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APERCU

CONTENTS

THE MONEY LAUNDERING CYCLE

The Financial Action Task Force (FATF) is an inter-government anti money laundering (AML) body comprising 34 member jurisdictions and two regional organisations. The primary objective of the FATF is to combat money laundering activities through the establishment of international AML standards and frameworks.

Money launderers are creative, sophisticated and well-networked. They design, evolve and comingle new money laundering techniques in thousands of different forms frequently. Studying and researching these new methods and developing new AML procedures are definitely one of the most difficult tasks of FATF.

Typically, a complete money laundering cycle has three stages. Although money laundering methods emerge in different forms, they are always based on these three stages.

Nevertheless, "Know Your Enemies" is the underlying principle.

Placement stage

Crime is big business which generates large amounts of cash.

After evading the police, the next question money launderers ask is how to hide away the load of illicit cash. This kicks off the first stage of the money laundering cycle – placement – which is about injecting cash into the financial system in the least suspicious manner.

The traditional placement method is direct cash deposit into financial institutions (eg banks and securities firms). In order to get around the algorithm of AML transaction monitoring systems, money launderers usually break down the cash deposits into small amounts, so that they can go under the detection thresholds of AML systems, such as the US$10,000 rule which requires banks to file AML reports of cash transactions over US$10,000 to the authorities under the US Bank Secrecy Act.

This technique is simple, but immature. It takes a rather long period of time to process all the small-amount transactions. In addition, the illicit money is scattered among different bank accounts held by different dummies whose number has limit. In the long run, evolving algorithms of AML systems are able to recognise such deposit patterns.

"Comingling with clean funds" may be a more effective placement method. Money launderers can place illicit cash into financial systems by assimilating it into their legitimate cash businesses, such as pubs, restaurants and retail stores, and by such means comingle the illicit money with clean funds earned from the business.

Operationally, these comingled funds can be injected as sales proceeds during peak business seasons which "apparently" justify the increase of sales and related cash deposits. Strategically, money launderers operate different money-washing businesses, close them down on a rotational basis and re-establish them in another form in order to remove unexplainable patterns and trails.

In the course of this, the books of these businesses are closed and audited in the normal way and, on that basis, taxes are paid as a small cost of washing money. This could be one of the reasons why the suspicious transaction reporting duty under AML law in many jurisdictions is now extending beyond financial sectors to professional regimes, such as lawyers and accountants.

Layering stage

Once illicit funds enters the financial system in the placement stage, money launderers then create a large number of financial transactions in order to disassociate the funds from its illicit sources. This is the second stage – layering – which is usually featured by:

1. Moving funds around the globe in order to stop local authorities from tracing trails at their borders;
2. Engaging in financial instruments trading which hides the unusual trading patterns in transaction pools of extremely high volume;
3. Using different dummies in each transaction to conceal the original illicit sources.

Figure 1 demonstrates a simple web of transactions and it can go on and on until money launderers are comfortable about the level of disassociation from the original illicit sources.

