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GREATER CHINA EDITION

THIRD QUARTER 2020

INSIDE

Some U.S. Listed Chinese Companies Face Delisting Under New Treasury Oversight Requirements

On August 6, 2020, the President's Working Group on Financial Markets (PWG) recommended that all Chinese companies seeking initial public offerings (IPO) in the U.S. must be required, as a precondition to listing, to allow American government regulators to review their audit records.[1]

The new proposed regulations also cover current Chinese listings stateside, representing over 240 Chinese companies with a combined market capitalisation of $1.88 trillion as of July 28.[2]

The recommendations are aimed at what the U.S. perceives as "non-compliant jurisdictions" (NCJs) that impede the work of the Public Company Accounting Oversight Board (PCAOB), the American audit regulator. The recommendations include:[3]

- Enhanced listing standards for U.S. exchanges, requiring turnover of work papers of the publicly listed company's principal audit firm to the PCAOB as a condition to initial and/or continued listing
- Enhanced issuer disclosures that warn against the risks of investing in NCJs
- Enhanced fund disclosures covering registered funds that have exposure to issuers from NCJs
- Greater due diligence of indexes/index providers by SEC-registered funds prior to selection
- Guidance for investment advisers regarding their fiduciary obligations when considering investments in NCJs

The PWG paper is just the latest salvo from the U.S. side in an ongoing trans-Pacific trade war. President Donald Trump has consistently decried "massive trade deficits" in ties between the world's two largest economies,[4] following through with legislation like the May 2020 passage of Senate Bill 945, the Holding Foreign Companies Accountable Act.[5]

Government agencies like the PCAOB and the U.S. SEC have often objected that Chinese regulations prevent them from receiving accurate financial reporting from companies with operations based in China.[6]

The Chinese government has also just as consistently denied these accusations. In a response to the PWG paper, the China Securities Regulatory Commission (CSRC) argued the PWG report itself noted that "China's securities regulators have so far provided U.S. securities regulators with audit working papers of a number of Chinese companies listed in the U.S. market."[7]

The recommendations also allow for a grace period "to reduce market disruption," ending January 2022, for currently listed companies and new China listings to comply with the new rules.

To beat the clock, Chinese companies fast-tracked their listing in U.S. bourses, raising around $2 billion in U.S. IPOs between mid-June and early August. This record figure was equivalent to the same amount raised in 2020 prior to that period and exceeded the full-year total for 2019.[8]

Alternatively, a number of China-based companies have established secondary listings in Hong Kong as a backup or have received shareholder privatisation offers. The former include e-commerce giant Alibaba, travel conglomerate Ctrip and tech giant Baidu[9]; the latter include Sina Corporation and search engine Sogou.[10]

The CSRC issued a cautious response to the August 6 announcement: "We believe the only way to resolve the issues of common concerns and achieve win-win results is to have open and candid dialogue, and only by doing so can regulators together create a sound environment for the healthy and orderly functioning of the global capital market," it read.

The CSRC said in its response that it had earlier proposed joint accounting inspections with U.S. regulators, in the spirit of "total sincerity towards cooperation".[11]

1. "President's Working Group on Financial Markets Releases Report and Recommendations on Protecting Investors from Significant Risks from Chinese Companies." U.S. Department of the Treasury. U.S. Department of the Treasury, August 6, 2020. https://home.treasury.gov/news/press-releases/sm1086

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3. "Report on Protecting United States Investors from Significant Risks from Chinese Companies." President's Working Group on Financial Markets. U.S. Department of the Treasury, July 24, 2020. https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf.

4. “Read Donald Trump’s Speech on Trade.” Time.com. Time USA LLC, June 28, 2016. https://time.com/4386335/donald-trump-trade-speech-transcript/.

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11. “Officials from Relevant Departments of the CSRC Answered Reporter Questions regarding the ‘Report on Protecting United States Investors from Significant Risks from Chinese Companies’ by the U.S. President’s Working Group on Financial Markets.”

Hang Seng Launches New Index Tracking 30 Largest Tech Stocks

On July 27, 2020, Hang Seng Indexes Company Limited launched its Hang Seng TECH Index, an index that tracks the 30 largest (by market capitalisation) of the tech stocks listed in Hong Kong that pass the Index's criteria.[1]

Of the industries presently included in the TECH Index, the IT industry dominates with a 68.3% weighting distribution, followed closely by industrials (12.2%) and healthcare (9.1%). Among the top 10 constituents (by weighting) on launch are technology conglomerates Alibaba, Tencent, Meituan Dianping and Xiaomi along with three healthcare-focused tech companies: Sunny Optical, Ali Health and PA Good Doctor.

Hang Seng TECH Index Methodology

The constituent stocks in the TECH Index represent industries in the following sectors: Industrials, Consumer Discretionary, Healthcare, Financials, and Information Technology (IT); with high business exposure to the following technology themes: Internet, Fintech, Cloud, E-commerce and Digital.

The TECH Index aims to review the constituent companies every quarter, with market value (MV) rank to be used as a determining factor for inclusion.

