company can demonstrate that it has sufficient procedures, systems and controls, even taking into consideration any non-compliance in the past. It is anticipated that with the forthcoming new sponsor regulations regime, identification of all potential material non-compliance with laws and regulations at an early stage, timely rectification of material breaches and appropriate disclosures in the prospectus will become even more critical.

## **Disclosure of unaudited net profits after the track record period**

To provide investors with more updated information, a listing applicant may include in the listing document qualitative or quantitative disclosures of updated results and financial position after the track record period ("subsequent financial information"). The

Exchange released in June 2013 a [frequently asked question](#) ('FAQ') document which discusses **whether disclosure of updated financial results after the track record period would constitute a profit forecast/estimate under the Listing Rules.**

The Exchange's response in the FAQ indicates that where an applicant discloses unaudited net profit or financial information which can explicitly or implicitly result in an investor ascertaining the applicant's estimated level of profits or losses since the last audited period end (e.g. disclosures of total revenue together with net profit margin), the subsequent financial information will constitute a profit forecast/estimate subject to the relevant reporting requirements by the sponsor and the reporting accountants.

If the subsequent financial information deemed to be a profit forecast/estimate covers a period (for example, a three-month period) other than the acceptable periods as set out in the Main Board ('MB') Listing Rule 11.18 (or Growth Enterprise Market ('GEM') Listing Rule 14.30), i.e. covering a period coterminous with the applicant's financial year end or a period end at a half year end (or quarter end for a GEM listing applicant), the applicant should seek a waiver from the Exchange. Where a waiver is not sought, the listing applicant should include in the listing document a review report on the subsequent financial information issued by the independent auditor in accordance with the International or Hong Kong Standard on Review Engagements 2410, *Review of interim financial information performed by the independent auditor of the entity*.

***Our observations:***

The guidance provided in the Exchange's FAQ essentially requires that disclosure of any actual, preliminary and/or estimated financial results (i.e. profit or loss) of the listing applicant for a period after the track record period be included in the prospectus as either (i) a profit estimate or (ii) unaudited historical interim financial information, reviewed by the auditors/reporting accountants under the interim review standard. This represents a change from the previous practice of including such recent financial information as 'unaudited' and 'unreviewed' subsequent financial information in the prospectus (typically within a section titled 'Recent Developments').

Listing applicants are advised to continuously assess, taking into consideration the listing timetable, whether and what financial information after the track record period will be disclosed, and whether reporting from the reporting accountants and/or the sponsors will be required taking into account the above guidance, such that any required work can be planned in advance.

**'Clear Path to Commercial Production' for mineral companies**

In [LD74-13](#) (June 2013), the listing applicant's mineral project was at the exploration stage and had not generated any profits. In order to seek a waiver from meeting the minimum profit requirement for listing, the applicant was required under MB Listing Rule 18.07 to demonstrate that its project had a clear path to commercial production. The Exchange, having considered the totality of the applicant's facts and circumstances, in particular the high risk concerning the project payback period, high uncertainty in obtaining the necessary permits and licences from the government agencies and concerns on the overly ambitious funding plan requiring the listing applicant to undertake 12 more post-listing equity fund raisings of a similar scale of the proposed IPO to bring the project to production stage, considered that the applicant had not satisfactorily demonstrated that its project had a clear path to commercial

production. This consequently meant that the company failed to meet the minimum profit requirement for listing.

### Simplification of disclosures in listing documents

As a continuation to the three Guidance Letters issued in January 2013 to provide guidance on the simplification of disclosures in the 'Industry Overview', 'History and Development' and 'Business' sections of the listing documents (see our [Hong Kong Capital Markets Update – Issue 2, April 2013](#) for details), the Exchange gave **guidance on the disclosure in the 'Risk Factors' section in the listing documents** in [GL54-13](#) (May 2013). The Exchange considers that the 'Risk Factors' section should be concise, relevant to the listing applicant and be able to explain how the risks affect the applicant. Risk factor disclosures should relate to risks that applicants are unable to mitigate adequately, and if possible and meaningful, should include quantitative disclosure of the likely impact of those risks. Mitigating factors should not be included in the description of a risk factor but may be included in other sections of the listing document. The Exchange noted that a listing document that does not follow this guidance may be considered not substantially complete.