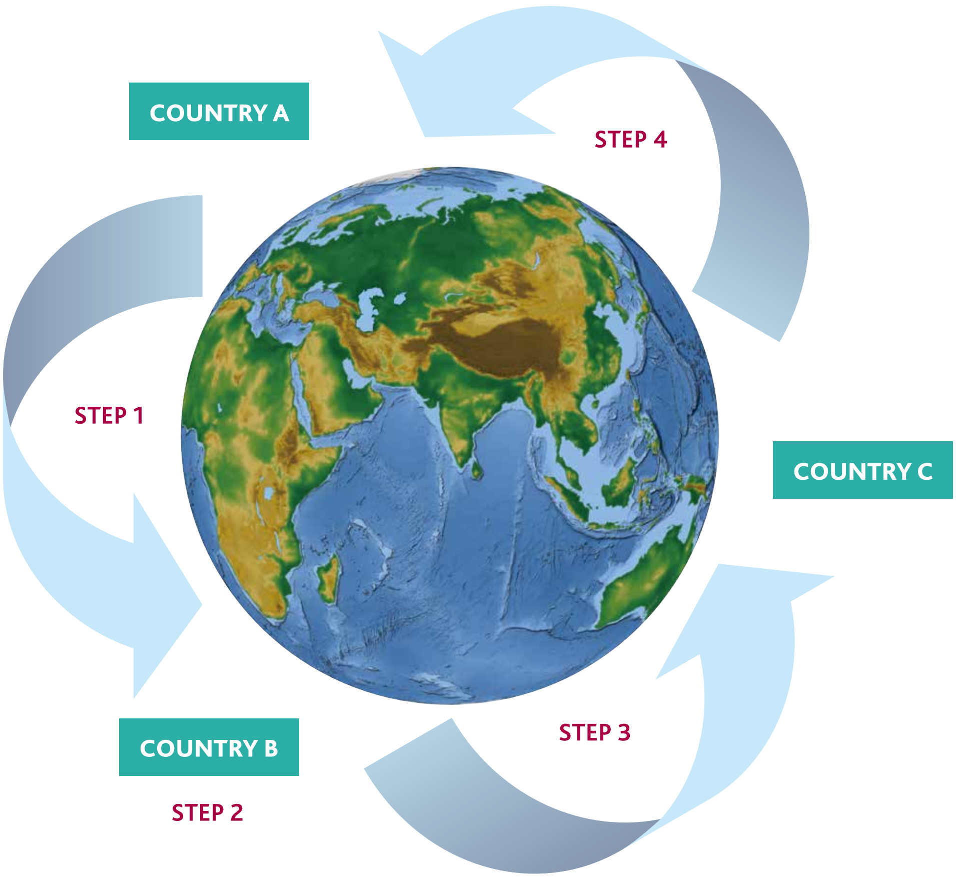
In layering stages, it is difficult to distinguish a normal transaction from one conducted by money launderers unless the whole chain of transactions is presented. In fact, this is the whole purpose of layering.

Integration stage

After trails are substantially removed in the layering stage, money launderers need to reunite with the washed money and return it to themselves as if it is from legitimate sources. This is the ultimate objective and final stage of the money laundering cycle – integration.

Traditionally, integration is achieved through dealing in high-value items, such as properties and antiques whose subsequent sales would return legitimate proceeds. In less developed areas, such transactions can even be facilitated by corrupt professionals, eg accountants and lawyers as perfect "witnesses" endorsing the legitimacy of the fund source. This kind of integration technique is usually applied locally.

Figure 1



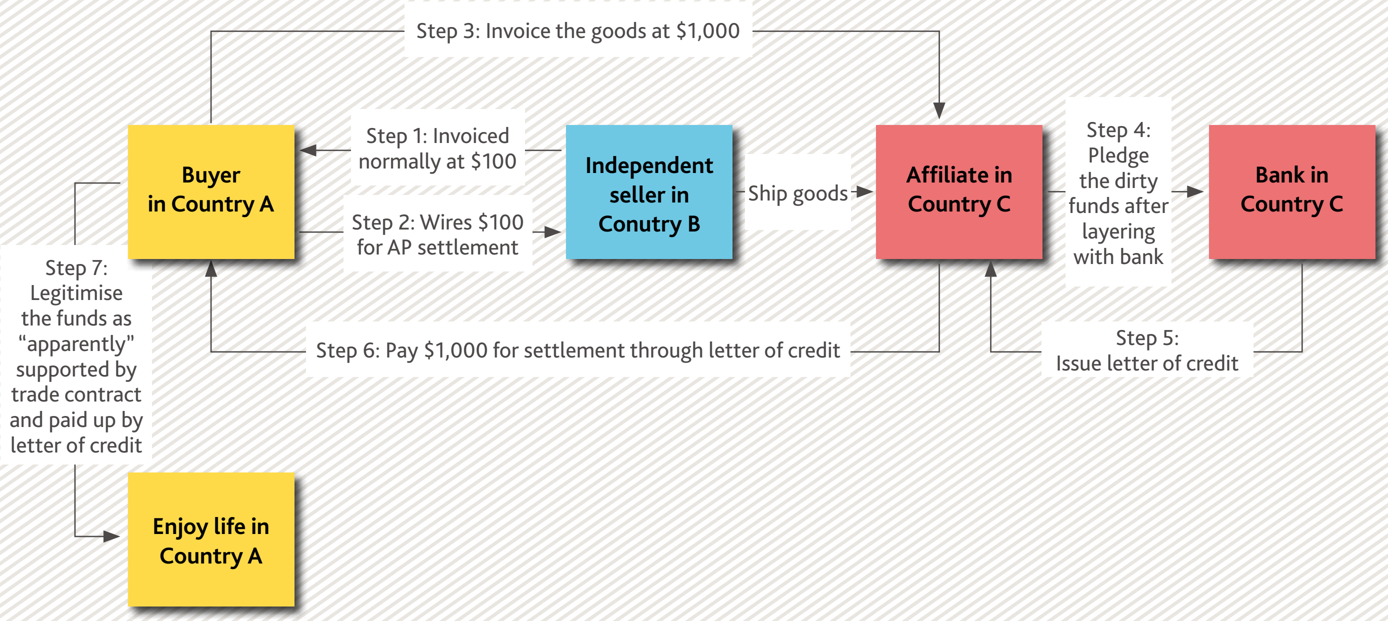
Step 1:
- A listed company director engaged in insider dealing wires his funds from the US to HK. (Let's say)

