

HKCGI Securities Law and Regulation Guidance Note (Eleventh Issue) – Governance and Best Practices for Listed Issuers in Handling Loans and Lending Arrangements - Part 2

Introduction

In Part 1 of this Guidance Note, we set out for governance professionals the regulatory expectations and practical tips in advising listed issuers and their directors on governance and the related best practices in handling loans and lending arrangements. In this Part 2, we now turn to the common pitfalls relating to loans and lending arrangements and Hong Kong regulators' recent enforcement actions in relation to the same.

Common Pitfalls

Based on the April 2024 edition of the Hong Kong Stock Exchange (HKEX) Enforcement Bulletin published on April 30, 2024 (Enforcement Bulletin),¹ governance professionals should be aware and provide appropriate

advice to listed issuers and their directors on steps to address or avoid the following common red flags at various stages of a loan or lending arrangement.

Pre-loan stage

- Insufficient or no due diligence, credit, business and risk assessment, and risk management plan regarding the lending portfolio.
- Approval of loans on questionable commercial terms (such as unsecured and interest-free loans or loans at an interest rate below the issuer's costs of financing) without any legitimate commercial rationale.

¹ 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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- Approval of loans without measures to safeguard assets (such as insufficient security and collateral and the lack of proper contractual arrangements).
- Advances of prepayments allegedly for the purchase of goods without a corresponding contractual requirement or without actual subsequent delivery of goods.
- Substantive loan amounts paid to borrowers connected to the issuer (or its directors or senior management) that are incompliant with the Listing Rules requirements.
- Unauthorized loans, or loans that were not properly approved by the board of directors (such as loans purportedly approved by the chairman or senior management personnel only, without the board of directors' scrutiny) or loans bypassing the usual internal pre-lending assessment procedures.
- Lack of records of due diligence and assessments prior to the grant, extension, or renewal of loans.
- Minimal efforts in securing repayments despite default risk.
- Failure to recognize and provide for bad debts.
- Significant impairment of loan receivables.

Regulators' recent enforcement actions

According to the HKEX's statistics in the Enforcement Bulletin, in the second half of 2023, the HKEX issued 14 public disciplinary actions, among which director unsuitability statements were made against 12 directors, and prejudice to investors' interests statements were made against eight directors. These cases commonly involved the failure of directors and governance professionals of listed issuers to take proactive steps to safeguard the issuers' assets.

In 2024, the HKEX continued its enforcement efforts and took disciplinary actions against the misconduct of listed issuers and directors for breaches of the Listing Rules involving lending practices. Some recent related sanctions made by the HKEX include:

- On June 17, 2024, the HKEX imposed public censures against three former executive directors and an independent non-executive director of Enviro Energy International Holdings Ltd (with the four individuals also separately receiving a director unsuitability statement or a prejudice to investors' interests statement in view of their personal involvement and conduct).² This case related to questionable loan arrangements, including certain unauthorized loans and a guarantee involving the former executive directors that constituted major and/or connected transactions that did not comply with the requirements under Chapters 14 and 14A of the Listing Rules. There were also serious issues of internal control deficiencies, conflicts of interest of directors, delayed or

Post-loan stage

- Insufficient internal controls for continuous monitoring of repayments and loan portfolios (even in light of changes in circumstances and risk factors).
- Repeated renewal, extension, or rolling-over of loans on identical terms despite unsatisfactory repayment status and without legitimate commercial reason.

Recovery stage

- Insufficient internal controls to promote and require recovery actions.

² HKEX's Statement of Disciplinary Action against Four Former Directors of Enviro Energy International Holdings Ltd (Stock Code: 1102) dated June 17, 2024 (https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Disciplinary-and-Enforcement/Disciplinary-Sanctions/2024/240617_SoDA.pdf).

nondisclosure of price-sensitive information by the issuer, and a disregard for a series of red flags arising from irregular board activities.

- On August 27, 2024, the HKEX imposed public censures against Brilliance China Automotive Holdings Limited and three of its former executive directors (who separately received a director unsuitability statement or a prejudice to investors' interests statement in view of their personal involvement and conduct). The case involved financial assistance exceeding RMB 53.4 billion (including guarantees, deposit pledges, and fund transfers) being provided by subsidiaries of the issuer to the controlling shareholder of the issuer (and its subsidiaries). The issuer failed to comply with the requirements for announcement, circular, and shareholders' approval under Chapters 13, 14, and 14A of the Listing Rules for these transactions, and the former directors also failed to discharge their fundamental directors' duties. In particular, the former directors were each involved in the relevant financial assistance arrangement to varying degrees but failed to properly escalate the matters for consideration by the issuer's board, even when legal proceedings were threatened. The former directors also held senior positions with the controlling shareholder, and there was a clear conflict of interest. The issuer suffered billions of losses as a result of the misconduct.³

Per the statistics provided by the Securities and Futures Commission's (SFC) in September 2024,⁴ out of the approximately 170 misconduct cases referred to

the SFC for investigation from 2020 to June 2024, "a good proportion" involved suspicious loan transactions, which were subsequently impaired, resulting in multibillion-dollar losses to the shareholders of listed issuers and investigations by the SFC. The related issues were also wide-ranging, including unauthorized loans or fund transfers to third parties and misappropriation of companies' assets.