In June 2013, the Exchange also updated the guidance on simplification of the 'Summary and Highlights' section of the listing documents in [GL27-12](#), adding the use of a legible type size as a general plain language principle for the 'Summary and Highlights' section.

### Other regulatory matters

The Exchange updated [LD35-1](#) (published in July 2003, updated in April 2013) to include details of subsequent cases of waiver applications by PRC listing applicants in appointing a **company secretary** who does not possess the qualifications required under MB Listing Rule 8.17. Each waiver application will be considered on a case-by-case basis including factors such as the company secretary's experience in handling company secretarial matters, work experience, professional qualifications and academic background.

## 2 Guidance on continuing obligations of listed issuers

### Connected transactions

- The Exchange accepted **alternative revenue ratio tests** proposed by listed issuers in classifying certain continuing or new connected transactions following the change in the group structure and accounting policy in two listing decisions.

In [LD60-13](#) (April 2013), the listed issuer acquired a target group and, as a result, a substantial shareholder of the target group's subsidiaries became a connected person of the listed issuer. The target group would continue to purchase certain raw materials from the substantial shareholder after the acquisition, which would constitute continuing connected transactions of the listed issuer. In calculating the ratios in accordance with Chapter 14 of the MB Listing Rules to classify the connected transaction, the revenue ratio does not take into account the target group's

results when using the listed issuer's latest published audited consolidated revenue as the denominator.

In this case, the listed issuer was substantially enlarged following the acquisition and the Exchange accepted an alternative revenue ratio calculation proposed by the listed issuer of using the enlarged group's revenue shown in the pro forma consolidated income statement published in the circular for the acquisition. The Exchange took into consideration that the purchase transactions were conducted in the ordinary and usual course of the target group's business and it would be reasonable to take into account the target group's results when assessing the materiality of the continuing connected transactions.

In [LD61-13](#) (April 2013), the listed issuer operates its business through various jointly controlled entities ('JCEs') and in the last financial year, the listed issuer changed its accounting policy for JCEs from the proportionate consolidation method to equity method of accounting. The listed issuer considered that using the revenue figure from the latest published audited financial statements (which did not include the group's share of revenue of the JCEs) as the denominator for calculating the revenue ratio would produce anomalous results.

The listed issuer proposed an alternative revenue ratio where the denominator would be the sum of the published consolidated revenue figure and its share of the JCEs' revenue with adjustment to eliminate the revenue from transactions between the listed issuer and the JCEs. The Exchange accepted the alternative revenue ratio taking into consideration that (i) there was no change in the principal business or operating model of the listed issuer and the substantial decrease in revenue was due to the change in accounting policy and (ii) JCEs were treated and regulated as if they were subsidiaries of listed issuers for the purpose of the MB Listing Rules.

- In [LD63-13](#) (April 2013), the Exchange granted a **waiver from the annual review and reporting requirements** for a continuing connected transaction between the listed issuer and a company indirectly owned as to 30% by an independent non-executive director of the listed issuer ('INED'), on the basis that it was unlikely that the INED could exert undue influence over the listed issuer to obtain a benefit through the transaction and that the size of the transaction was not material (with the highest percentage ratio just slightly over 0.1%).

### **Notifiable transactions**

Five Listing Decisions were published during the second quarter to provide guidance on disclosure of information for certain notifiable transactions.

- **Waiver from disclosure of certain information in an announcement for a discloseable transaction where meaningful alternative disclosures were proposed**

In [LD67-13](#) (May 2013), the Exchange granted a listed issuer engaged in providing financing services a waiver from disclosing the identity of the borrower, the interest rate and the amount of interest and service fees receivable from the borrower under a secured entrusted loan arrangement on normal commercial terms. The listed issuer submitted that there were practical difficulties in disclosing the information as it might undermine its market competitiveness and the customers would be unwilling to

accept such public disclosure which might create unnecessary adverse impact on their business operations. As an alternative, the listed issuer proposed to disclose information that allowed investors to assess the creditworthiness of the borrower and the risks and exposures of the loan transaction. Having considered that this is only a discloseable transaction and is not significant to the listed issuer, the Exchange accepted the alternative proposal.