Step 2:
- The proceeds are used to buy some stocks in HK.
- The shares are transferred to Dummy X which pays some stamp duty to legitimise the trade.

Step 3:
- Dummy X sells the shares.
- A loan arrangement is entered into with Dummy Y which justifies the related fund transfer in another country.

Step 4:
- Dummy Y transfers the funds back to Country A as capital injection of a company held by Dummy Z on behalf of the listed company director.
- "Dizzy enough? Let's loop again." said Money Launderers.

Graph 2



Trade-based money laundering (TBML) is one of the most complex and increasingly important method of bringing together the illicit funds and legitimising it through the use of international trade, according to a study of the FATF in 2006. It is estimated that hundreds of billions of dollars are laundered through TBML globally.

The key element of a basic TBML model is misrepresentation of trade prices.

Over-invoicing
Make falsified international trade of "apparently" high-valued products and over-bill the amount; hence claim the proceeds in the seller's country to be legally earned profit.

Under-invoicing
Make falsified international trade of "actually" high-valued items and under-bill the amount; hence transfer the profit to the buyers' country in which the items will be resold at a high margin as legally earned profit.

Graph 2 depicts the basic operation of TBML where the key notes are:

1. The illicit funds originate and are maintained in Country C;
2. Buyer in Country A enters into international trade with seller in Country B in the normal course of business. Shipment is instructed and made to affiliate in Country C;
3. Buyer in Country A enters into another trade contract with affiliate in Country C and re-invoices the goods at an inflated price of $1,000. The funds are legitimised and channelled to Country A through letters of credit.

This case demonstrates that TBML (buyer in Country A and affiliate in Country C) can be processed through paper work only and requires no costs of operation.

Some red flags of TBML are:

1. Significant deficiencies between the description of the traded items on the bill of lading and the invoice;
2. Significant deficiencies between the description of the traded items on the bill of lading (invoice) and the actually shipped goods;
3. Significant deficiencies between the reported value of traded items and the fair market price;
4. The volume of trade is inconsistent with the scale of operation or size of capital of exporters/importers;
5. Settlement by unrelated third parties.

It is difficult to tackle TBML because it requires meaningful statistical analysis built on a strong international trade database. Internationally, many countries are starting to establish a function generally called "Trade Transparency Unit" for conducting ongoing comparison analysis and exchanging trade data. Yet, it will take a while to see the effectiveness of such programmes.

