

Listed companies beware: Be careful how you spend your money

February 10, 2021

- Buying and selling of securities in the ordinary course of business no longer qualify for the “revenue exemption” under the notifiable transactions rules. These activities will be subject to the same regulatory requirements (as regards notification, public announcement and shareholders’ approval) as other forms of post-listing transactions.
- Wealth management products with fixed or guaranteed returns are not necessarily given the same regulatory treatment as traditional bank deposits. Buying and selling these products may constitute a “transaction” and trigger the notifiable transaction requirements.
- Newly listed companies should beware of the regulatory implications of these activities when using some of their IPO proceeds to purchase short-term investment products.
- The internal controls and compliance systems of listed companies should be updated to enable the management to monitor relevant transactions (individually as well as on an aggregated basis).

In recent months, the Hong Kong Stock Exchange has stepped up its scrutiny of investments by Hong Kong-listed companies in various types of short-term investment products. This memorandum sets out the relevant regulations and some of our recommendations for compliance.

The “revenue exemption”

After a company is listed in Hong Kong, it must continuously pay attention to any transaction it proposes to enter into, to ensure that the applicable requirements of Chapter 14 of the Listing Rules (as regards notification, public announcement and shareholders’ approval) are complied with.

Under Listing Rule 14.04(1)(g), a transaction of a “revenue nature” in the ordinary and usual course of business falls outside the definition of “transaction” under Chapter 14 of the Listing Rules and is therefore not subject to the regulatory requirements of that chapter.

2019 reform of the “revenue exemption”

In October 2019, a note 2(b) was added to this rule, stating that the acquisition or disposal of securities would not be generally considered to be of a revenue nature, unless carried out in the ordinary and usual course of business by licensed financial intermediaries such as banks, insurance companies and securities firms.

Additionally, under [FAQ 057-2019](#) issued at the same time, the Rule 14.04(1)(g) revenue exemption does **not** apply to securities transactions carried out by a listed issuer for treasury management purposes. Furthermore, securities transactions carried out within a 12-month period must be aggregated if they fall within any of the following categories:

- There are acquisitions or disposals of securities or an interest in one particular company or group of companies.
- The transactions are entered into by the listed company with the same party or with parties connected or associated with one another.

- The transactions together lead to substantial involvement by the listed company in a business activity which did not previously form part of its principal business activities.

Also included in the same package of Listing Rules reform was a requirement to include in annual reports a breakdown of significant investments (namely, investment in an investee company with a value of 5% of the total assets of the listed company), covering four specified items of information set out in para. 32(4A) of Appendix 16 (further explained below).

Increased regulatory scrutiny and enforcement

Since then, the Hong Kong Stock Exchange has been paying closer attention to this aspect of regulation. In the November 2019 issue of its [Listed Issuer Regulation Newsletter](#), two common pitfalls were reported:

- Some companies purchased wealth management products with fixed or guaranteed returns issued by financial institutions. They have mistakenly considered these products as similar to traditional deposits placed with banks. Taking the view that these purchases did not constitute “transactions”, the companies then failed to announce these transactions even though they were of a size to trigger the public announcement requirement under Chapter 14.
- Some companies acquired similar securities and did not aggregate these acquisitions in accordance with FAQ 057-2019 mentioned above. They then failed to make the required announcements.

This issue must be taken seriously, as the Hong Kong Stock Exchange has not hesitated to take enforcement actions in case of compliance failure. In December 2020, Main Board-listed Wai Chi Holdings Company Limited and one of its directors were publicly criticised by the Listing Committee in respect of subscriptions of wealth management products (in this case, index- or asset-linked deposits). These were recorded as “financial assets at fair value through profit or loss” in the relevant annual results, representing 9.8% of the company’s total assets as at the relevant year-end.

Some of these transactions individually constituted a discloseable transaction whilst some of them in aggregate constituted a major transaction. In none of these cases were the Chapter 14 requirements complied with.

Judging by the relevant [Hong Kong Stock Exchange release](#), this appears to be a classic case of misreading of the rules, as the director who was in charge of the investments had considered the investments as cash deposits that did not fall under the meaning of “transactions” under Rule 14.04(1)(a), then proceeded to assume that there was no need to notify the Board or consult professional advisers.

Points to note

Listed companies should tread carefully with respect to wealth management and treasury activities. Internal controls and compliance systems should be updated in light of the above, so that investments in relevant products do not “slip through” without an appropriate Chapter 14 size analysis.

Newly listed companies should beware of this when using some of their IPO proceeds to purchase short-term investment products.

In particular, enhancements should be put in place to maintain a rolling 12-month aggregation system of relevant transaction values, as required under FAQ 057-2019.

In terms of annual reporting, it is important to note para. 32(4A) of Appendix 16, which requires mandatory breakdown of the following items where the company has made any investment in an investee company with a value of 5% or more of the listed company’s total assets as at the year-end date:

- details of each investment, including the name and principal businesses of the underlying company, the number and percentage of shares held and the investment costs;
- the fair value of each investment as at the year-end date and its size relative to the listed company's total assets;
- the performance of each investment during the year, including any realised and unrealised gain or loss and any dividends received; and
- a discussion of the listed company's investment strategy for these significant investments.

Failure to include the required disclosure may lead to a regulatory enquiry and the need to issue a supplemental public announcement. For example, in a recent case the Hong Kong Stock Exchange, in the course of reviewing a listed issuer's annual report, noted certain investments whose fair value through profit or loss and amortised costs were disclosed, but not the information required by para. 32(4A) of Appendix 16. The regulator raised a formal query as the investments apparently represented more than 25% of the listed group's total assets. The company was asked to disclose the information by way of a public announcement and to submit the size tests in relation to the Chapter 14 notifiable transaction requirements.

After relevant fact-finding, the company responded to the Hong Kong Stock Exchange by way of confirmation of the immateriality of the investments, as the total investment amount was made up of some three dozen individual investments, each of which being of 5% or less under the Chapter 14 size ratios. None of the transactions involved constituted notifiable transactions under Chapter 14. However, the company also confirmed, on a voluntary basis, that it intended to make more detailed disclosure in future annual and interim reports in respect of these investments, based on an assessment of the overall materiality of the investment portfolio to the listed group. This approach was found to be acceptable to the Hong Kong Stock Exchange.

Individual circumstances and the suitable responses to regulatory enquiries would vary from case to case. If you have any questions regarding this subject matter or any other aspect of this memorandum, please reach out to the persons set out below or your usual Davis Polk contact.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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