

HKCGI Securities Law and Regulation Guidance Note (Tenth Issue) – Governance and Best Practices for Listed Issuers in Handling Loans and Lending Arrangements - Part 1

Introduction

This Guidance Note, which consists of Part 1 and Part 2, provides governance professionals with practical guidance on advising listed issuers and their directors on governance and the related best practices in handling loans and lending arrangements, as well as how to avoid common pitfalls in relation to the same.

The context is that loans, advances, prepayments, and other lending arrangements involving funds being transferred by Hong Kong-listed issuers to other parties have come under close scrutiny from Hong Kong regulators in recent years, following a string of misconduct cases where dubious fund transfers made under the pretext of loans and lending practices

resulted in significant losses to the listed issuers and investors.

This has prompted regulators to investigate and take disciplinary and enforcement action against the wrongdoing parties and publish various guidance on this topic, including the Joint Statement issued by the Securities and Futures Commission (SFC) and the Accounting and Financial Reporting Council (AFRC) on July 13, 2023 (**Joint Statement**),¹ and the April 2024 edition of the Hong Kong Stock Exchange (HKEX) Enforcement Bulletin published on April 30, 2024 (**Enforcement Bulletin**).²

1 Joint statement of the SFC and the AFRC in relation to loans, advances, prepayments, and similar arrangements made by listed issuers dated July 13, 2023 (<https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Joint-statement-of-the-SFC-and-the-AFRC>).

2 April 2024 edition of the HKEX Enforcement Bulletin (<https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Disciplinary-and-Enforcement/Enforcement-Newsletter/newsletter202404.pdf>).

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In this Part 1, we set out the regulatory expectations and provide governance professionals with practical guidance on corporate governance on loans and lending arrangements. In Part 2, we will explore the common pitfalls and regulators' recent enforcement actions against the misconduct of listed issuers and directors in relation to loans and lending arrangements.

Regulatory Expectations

In the Joint Statement, the SFC and the AFRC observed that there has been a noticeable increase in the number of misconduct cases involving dubious fund transfers by listed issuers. These fund transfers are usually labelled as, for example, loans, advances, prepayments, and deposits, and are often related to the listed issuers' associated parties, management, or other unknown persons/entities. The regulators also found that, in some cases, the terms of the relevant arrangements are so favourable that they do not sit well with commercial reality. These dubious fund transfers usually result in huge unrecoverable impairment losses to the listed issuers and may even be disguises for misappropriation of the issuer's assets or other wrongdoings, or an attempt to create a false impression of positive financial performance for the listed issuer.

The SFC and the AFRC stressed the expectations placed on directors and audit committees of listed issuers in establishing and maintaining effective internal controls over the granting of loans, monitoring repayments and recovery and the detection of irregularities to safeguard the issuer's assets, and ensuring adequate disclosure in financial statements and announcements. The SFC and the AFRC also reminded auditors of listed issuers of their obligation to maintain professional scepticism throughout the whole audit process and critically evaluate representations made by the management of listed issuers in relation to loans to ensure that the listed issuers' financial statements are free from material misstatements.

In the Enforcement Bulletin, the HKEX expressed similar concerns over the handling of loans, advances, and other lending arrangements by listed issuers,

flagging situations where there were no proper risk assessments done, insufficient monitoring of receivables, and a lack of legitimate commercial rationale for entering the transactions. The HKEX noted that improper handling of lending arrangements can often result in defaults to such loans, followed by significant impairment losses suffered by the listed issuers. This puts the issuers' assets and the public investors' funds at risk. The HKEX further drew attention to some common red flags that may be indicative of loan-related misconduct and reminded listed issuers and their directors of their duties.

Practical Tips on Maintaining Good Corporate Governance on Loans and Lending Arrangements

Given the level of scrutiny from Hong Kong regulators on the loans and lending practices of listed issuers, it is imperative for issuers and directors to ensure that proper protocols, procedures, and safeguards are implemented to protect the issuer's interests. This invariably includes having robust internal controls requiring proposed lending transactions to be properly vetted, assessed, and approved (including escalation to the issuer's board for consideration if the amount of which is significant).