For further enquiries about Anti-money laundering standards and programmes, please contact our Director and Head of Risk Advisory Services, Mr Patrick Rozario on (852) 2218 3118 or patrickrozario@bdo.com.hk

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VALUATION OF FINANCIAL INSTRUMENTS

Employee Share Option Plan, valuation and practical applications and issues

Part II - Practical applications

As introduced in the last issue, the Black-Scholes Merton Option Pricing Model (Black-Scholes), Binomial Option Pricing Model (Binomial) and Monte-Carlo Simulation Model (Monte-Carlo) are the most extensively used methods for determining the fair value of employee share option plans (ESOPs).

In theory, these three methods should produce the same valuation for an ESOP. However, each of them may have specific advantages over the other two when valuing ESOPs that have particular terms or features. Valuation specialists must therefore be careful to choose the most appropriate method to value an ESOP.

The following section provides a few examples that highlight various practical applications of the three valuation methods. The first two cases outline key assumptions and issues that a valuation specialist will come across when valuing an ESOP. The third case presents a brief introduction to the application of Monte Carlo to value a warrant with exotic features. Although such features are unusual in an ESOP, the case shows how Monte-Carlo can model them effectively and flexibly, especially since the contractual terms of ESOPs and many other financial instruments have evolved over the years.

CASE 1 (ESOP OF A LISTED COMPANY)

Situation:
A small listed company is considering rolling out an ESOP for employees at different levels. It plans to set the exercise price at a relatively high level. The ESOP itself consists of complex market-based vesting with a long maturity period. It has been provisionally valued using Black-Scholes.

Points to note about the valuation:

1. An underlying assumption of the Black-Scholes model is that the option may only be exercised at one particular time, without the flexibility of variable exercise dates. Therefore, although it is a generally accepted method for valuing share options, Black-Scholes may not be the best way to model this type of ESOP, given its market-based vesting feature. Either the Monte-Carlo or Binomial methods would be more appropriate.

2. Employees at different levels will probably be slotted into tranches with different vesting periods. Hence the valuation model should separate the options into these different tranche vesting periods and prepare a separate valuation for each tranche.

3. If available, records of all previous employee option exercise transactions should be requested for use in estimating the early exercising behaviour of groups of employees at different levels.

4. Post-vesting termination rates (sometimes referred to as exit rates) should be considered in the valuation. Since a vested option may only be exercised for a certain number of days after the termination of employment, the maturity of an ESOP is truncated upon the termination of employment. Historical records of the exercise behaviour of terminated employees – if any – can be used for analysis. Even so, this may not be easy, given that the changing value of options may influence the behaviour of employees.

   A post-vesting termination rate will usually lower an option's value, since it represents an early exercise if the option is at-the-money at the time of termination, or zero value (forfeiture) if it is out-of-the-money at that time. It is also worth noting that HKFRS 2 does not permit consideration of pre-vesting termination rates in option valuation models.

5. It is often a good idea for a company to consult a valuation specialist for advice about estimating the overall impact on the Company's financial results before it drafts actual ESOP terms and agreements.

CASE 2 (ESOP OF A PRIVATE COMPANY)

Situation:
A successful private company has been busy with buyouts and restructuring during the past few years. It is considering an IPO at the end of the year, and it plans to issue share options to certain key management staff, but with terms and conditions that include a restricted period for exercising options or selling shares once they have been exercised. The company's directors have requested a preliminary assessment of the pre-IPO share option valuation to be conducted.

1. Since the company's shares are not publicly traded, two of the six key inputs required by option pricing models, namely the spot price and volatility, are not available. A business valuation would be required to assess the company's theoretical share price as at the valuation date. In general, models of Discount-Cash-Flow or Market-Approach can be used to derive the business value and share price.

2. The volatility of the share option has to be estimated, as mentioned above. In practice, comparable listed companies would be selected, and the average historical volatility of their share price would generally be used as a proxy for the share price of the company. The degree of comparability of the selected companies is crucial in this exercise.

3. Based on the terms of the restricted time period, an illiquidity discount on the option value would be required to reflect such restrictions. In practice, an at-the-money put option, which by its nature is the very option the ESOP grantees would lose if they sell their shares, is one way to estimate the discount for the restrictive features.