The Exchange granted a waiver in [LD68-13](#) (May 2013) to a listed issuer so that it would not be required to disclose certain information in the announcement relating to an acquisition of a property. The target property was a building that comprised a number of residential and commercial units owned by various vendors. The listed issuer was still negotiating with other vendors for acquiring the remaining units and the disclosure of the information, such that the conditions precedent for completion of the acquisition, would have been prejudicial to the interests of the listed issuer and would affect the ongoing negotiations with other vendors.

The listed issuer proposed alternative disclosures to be included in the initial announcement and a further announcement to disclose the required information upon completion of the acquisitions. The Exchange accepted the alternative disclosure on the basis that the transaction was not significant to the listed issuer (i.e. discloseable transaction only) and the alternative disclosures would allow investors to understand the nature of the acquisitions.

- The Exchange **waived the requirements to produce a competent person's report and a valuation report for a proposed acquisition** of a target company already listed on an overseas stock exchange in [LD65-13](#) (May 2013). In assessing the waiver application, the Exchange took into consideration that (i) the target company's reserve information was subject to supervision by regulatory authorities; (ii) the reserve information was prepared using a standard acceptable to the Exchange and prepared and reported on by appropriately qualified experts; and (iii) the listed issuer would provide a 'no material change' statement for the reserve information in the circular.
- In [LD66-13](#) (May 2013), the Exchange granted a **waiver from the disclosure requirement of the three-year profit and loss statement for the acquisition of a revenue-generating property** due to practical difficulties of the listed issuer in gaining access to the vendor's books and records and was unable to properly compile the financial information given the limited information available from the vendor. The listed issuer proposed, and the Exchange accepted, alternative disclosures in the circular to enable investors to assess the transaction including (i) a summary of the tenancy agreements; (ii) the gross rental income from the commencement of the earliest tenancy agreement to the latest financial year end date; (iii) an estimate of the monthly expenses for the property payable by the landlord; and (iv) the experience of the listed issuer's management in the property industry.
- The Exchange granted a **waiver from the requirement for a circular** in respect of a major transaction in [LD69-13](#) (May 2013). The listed issuer had previously announced a disposal of its interest in a non-wholly owned subsidiary that was also listed on the Exchange (the 'Subsidiary'), subject to obtaining the regulatory approvals. The Subsidiary then proposed to acquire a target company which would constitute a major transaction of

the listed issuer as the disposal of the Subsidiary had not yet been completed. The Exchange agreed that it would be unduly burdensome for the listed issuer to publish a circular and the proposed acquisition would be irrelevant to the listed issuer and its shareholders on the basis that the disposal would be completed before the Subsidiary issued its circular for the acquisition.

#### ***Our observations:***

It is noted that for notifiable transactions of listed issuers, waivers from certain disclosure requirements may be granted by the Exchange provided that investors are given sufficient and relevant information to assess the impact of the transaction. Listed issuers are advised to consider this general principle in determining the alternative disclosures to be made in connection with their waiver applications. It is also worth noting that commercial sensitivity of the details of a transaction should not override the disclosure obligations where such information is material to the shareholders and investors. Waivers from disclosure requirements are unlikely to be granted solely because the information required to be disclosed is commercially sensitive.

