

Corporate Finance

SFC's concerns over dubious transactions and directors' duties

Introduction

The Securities and Futures Commission (the “**SFC**”) has been proactively intervening in market misconducts at an early stage. According to its Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals published by the SFC in July 2019 (the “**Statement**”), it issued letters of concern to more than 46 listed issuers about proposed corporate transactions or other actions in 2017 and 2018. In view of the tightened regulations over proposed corporate transactions by listed issuers, and by virtue of the powers under the Securities and Futures (Stock Market Listing) Rules (Cap. 571V) (the “**SMLR**”) and the Securities and Futures Ordinance (Cap. 571) (the “**SFO**”) to maintain an orderly market and protect the interests of shareholders as a whole, the SFC issued a regulatory bulletin (the “**Bulletin**”) in February 2020 to address concerns over commonly identified types of dubious transactions and reminds the directors of listed issuers of their duties to exercise their independent judgment when assessing proposed corporate transactions, in order to sufficiently discharge their fiduciary duties owed to the listed issuers.

Concealed share ownership and control

According to the Bulletin, the SFC has been focusing on tackling shell-related activities, vote rigging and “pump and dump” schemes. One common element of these unfair market practices is concealed share ownership and control via schemes to transfer control without disclosing the identities of the incoming controllers. In particular, the SFC highlights the use of tools such as nominee accounts, third-party financing and private funds in these cases, where only the names of the entities used to consummate the transaction is disclosed. The SFC reminds the boards of listed issuers that, before deciding not to disclose identity of the controllers or beneficial owners of the entities, the board must be satisfied that such information is not necessary for the shareholders and the investing public to assess the listed issuer's activities or financial position.

Suspect valuations

The Statement also summarised the common pitfalls of the board of listed issuers when assessing independent professional valuation reports. First, the SFC noted that there were instances where the board simply relied on the forecasts from the vendor of the target company to determine the consideration to be paid, without conducting independent verification of the basis of the vendor's forecasts. In addition, some listed issuer directors

cherry-picked companies which had higher trading multiples and disregarded others with poorer performance, or conducted comparison by using companies with longer and more profitable track records than the target companies. Moreover, there were instances where the board of listed issuers allowed the valuers to put up a complete disclaimer of their liabilities in relation to the reliability of the projections.

To illustrate these points, the Bulletin cites two case studies. In the first case, a listed issuer sought to acquire a majority interest in a target company with minimal net profit and assets and whose vendor provided a 2019 profit guarantee that was 20 times higher than the 2017 net profits. In another case, the acquisition target recorded losses for two consecutive years and had net liabilities, and the price was determined on the valuation basis that the target would achieve a revenue growth rate of over 40% and that its profit margin would turn positive. It was unclear how the directors concluded that these assumptions would be realistic and achievable. In these two cases, the SFC issued a series of letters of concerns pointing out that the valuation in these cases were aggressive and unlikely to be independently determined, while considering the potentially prejudicial effect of the proposed acquisition to the shareholders as a whole. At last, both listed issuers terminated the proposed acquisitions voluntarily. This demonstrates that the boards of listed issuers must review the basis and assumptions of the valuation report and independently make judgment as to the reasonableness and accuracy of the valuation report obtained.

Warehousing of shares and nominee arrangements

Another common dubious transaction pattern is the warehousing of shares, whereby the actual control behind a nominee is hidden and nominee arrangements are used for vote rigging and market manipulation. Market intermediaries should be on the constant lookout for characteristics of client transactions that suggest the warehousing of shares, including frequent and large fund transfers to and from third parties in the absence of a credible commercial rationale or explanation, and a large number of seemingly unrelated clients sharing the same trading and settlement patterns or having the same correspondence address.

Highly dilutive share issues

The SFC often directly intervenes in deeply discounted share placements, as they may be against the interests of minority shareholders whose interests in the listed issuer will be heavily diluted. The SFC is proactive in identifying rights issues and open offers that are oppressive and prejudicial to shareholders. In one case, a listed issuer engaged in two rounds of highly dilutive fundraisings and proposed a third round. The SFC discovered undisclosed connections between some of the directors and shareholders voting in favour of the fundraisings, as well as between the directors and the buyers of the listed issuer's shares. As a result, the SFC suspended the trading in the shares of the listed issuer. In another case,

a listed issuer proposed to place new shares for a small amount of funds but at steep discounts to its net asset value and cash, claiming to raise money for the development of its food and beverage business (the “**Proposed Placing**”). The Proposed Placing would be highly dilutive to the existing members’ shareholding. The SFC noted that the listed issuer had no imminent funding needs and had no debt, and therefore the SFC was concerned of the oppressive and prejudicial nature of the Proposed Placing. As such, the SFC issued a letter of concern followed by a letter of mindedness, leading to the termination of the Proposed Placing by the listed issuer.

A reminder of directors’ duties

In summary, directors of issuers should be mindful of their obligations to guard shareholders’ interests and remain professional and vigilant when performing their duties. When entering into transactions involving acquisitions or disposal of target companies or injection of capital into target companies, the board should use its best endeavour to ascertain the identity of the counterparty and its ultimate beneficial owner. In addition, when assessing valuation reports obtained from independent valuers, the board should independently ensure that any forecast or estimate relied on is fair, reasonable, and computed with due care. The presentation of comparisons should be true and fair. There should not be cherry-picking of market comparables, inclusion of unsustainable source of revenue, or in worse cases, placing complete reliance on the vendor’s projections. Moreover, for share issues, the board should avoid conflicts of interests and refrain from proposing share issues while having no genuine funding needs or that will ultimately result in the unfair dilution of non-subscribing shareholders’ interests.

For enquiries, please contact our Corporate & Commercial Department:

E: cc@onc.hk
W: www.onc.hk

T: (852) 2810 1212
F: (852) 2804 6311

19th Floor, Three Exchange Square, 8 Connaught Place, Central, Hong Kong

Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

Published by **ONC** Lawyers © 2020