4. Another key consideration is the dilution effect created by issuing new shares under the ESOP scheme. The dilution effect of an ESOP on a company that is already listed might not be accounted for, because a valuation specialist may consider that the market price of the listed company should have efficiently incorporated any dilution effect immediately after a public announcement of the ESOP was made, and making a separate adjustment would duplicate this dilution effect. However, whether to make an adjustment for the dilution effect should be considered on a case-by-case basis.

   In this case, the valuation is a pre-IPO assessment, and there are no market prices for the company's shares, thus no dilution effect can already be reflected in them. A dilution effect should therefore be considered during the valuation.

CASE 3 (FINANCIAL INSTRUMENT WITH A PATH-DEPENDENT FEATURE)

Situation:

A fast-growing listed company (share price (S) as at 1 Jan 201X: HK$1.0) is principally engaged in the Hong Kong retail sector. It is currently planning to expand its distribution network to the PRC, and formulating its financing plan. Instead of using direct equity financing, the company has decided to issue a loan with a detachable warrant to finance the project.

The time-to-maturity of the warrant is three years, and it is exercisable throughout the life at a strike price (K) of HK$1.10. In addition, the warrant has the exotic feature that its holder will be forced to exercise the warrant or it will expire if the closing price of the company rises above HK$1.50 for any 15 consecutive trading days prior to the scheduled expiry of the warrant period (Early Expiry Feature).

The markets react positively to the company's announcement of its business development plan in the PRC, and its share price increases significantly following the issue of the warrant.

1. As the warrant contains the Early Expiry Feature, the warrant holder would be compelled to exercise the warrant if the price of the company's common shares closes at above HK$1.50 for a period of 15 consecutive trading days.

   This feature would yield a lower warrant value compared to one without the Early Expiry Feature, as the "upside potential" of the warrant's value has been capped. Obviously, the value of the warrant would be affected by the closing price movement of the company's shares, and this would create a path-dependent issue in the warrant valuation.

   The exotic path-dependant feature would mean that it may not be possible to value the warrant using the close-form Black-Scholes method, as this formula has no flexibility for such purposes. And although the Binomial method provides flexibility for special features, including early exercise, its lattice tree structure generally cannot model path-dependent features, such as the Early Expiry Feature. In such a case, Monte Carlo appears to be the most appropriate valuation method.

2. The first step in applying Monte Carlo is to simulate the share price. In general, the future share price of the company is simulated on the basis that the share price will follow a "random walk" movement, in which no prediction of the company's future share price is possible. The formula used to simulate the share price is as the right hand side:

   The time horizon of the simulation, in this case three years, is divided into n steps (t = 1, 2, 3,…n, for n step in each path) and the share price is simulated at each step on the basis of the above equation. This simulation is repeated numerous times until sufficient paths have been obtained.

$$dS_t = S_t \mu d_t + S_t \sigma dW_t$$

S_t = Stock price
dS_t = Change of stock price
μ = Drift
d_t = Time step
σ = Volatility
dW_t = Wiener (Brownian motion) with Gaussian distribution $dW_t \cong N[0,1]\sqrt{d_t}$
$St\mu d_t$ = Drift, deterministic trend
$St\,\sigma dW_t$ = Shock, uncertain event

3. For each share price path, based on the simulated share price, the intrinsic value (intrinsic value = S_t – K) at each node can be calculated accordingly.

   In general, when Monte Carlo is used to value a plain vanilla European option, the intrinsic value in the last node of each path is discounted back to t = 0 through a backward induction process, and the option value is derived by averaging the discounted values of the numerous simulated paths.

   Simple Monte Carlo cannot be directly applied to value American-type financial instruments, such as a warrant in this case, because of "foresight bias". Foresight bias means that, during the backward induction process, the holder has known the subsequent share price movement of the company when making the early exercise decision. This is not predictable in reality, and it therefore leads to an overestimation of value, as the exercise is always optimal in a backward induction.

   Various academic studies have suggested several methods to mitigate the foresight bias. The Least-Square Monte Carlo Method (LSMC) is one of the most widely used.