#### **Reverse takeovers (RTO)**

- The Exchange set out the guidance that a **transaction that is in substance a backdoor listing but falls outside of the scope of MB Listing Rule 14.06(6) could still be treated as a RTO** in [LD57-13](#) (April 2013). In this acquisition transaction, MB Listing Rule 14.06(6) did not apply as the acquisition would not trigger a change in control of the listed issuer; and the vendor did not gain control of the listed issuer within 24 months prior to completion of the acquisition. However, the Exchange noted that the acquisition would be a very substantial acquisition and, upon completion, the listed issuer's existing businesses and assets would be relatively immaterial to the enlarged group. The acquisition was considered to be a means to achieve the listing of the acquisition target. Further, as a result of losses of the listed issuer in recent years, the enlarged group could not meet the profit requirement for a new listing applicant. As a result, the Exchange considered that the acquisition was a transaction to circumvent the new listing requirement, and should be classified as a RTO.
- In [LD58-13](#) (April 2013), the Exchange refused to waive the requirements in MB Listing Rule 14.06(6)(a) for a **very substantial acquisition that would result in a change in control of the listed issuer to be considered a reverse takeover**. In this case, the listed issuer had ceased operations and was a listed shell. The acquisition transaction was considered to be an attempt to achieve a listing of the target's business by injecting it into a listed shell. A waiver was not granted despite the fact that the listed issuer considered that the target would be able to meet the trading record requirements for new listing applications.
- A waiver was granted in [LD59-13](#) (April 2013) such that the listed issuer's **proposed acquisition of certain assets from a substantial shareholder of the listed issuer was classified as a very substantial acquisition instead of a RTO**. The consideration for the acquisition included cash and consideration shares to be issued. Following the acquisition, the substantial shareholder would hold more than 30% of the enlarged issued

share capital. Consequently, this would result in a change in control of the listed issuer under MB Listing Rule 14.06(6)(a) and is deemed to be a RTO under the MB Listing Rules. In considering whether a waiver from treating the transaction as a RTO is to be granted, the Exchange considered that the assets acquired were patents related to the listed issuer's existing principal business and would enable its expansion into an overseas market. Circumvention of the new listing requirements was not considered a material concern in this case and the waiver was thus granted.

#### ***Our observations:***

MB Listing Rule 14.06(6) sets out bright-line tests that apply to two specific forms of reverse takeovers: (i) an acquisition or a series of acquisitions that will result in a change in control of the listed issuer and (ii) injection of significant assets into the listed issuer. The Exchange will consider each case based on its own facts and circumstances. Acquisitions that are in substance attempts to circumvent the new listing requirements could still be treated as an RTO even if they fall outside the requirements of MB Listing Rule 14.06(6).

#### **Rights issues**

- In [LD70-13](#) (May 2013), the listed issuer announced a rights issue where the issue price represented a substantial discount to the recent trading price of its shares. The rights issue was over-subscribed and the listed issuer noted unusual patterns of excess applications. The Exchange determined that **listed issuer's proposed arrangement to dispose of the excess rights shares complied with the MB Listing Rule 7.21(1)** which requires the directors to allocate the excess rights on a fair basis. The Exchange further noted that if a listed issuer identifies any problems which indicate a possible abuse of the mechanism for allocating the excess rights shares, it must look into the problem and take appropriate steps to avoid the abuse and to ensure fair treatment of shareholders. The intended basis of allocation must be disclosed to ensure that sufficient information is provided to shareholders to make an informed decision before they apply for the rights shares.
- In [LD71-13](#) (May 2013), the Exchange set out the principle that when a proposed rights issue would **increase the issuer's market capitalisation by more than 50%, it is subject to independent shareholder approval** in accordance with MB Listing Rule 7.19(6). The purpose is to protect minority shareholders' interests when the potential dilution effect of a proposed rights issue is material.

#### **Other regulatory matters**

- In [LD62-13](#) (April 2013), a very substantial acquisition conditional on the completion of a placing of shares had been previously approved by the shareholders of the listed issuer. Subsequently, the issuer proposed to waive the placing as a condition precedent for completion of the acquisition, due to adverse market conditions. The Exchange considered such amendment to be a **material change to the terms of the acquisition** which should be subject to shareholders' approval at a subsequent general meeting.

- In [LD72-13](#) (May 2013), the Exchange granted a **waiver from the requirement for a spin-off transaction to provide shareholders with an assured entitlement** to the shares of the entity being spun off from the listed issuer. The spun-off entity sought to offer A shares in the PRC. Local law in the PRC prohibits foreign natural persons, legal persons or institutions to invest in the A-share market unless they are qualified foreign institutional investors. The Exchange granted the waiver on the condition that the listed issuer would disclose in its announcement for the proposed spin-off details of the waiver to include the reasons for not providing its shareholders with an assured entitlement to the A shares, and the legal restrictions under PRC laws and regulations on providing such an assured entitlement.