Equally, directors need to maintain sufficient oversight over the transactions to ensure compliance with their directors' duties and the issuer's disclosure obligations. This includes not just at the listed issuer level but also at the subsidiary level, where major assets of the overall corporate group may be subject to loans and lending arrangements.

Governance professionals should remind, as appropriate, listed issuers and their directors to be mindful of adopting the best corporate governance practices and bear in mind the following principles in handling lending arrangements to minimize the risks of loss and potential regulatory enforcement.

1. Legitimate commercial rationale

- Directors are expected to critically evaluate the loans and lending arrangements to ensure that it is supported by a legitimate commercial rationale, made on terms that are fair and reasonable and is overall in the best interests of the issuer and its shareholders. They should also ensure that the intended transaction aligns with the issuer’s business strategy and policies.

2. Risk management

- Directors are expected to ensure that any loans and lending arrangements would be subject to proper risk management over the entire lifecycle of a loan.
- For example, before granting a loan, directors should ensure that the issuer performs (i) proper due diligence on the borrower, its creditworthiness, and its assets provided to secure the loan; (ii) a proper assessment of recoverability, enforceability of the underlying security, and the overall risk of default ; (iii) a working capital stress test to assess to determine the sufficiency of capital amidst adverse financial conditions, and (iv) an assessment of any potential reputational and investor relations impact.
- After granting the loan, directors should be required to regularly monitor and review the status of repayment and the status of the loan portfolio. In case of a renewal or extension of the loan, the risk assessment should also be renewed as the circumstances may have changed.
- In case of a default or delay in repayment by the borrower, directors should adopt a proactive approach to address the risks and minimize the potential loss for the issuer. This includes implementing measures such as requesting additional collateral, enforcing existing securities, issuing demand letters, negotiating

repayment plans, and commencing legal actions for recovery if necessary.

3. Effective internal controls

- Listed issuers and directors have to ensure an effective and robust internal control system for vetting and approving the initial grant and further extension of loans, which entails adequate checks and balances, segregation of duties, and safeguards against any unfettered authority vested in one individual in the decision-making process. This is especially true for issuers where the executive directors are also majority shareholders or where the relevant directors have substantial operational authority which may enable them to unilaterally approve significant transactions for the issuer.
- If the loan transaction (i) takes place at the subsidiary level of a listed issuer’s group and outside of Hong Kong in particular, an onus should be placed on the management of the relevant subsidiary to make a proper and periodic report of the matter to the issuer’s board so proper oversight can be maintained over the loan.

4. Recordkeeping

- Listed issuers ought to keep contemporaneous records evidencing the circumstances and internal processes undertaken when granting substantive loans at the issuer and subsidiary levels, as well as in respect of any relevant risk and commercial assessments mentioned earlier, and records of professional advice obtained during the process (if any). These records are essential for demonstrating to regulators that a robust and proper process was undertaken to assess the transaction because execution steps were taken. The absence of such documents may draw adverse inferences from the regulator in the event of an investigation or disciplinary action.

5. Compliance with the Listing Rules

- When granting, renewing, and extending loans, listed issuers should not forget their obligations under the Main Board Listing Rules (**Listing Rules**) or GEM Listing Rules, which include making timely disclosures, renewing size test calculations, and obtaining shareholders' approval (where applicable), not least when the amount of the loan is significant or when the loan may constitute a connected transaction or fall under the definition of an “advance” or “financial assistance” and thereby trigger obligations under Chapter 13 of the Listing Rules. In particular, the HKEX emphasized that renewal/extension of a loan is seen as a new transaction, and issuers should comply with the applicable Listing Rules requirements.
- Listed issuers are required to exercise caution when assessing and referring to recoverability and impairment of loan receivables, and when making representations to auditors to ensure that the disclosures in the financial statements and announcements are accurate and complete in all material respects and not misleading or deceptive.

This Guidance Note continues in Part 2 where we will discuss the common pitfalls in listed issuers engaging in loans and lending practices, and recent enforcement actions taken by Hong Kong regulators in combating related misconduct.