



Importance of Adhering to Regulatory Guidance on Corporate Transactions, Particularly as to Valuations

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NEWSLETTER

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In recent years, the Securities and Futures Commission of Hong Kong (“**SFC**”) and The Stock Exchange of Hong Kong Limited (“**HKEx**”) have increasingly stressed the importance for listed companies and their directors to follow regulatory guidance on corporate transactions. The regulators’ concerns regarding cases where transaction terms (including consideration) may not be fair and reasonable to the listed companies and their shareholders as a whole have prompted closer scrutiny of such transactions.

The increase in recent months in the publication of supplemental announcements to transaction related disclosures and receipt of HKEx enquiries by listed companies to follow the guidance as stated below has highlighted the critical need for listed companies and their directors to adhere to the published guidance. In 2017, the SFC issued the guidance note on directors’ duties in the context of valuations in corporate transactions (“**SFC 2017 Guidance Note**”). In 2019, the SFC released the statement on the conduct and duties of directors when considering corporate acquisitions or disposals (“**SFC 2019 Statement**”). Further, in 2023, the HKEx issued HKEx-GL116-23 (“**HKEx Guidance Letter**”) directing listed companies to adequately disclose the basis for consideration and business valuations in notifiable transactions.

The SFC 2017 Guidance Note underscores the key duties for directors of listed companies when the directors consider or approve a corporate transaction, particularly when the transaction involves a valuation:

- **Act in Good Faith:** Directors must act in good faith in the interests of the listed company.
- **Exercise Due Diligence:** Directors must exercise due and reasonable care, skill, and diligence in scrutinizing the proposed corporate transaction.
- **Exercise Independent Judgment:** Directors must exercise independent judgment rather than relying solely on external opinions or valuations.
- **Act for a Proper Purpose:** Directors must exercise their powers for proper purposes and avoid any conflicts of duty and interest.

This guidance specifically responds to the SFC’s observation and concern that listed companies too often either neglect to obtain valuations when circumstances suggest it would be appropriate or rely on them imprudently, which leads to listed companies suffering loss.

In evaluating breaches of these duties, the SFC will consider whether directors have followed the SFC 2017 Guidance Note and will be more likely to investigate and seek orders under section 214 of the Securities and Futures Ordinance (“SFO”) against directors who fail to act in accordance with the SFC 2017 Guidance Note. The SFC may seek disqualification, compensation and other orders as a result.

Further, the SFC 2019 Statement highlights recurring types of regulatory misconduct related to directors’ breach of duties in evaluating and approving corporate acquisitions or disposals. These include, but are not limited to:

- Directors may fail to exercise the degree of care, skill and diligence that may be reasonably expected of them by not obtaining a professional valuation.
- Directors simply relying on the vendors’ forecasts in assessing the consideration for the target businesses in the cases where an independent professional valuation was obtained.
- Directors performing little or no independent due diligence on the forecasts, assumptions, or business plans which were provided by the vendors or the management of the targets and on which the acquisition price were based.
- Directors failing to ensure that the comparables referred to in the valuation constitute fair and representative samples by “cherry-picking” companies that had higher trading multiples and disregarding others with poorer performance.
- Directors failing to assess the negative impact that the planned acquisition could have on the listed company’s resources and financial position.

These types of regulatory misconduct may lead to regulatory intervention and enforcement action by the SFC under the SFO.

The HKEx Guidance Letter provides guidance on the recommended disclosure of business valuations, which is a primary factor in determining the transaction consideration. This guidance should be read in conjunction with the SFC 2017 Guidance Note and the SFC 2019 Statement:

- A listed company should adequately explain the basis for determining the transaction consideration so that its shareholders can assess whether the terms of the transaction are fair and reasonable.
- For an acquisition or disposal that constitutes a notifiable transaction, a listed company’s circular should contain the valuation report for the transaction target or a summary that fairly presents the views and analysis of the valuer as well as all material factors contained in the report. The valuation report (or summary of it) should adhere to generally accepted valuation standards and include, among others:
 - a. the valuation approaches and methods used by the valuer and the reasons for their selection;
 - b. the scope of work performed by the valuer, any limitations on the work, and the reasons for those limitations;
 - c. the nature and source of information relied upon;
 - d. the key inputs and assumptions, and how they were determined and translated into the appraised value;
 - e. the appraised value assigned to the transaction target and the principal reasons for conclusions reached;
 - f. the effective date of the valuation; and
 - g. the identity, qualification and independence of the valuer.

The HKEx Guidance Letter also provides guidance on disclosing the basis for consideration in notifiable transactions, regardless of whether an independent valuation is disclosed:

- A listed company should adequately explain the basis for determining the consideration by disclosing sufficient and objective information with quantitative inputs and analysis to substantiate how the consideration for the notifiable transaction was determined.
- A listed company should provide adequate and relevant disclosure (both quantitative and qualitative) of the factors that are key to determining the consideration.

In summary, listed companies and their directors should strictly follow the guidance provided by the SFC 2017 Guidance Note, the SFC 2019 Statement, and the HKEx Guidance Letter. Any failure to comply with this guidance may attract regulatory enquires to listed companies on the fairness and reasonableness of the transactions, which may result in these companies being required to publish supplemental announcements due to inadequate disclosure and their directors being questioned for failing to discharge their duties and responsibilities under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. To best protect listed companies and their shareholders' interests, listed companies are encouraged to seek professional advice before conducting corporate transactions.

Fangda Partners' Hong Kong Contentious Regulatory Practice Group (HKCRP) will continue to closely monitor these and other regulatory developments so that we are prepared to advise clients on any of their regulatory concerns.

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