4. To consider the Early Expiration Feature in the LSMC, an additional rule has to be included in each node: that all the share prices in the previous 15 consecutive trading days should be checked to see whether the condition of the Early Expiration Feature has occurred (15 consecutive closing prices > HK$1.5). If this has happened, the warrant should be forced to be exercised at the current node and the value at subsequent nodes along the price path should become zero.

5. If the Early Expiration Feature condition is not met and the warrant is not exercised during its lifetime in a particular path, then its intrinsic value at its maturity is discounted back to the origin (t = 0) at the risk-free rate.

6. The accuracy of Monte Carlo is highly dependent on the number of paths simulated (over 5,000 path simulations would be considered necessary to obtain accurate results). The higher the number of simulated paths, the more converged the simulated warrant values would become. The whole Monte Carlo process is very time consuming to produce, and a valuation specialist will then need to apply a trade-off between time consumption and computer power and the accuracy of the result.

Conclusion

We have introduced the methods commonly used in ESOP valuations and highlighted the major issues that a valuation specialist and accountant should pay attention to. However, even if the abovementioned issues have been considered during the valuation process, an inaccurate input or an inadequate method of modelling the features could result in the valuation deviating substantially from its true theoretical value.

As the terms of the ESOP or other financial instruments could be considerably different, there is no general guideline that can be applied to all valuations, and each valuation should be evaluated on a case-by-case basis. Valuation specialists should be consulted for their professional expertise and judgement during the valuation, to ensure that an appropriate valuation methodology is used, and that the parameters adopted in the valuation are adequate and sufficiently supported.

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BDO SUPPORTS THE CHAMBER OF HONG KONG LISTED COMPANIES (CHKLC) DIRECTOR TRAINING SERIES 2014


香港上市公司商會
THE CHAMBER OF HONG KONG LISTED COMPANIES

CHKLC DIRECTOR TRAINING SERIES 2014

A six-part training programme aiming at supporting directorship in Hong Kong

Programme Partner: BDO Limited

Dates: 2 April 2014 | 27 May 2014 | 24 June 2014 | 17 July 2014 | 8 October 2014 | 5 November 2014

Company directors play a pivotal role in company success. With the increasing demand of corporate governance of listed companies both from the regulators and shareholders, coupled with the tightening of various sets of rules and regulations with more serious consequences, company directors operate in an increasingly challenging environment. Once again, the Chamber of Hong Kong Listed Companies is launching a training programme for company directors. Addressing the common issues faced by directors, the programme will equip directors with the most relevant information and updated knowledge about directorship and will help them discharge their duties effectively.

The whole programme comprises six sessions dealing with the important aspects of directorship for a listed company. These range from corporate governance, risk management to the latest updates in various applicable rules and laws. Experienced professionals as well as directors from listed companies will act as speakers to share their knowledge and first-hand experience, ensuring the practical value of this training programme. Attending this training series will fulfil the training requirements under the revised Code of Corporate Governance by the HKEx.

The Chamber is pleased to partner with BDO in offering this programme whose involvement ensures the relevance of the topics covered and adds depth to the discussion.

Time	4:00 pm Registration 4:30 – 6:30 pm Course Session
Venue:	BDO Limited 25/F, Wing On Centre, 111 Connaught Road Central, Hong Kong
Language:	English
CPT	Total 12 CPT Hours

REGISTRATION

	Full Course	Per Session
CHKLC Members / BDO Clients & Contacts	HK$2,980	HK$580
Non-members	HK$3,480	HK$680

Enquiry: CHKLC Secretariat ☎ (852)2970 0886 (852)2970 0555 @ info@chklc.org
Online Registration: http://www.chklc.org/web/eng/events.htm

BDO supports the CHKLC Director Training Series for the fourth consecutive year. Running from April to November, the programme will address the common issues faced by directors and equip directors with the most relevant information and updated knowledge about directorship and will help them discharge their duties effectively.