Notably, the SFC has recently invoked its statutory power to suspend dealings in a listed issuer following investigations that revealed accounting irregularities and missing funds that represented over 90% of the issuer's cash and bank balances and over 45% of its net asset value in its published financial results for the past four years to protect the interest of the investing public.⁵

It is therefore, notable that suspicious fund flows, loans, and lending arrangements of listed issuers continue to be among the most heavily scrutinized areas by Hong Kong regulators and are identified as a major area of weakness in internal controls.

We also observe an increasing trend for regulators to join forces in their enforcement efforts, notably in terms of cross-referrals for parallel investigations and the sharing of investigation findings and evidence, which enables swifter disciplinary outcomes against wrongdoers.

In April 2024, the HKEX and the SFC collaborated in taking enforcement action and securing a disciplinary outcome by the HKEX against China Ecotourism Group Limited and its seven current and former directors.⁶ Having reviewed the issuer's annual results, the HKEX

3 HKEX's Statement of Disciplinary Action against Brilliance China Automotive Holdings Limited (Stock Code: 1114) and Three Former Directors dated August 27, 2024 (https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Disciplinary-and-Enforcement/Disciplinary-Sanctions/2024/240827_SoDA.pdf).

4 Speech titled "Sound Corporate Governance as Bedrock for Quality Listing Market" delivered by Ms Julia Leung, Chief Executive Officer of the SFC, at the Hong Kong Chartered Governance Institute's 14th Biennial Corporate Governance Conference on September 20, 2024 (<https://www.sfc.hk/-/media/EN/files/COM/Speech/HKCGI-14th-Biennial-Corporate-Governance-Conferencespeech-published-versionEng-20-Sep-final.pdf?rev=a178d18e9935418fa0475bb224c31ee7&hash=A8EDEFB8D589901F4D49F56931F795DC4>).

5 See the SFC's enforcement news titled "SFC suspends dealings in Tianyun International Holdings Limited shares over massive missing corporate funds" dated April 15, 2024 (<https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=24PR67>).

6 HKEX's Statement of Disciplinary Action against China Ecotourism Group Limited and Seven Directors dated April 25, 2024 (https://www.hkex.com.hk/News/Regulatory-Announcements/2024/240425news?sc_lang=en) and the SFC's enforcement news titled "SFC and HKEX collaborate in enforcement action against Main Board-listed company over dubious investment and financial arrangements" dated April 25, 2024 (<https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=24PR76>).

was alerted to the issuer’s substantial impairments related to, inter alia, various loans. Upon the HKEX’s referral, the SFC’s further investigation revealed that the loan proceeds and other payments were in fact, made to individuals and entities related to two former executive directors. It was found that the issuer failed to put in place adequate internal controls to protect its assets and ensure compliance with the relevant Listing Rules. Further, the issuer had failed to comply with the Listing Rules requirements for seeking shareholders’ approval, publishing announcements and circulars, and making relevant disclosures with respect to the transactions, and the directors had breached their directors’ duties and undertakings. As a result, the HKEX criticized the issuer, censured four of the former and current directors, and imposed prejudice to investors’ interests statements against the other three former and current directors. While the HKEX has imposed sanctions against the relevant parties, the SFC’s investigation remains ongoing and it may take further enforcement action.

This case demonstrates the regulators’ collective commitment to combat corporate misconduct and promote a robust corporate governance culture for the protection of investors. The regulators are also becoming more synchronized in deploying their respective investigation powers to more effectively secure actionable evidence for enforcement action. The greater strategic coordination in their investigation approach will allow the regulators to better detect and impose disciplinary measures against misconducting parties and take action against the misappropriation of issuer’s assets.

Conclusion

The use of company assets by listed issuers is subject to ongoing surveillance and close scrutiny by regulators, and any failure in safeguarding such assets will likely result in possible enforcement actions against not only the listed issuers but also directors and governance professionals.

Notably, it is observed that the HKEX would investigate suspicious arrangements notwithstanding there being apparent compliance with the relevant disclosure and approval requirements under the Listing Rules. Significant overdue debts, material asset impairments, and questions raised by auditors concerning lending arrangements (e.g., lack of an audit trail showing proper internal approvals and evidence of transfers) will continue to be key indicators that may trigger scrutiny from the HKEX.

Aside from the HKEX taking a close interest in the lending practices of issuers, the SFC and the Accounting and Financial Reporting Council are monitoring their conduct and practices concurrently. Therefore, any noncompliance with the requisite requirements may result in parallel investigations followed by multiple disciplinary actions and sanctions in the prevailing regulatory environment.

Listed issuers, their directors, and governance professionals are strongly recommended to maintain the highest standards of corporate governance when handling loans and lending arrangements, including by:

- Putting in place written policies on approvals of loans;
- Reviewing and updating existing internal controls policies on a regular basis to ensure their adequacy and effectiveness;
- Keeping a list of connected parties for monitoring compliance with the Listing Rules;
- Exercising vigilance in considering and vetting all lending transactions and arrangements; and
- Maintaining proper relevant records and documentation of all compliance steps taken by the issuer and the directors.

In particular, newly listed issuers that have acquired a substantial war chest from investors after a successful initial public offering (IPO) should be especially mindful of the proper handling of the IPO proceeds, and any contemplated lending arrangements using such proceeds should adhere to the Listing Rules requirements.

All directors, including independent non-executive directors, should be mindful of their individual and collective responsibilities in ensuring the listed issuer's Listing Rules compliance and maintaining the highest corporate governance standard in order to prevent potential losses to shareholders and public investors. Any failure to do so would lead to investigations and possible sanctions, as well as possible civil actions to be taken by the SFC and shareholders for losses incurred as a result of the misconduct.

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