### 3 The Exchange's consultation papers on connected transaction rules

In April 2013, the Exchange published two consultation papers on proposals to amend the connected transaction rules. The first consultation paper proposes to refine the scope of connected transactions and the second consultation paper proposes to align the definitions of 'connected person' and 'associate' in the Listing Rules.

Major proposals as set out in the [first consultation paper](#) include:

- Simplifying the language of the connected transaction rules by replacing the current Chapter 14A of the Main Board Listing Rules with the '[Guide on Connected Transaction Rules](#)' issued in April 2012
- Introducing further exemptions for connected persons at the subsidiary level by adopting the following exemptions together or separately so that most transactions at the subsidiary level will be excluded:
  - Exempt from the independent shareholder approval requirements for transactions with connected persons connected only at the subsidiary level. Instead, these transactions would be subject to the approval of the issuer's board members (including the independent non-executive directors) who do not have a material interest in the transaction; and/or
  - Exempt all transactions conducted on normal commercial terms between the issuer group and persons connected at the subsidiary level (except for transactions between the person connected at the subsidiary level and the subsidiary (or any subsidiary below it) with which the person is connected
- Refining the definition of connected person to exclude certain persons who are unlikely to control or exert significant influence over the issuer

- Expand the 'insignificant subsidiary exemption' to exclude from the 'connected person' definition all persons connected only because of his relationship with the issuer's insignificant subsidiaries. The current exemption only applies to transactions between the issuer group and persons connected with the issuer's insignificant subsidiaries, subject to a 10% restriction on consideration test for any capital transaction between an insignificant subsidiary and the person connected with that subsidiary. An 'insignificant subsidiary' is a subsidiary of the issuer whose total assets, profits and revenue are less than (i) 10% under the percentage ratios for each of the latest three financial years; or (ii) 5% under the percentage ratios for the latest financial year
- Excluding transactions from the connected transaction rules where the risk of abuse is low. For example, at present, the connected transaction rules apply to transactions where each of the issuer and its 'controller' is, or will be, a shareholder of an acquisition target. A 'controller' is a director, chief executive or controlling (≥ 30%) shareholder of the issuer or any of its subsidiaries. The proposal will exclude from the rules 'controller(s)' at the subsidiary level
- Allowing the annual cap for continuing connected transactions of a revenue nature to be expressed as a percentage of the issuer's annual revenue or other financial items in its published accounts
- Removing the 1% cap on transaction value as a condition for the exemption for transactions involving the provision or receipt of consumer goods or services
- Introducing exemptions for the provision of indemnities to directors against liabilities incurred in the course of performing their duties
- Broadening the deeming provision of 'connected person' to cover a shadow director or de facto controlling shareholder of the issuer and a person who is accustomed to acting according to a connected person's directions or instructions.

The [second consultation paper](#) proposes to align the definitions of 'connected person' and 'associate' in the Listing Rules. The general definitions of 'connected person' and 'associate' contained in Chapter 1 of the MB Listing Rules are different from those used in Chapter 14A, which are broader. The proposals include renaming the definitions in Chapter 1 as 'restricted connected person' and 'close associate' to distinguish them from those defined in Chapter 14A and to align the definitions used in Chapter 14A with other parts of the Listing Rules.

The consultation period ended on 26 June 2013.

#### ***Our observations:***

In Hong Kong, about 75% of the listed issuers have a dominant shareholder that owns 30% or more of the issued shares. Frequently, the dominant shareholder appoints and nominates persons to the listed issuer's board, and family members often hold directorships in family-controlled listed issuers. The purpose of the

connected transaction rules is to protect the interests of minority shareholders when the listed issuer group enters into transactions with connected persons. Nevertheless, the administrative burden to identify and monitor transactions where the risk of abuse is low outweighs the benefits.

One of the key proposals in the consultation papers is to relax the requirements at the subsidiary level to exempt certain transactions from the existing independent shareholder approval requirements on the grounds that board approvals should be sufficient safeguards against possible abuse by connected persons at the subsidiary level and therefore the risk of abuse is low.

In general, the Exchange has received general market support for the proposals. We note that the use of a 'risk-based' approach in refining the scope of the connected transaction rules should help reduce the administrative burden on the listed issuers in identifying and monitoring connected transactions.

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