A "Fast Entry Rule" fast-tracks the inclusion of newly listed tech companies "if its full market capitalisation ranks within the top 10 of the existing constituents on its first trading day."[2]

Back-testing data provided by Hang Seng shows that the TECH Index (had it existed previously) "would have achieved significant returns of 36.2% and 35.3% for the full year of 2019 and the first half of 2020 respectively."[3]

Increasing Interest in China Tech Stocks

The TECH Index is seen to capitalise on growing investment interest in China-based tech stocks.

Data from Hong Kong Exchanges and Clearing Ltd (HKEX) bear this out—the number of tech companies listed on the HKEX Mainboard increased from 137 in 2017 year-end to 163 by end of June 2020; their market capitalisation increased from 14.3% at the 2018 year-end to 33.2% by end of June 2020; and their total value traded as a percentage of the value of all shares shot up from 18.5% in 2018 to 27.6% by end of June 2020.[4]

Recent disruptive events have further improved the outlook on Chinese technology-related investments. In the more immediate term, society's increased reliance on technology in the wake of COVID-19 has strengthened tech companies' positions, not just in China but across the world.[5]

China-based tech firms have surprisingly benefited from tensions between China and the U.S. The threatened U.S. ban on Chinese apps like TikTok resulted in a surprising jump in Chinese tech stock prices, buoyed by speculation that local companies would enjoy greater support from Beijing if decoupling of the two largest economies in the world continues apace.[6]

Indeed, the Hang Seng TECH Index specifically targets "homecoming Chinese companies", or U.S. listed Chinese stocks opting to create a secondary listing on the Hong Kong Stock Exchange, anticipating further developments in the U.S.-China trade war.[7]

Certain secondary listings have made fundraising records over the past year, including Alibaba's $12.9 billion when it listed in Hong Kong in November 2019;[8] and NetEase's $2.7 billion in June 2020.[9]

1. "New Hang Seng TECH Index to Track Main Technology Players Listed in Hong Kong." Hang Seng Indexes. Hang Seng Indexes Company Limited, July 20, 2020. https://www.hsi.com.hk/static/uploads/contents/en/news/pressRelease/20200720T160000.pdf

2. "Hang Seng TECH Index Methodology." Hang Seng Indexes. Hang Seng Indexes Company Limited, 20 July 2020. https://www.hsi.com.hk/static/uploads/contents/en/dl_centre/methodologies/IM_hsteche.pdf

3. "New Hang Seng TECH Index to Track Main Technology Players Listed in Hong Kong", page 1.

4. Ibid., page 5.

5. Wakabayashi Daisuke; Nicas, Jack; Lohr, Steve; and Isaac, Mike. "Big Tech Could Emerge From Coronavirus Crisis Stronger Than Ever." The New York Times. The New York Times Company, March 23, 2020. https://www.nytimes.com/2020/03/23/technology/coronavirus-facebook-amazon-youtube.html.

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7. "New Hang Seng TECH Index to Track Main Technology Players Listed in Hong Kong", page 7.

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SFC asks SEHK to Fortify "Chinese Wall" that Prevents Conflict of Interest

On July 2, the Hong Kong Securities and Futures Commission (SFC) issued a report encouraging the Stock Exchange of Hong Kong (SEHK) to improve internal processes that reduced internal conflicts of interest over new listings.[1]

As a front-line regulator with oversight over listed companies and new listing rules, it is imperative that SEHK's procedures for new listings are above reproach. The report, which covered transactions in 2018, suggested there was room to improve in that department, in a year when parent company Hong Kong Exchanges and Clearing (HKEX) instituted listing reforms that allowed dual-class shareholding companies and pre-revenue biotech firms to list for the first time.[2]

The main conclusions reached by the report were as follows:

Shortcomings of existing Chinese wall. Throughout 2018, HKEX had not sufficiently maintained a "Chinese wall," or a regulatory barrier that prevents conflicts of interest by blocking any exchange of information between business executives and the listing department.

"The [listing department's] Chinese wall protocol… contains numerous ambiguities and does not fully address key aspects of the 'Chinese wall'," noted the report. "As currently drafted, some of the policies and guidance stated in the Chinese wall protocol may be difficult for department staff to interpret or follow."[3]

Meetings with prospective applicants. Given the SEHK Listing Department's regulatory function, department staff should not be seen as assisting the HKEX business side to win business, or to service issuers and applicants.

This had been breached through common practice; "It was considered acceptable for the HKEX business side to invite the Listing Department to attend business introductory presentations with potential applicants to make the process more expedient for the applicant."[4]

To that end, the report recommended that department staff be prevented from attending introductory meetings with prospective listing applicants alongside HKEX executives.

"The mere presence of … senior department executives … where the HKEX business side was clearly pitching for business may undermine the perceived independence of the listing regulatory function and should be avoided entirely," noted the report.[5]

Perceived partiality. The SFC memo requested HKEX to review its internal procedures to ensure "that Listing Department executives should not be and should not be seen to be pressurised to respond more swiftly to particular applicants in indirect ways."[6]

In addition, the SFC memo enjoined the Listing Department to not rely on data provided by the HKEX business side. "The Listing Department should conduct its own independent research and information gathering (or obtain information from an independent source) to ensure the objectivity and independence of the data and research used and reach a balanced view."[7]

The HKEX's responses were attached to individual sections of the report. The responses included, among other things, a re-examination of the Listing Department's organisation and operation; and the cessation of any Listing Department officials' invitations to meetings with companies.

Removing potential conflicts of interest goes a long way towards strengthening investors' confidence in Hong Kong's investment climate.

Actions like the ones required in the SFC memo are seen to help elevate HKEX's standing vis-a-vis competing exchanges like the Shanghai Stock Exchange (SSE) and overseas bourses like NYSE and NASDAQ. In another development that demonstrated the strengthening of policies and oversight over the HKEX, the Independent Commission Against Corruption (ICAC) charged a former joint head of HKEX's listing department with bribery linked to IPO applications.[8]

1. "Report on the Securities and Futures Commission's review of the Exchange's performance in its regulation of listing matters." Securities and Futures Commission. Securities and Futures Commission, 2 Jul 2020. https://www.sfc.hk/web/EN/files/ER/PDF/26-2019_review_report_EN.pdf

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3. "Report on the Securities and Futures Commission's review of the Exchange's performance in its regulation of listing matters," page 19.

4. Ibid., page 14.

5. Ibid., page 15.

6. Ibid.

7. Ibid., page 17.

8. Yiu, Enoch and Wong, Brian. "Former Hong Kong Exchanges and Clearing senior executive charged for accepting HK$9.15 million in bribes." South China Morning Post. South China Morning Post Publishers Limited, 25 Mar, 2020. https://www.scmp.com/business/companies/article/3076898/former-hong-kong-exchanges-and-clearing-senior-executive-charged.

SEHK Solicits Feedback on Paperless Listing and Online Documents Display Proposals

On July 24, 2020, the Stock Exchange of Hong Kong Limited (SEHK) published a consultation paper seeking public feedback on proposals for a paperless listing and subscription regime, the online display of documents and reduction of documents on display, among other issues.[1]

The status quo for listings relies heavily on actual paper, at a time when paperless online submissions are already commonly accepted (last year, only 0.42% of applications for 162 initial public offerings (IPOs) handled by a major share registrar in Hong Kong were made through paper white application forms):[2]

- As per current listing rules, all issuers of equities, debt securities and collective investment schemes (CIS) must issue listing documents in physical printed form. As the law requires all application forms to be issued with (or accompanied by) listing documents, applicants have tended to submit application forms in the same physical printed medium required of all listing documents.[3]
- The rules require issuers to place certain printed documents on display, including (but not limited to) material contracts, directors' service contracts, experts' consents and statements of adjustments, for physical inspection.[4]

The consultation paper proposes a fully paperless IPO regime, where all listing documents in a new listing are to be published solely in an electronic format, and new listing subscriptions must be made through online electronic channels only (except for those issuers adopting Mixed Media Offer).[5]

The paper also proposes rules that significantly reduce requirements for documents to display. Documents such as notifiable transactions and connected transactions can be published online instead of physically displayed.

Other documents continue to retain a physical display requirement, though reduced in scope, being limited to contracts and certain expert reports. Other material contracts, constitutional documents, audited accounts and previously published transaction circulars already published and available on the Exchange's website and the issuers' websites no longer need to be physically displayed.

Finally, the paper seeks comment on an updated guidance letter HKEX-GL86-16 requiring additional corporate governance and ESG disclosures for IPO applicants.[6]

The consultation period for the paper will end on September 24, 2020. Any interested parties may comment on the consultation paper by completing and submitting the questionnaire. Links to the consultation paper and questionnaire are provided below, linked from the HKEX Website.

July 2020 – Consultation Paper on Proposals to Introduce a Paperless Listing & Subscription Regime, Online Display of Documents and Reduction of the Types of Documents on Display

- Consultation paper: PDF
- Questionnaire: DOCX

1. "Exchange invites feedback on Proposals to Introduce a Paperless Listing & Subscription Regime, Online Display of Documents and Reduction of the Types of Documents on Display." HKEX.com.hk. Hong Kong Exchanges and Clearing Ltd, July 24, 2020. https://www.hkex.com.hk/News/RegulatoryAnnouncements/2020/200724news?sc_lang=en.

2. "Proposals to Introduce a Paperless Listing & Subscription Regime, Online Display of Documents and Reduction of the Types of Documents on Display." HKEX.com.hk. Hong Kong Exchanges and Clearing Ltd, July 1, 2020, page 16. https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/July-2020-Paperless-Listing/Consultation-Paper/cp202007.pdf.

3. Ibid., page 4.

4. Ibid., page 9.

5. Ibid., page 6.

6. "Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications." HKEX.com.hk. Hong Kong Exchanges and Clearing Ltd, July 2020. https://en-rules.hkex.com.hk/node/5041.

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