BDO Director **Patrick Rozario**, Senior Managers **Eric Zegarra**, **Hermes Liang** and **Jason Wong**, Managers **Effie Tang** and **Vivian Chow** are among the speakers on important aspects of directorship in listed companies for the Series.

The first session "Corporate governance update and business review reporting requirement under new Companies Ordinance" by Eric Zegarra and Vivian Chow took place at BDO's premises on 2 Apr 2014.

The second session "Listing Rules update on connected transaction and inside information disclosures" by Patrick Rozario was held on 27 May 2014.

The third session "Annual Update on Listing and Related Rules and Regulations" was held on 24 June 2014.

The fourth session "Notifiable Transactions, Reverse Takeover, Spin-off, Model Code for Securities Transactions by Directors of Listed Issuers and Disclosure of Interest" was held on 17 July 2014.

The schedule and topics for the two forthcoming sessions are shown below.

Date	Topic
8 October 2014	Uprising Anti-Money Laundering Compliance Requirements and Hidden Pitfalls in China and Hong Kong
5 November 2014	Social Media Risk Management

BDO GLOBAL NETWORK DEVELOPMENT AT A GLANCE

BDO REACHES HIGHEST EVER RANKINGS IN MID-MARKET GLOBAL M&A

BDO has become a global top five M&A advisor for the first time according to the latest league tables issued by Thomson Reuters. The data, which tracks deals worth up to US$500 million, attributes 214 deals to BDO during 2013 – up from 167 the year before when the network was ranked at number 13.

The jump in rankings places BDO just behind some of the Big Four accountancy firms and Goldman Sachs, the investment bank, and ahead of firms such as Rothschild and Lazard.

This result is testament to our status as a leading M&A advisor to mid-market companies, private equity funds and entrepreneurs all across the globe.

BDO REPORT - THE FINANCIAL COST OF HEALTHCARE FRAUD 2014

The world is losing some US$487 billion to fraud and error annually according to a new report "The Financial Cost of Healthcare Fraud 2014" from BDO LLP, the accountancy and business advisory firm in partnership with The Centre for Counter Fraud Studies at the University of Portsmouth.

The report, one of the most detailed in the world, collates data from a total of 92 loss measurement exercises covering 14 different types of healthcare expenditure totalling over US$2.99 trillion (£1.93 trillion) over 15 years. The findings show that global average losses within the healthcare sector have, since 2008, risen 25% to 6.99%. When taken as a proportion of global healthcare expenditure of US$6.97 trillion (£4.48 trillion) this equates to US$487 billion (£313 billion) lost in a year equivalent to:

- More than three times the UK NHS budget for 2011/12;
- Two and a half times the total healthcare expenditure of Canada for 2011;
- Almost one fifth of the US total healthcare expenditure for 2011 and more than 27% of European Union countries total healthcare expenditure for the same period.

BDO ANNOUNCES APPOINTMENT OF A NEW MEMBER FIRM IN BANGLADESH

BDO is pleased to announce the appointment, effective 1 June 2014, of Nurul Faruk Hasan & Co, Chartered Accountants, including Business Consulting Services, as its new member firm in Bangladesh. Previously part of the RSM network, the new BDO Bangladesh evolved as major market player in the country within a very short space of time, with a team of 100 partners and staff members under the leadership of Nurul Haque.

BDO Bangladesh delivers accounting, auditing, financial advisory and taxation services. Focusing on audit, accounting and tax, the firm's full service offering also includes corporate finance, forensic accounting, investment advisory, IT consulting & audit services, together with other advisory services. Their impressive client list includes a majority of multinational companies and international organisations. The firm is particularly strong in the manufacturing, telecommunications and development sectors.

NEW COMPANIES ORDINANCE (CHAPTER 622)

The new Companies Ordinance (Chapter 622) (CO) consists of 921 sections and 11 schedules. It took effect on 3 March 2014, apart from its provisions relating to the restricted disclosure of residential addresses of directors and full identification numbers of individuals, and the scripless regime.

While the essence of most of the provisions in the previous Companies Ordinance remains the same, these have been completely rewritten and rephrased in more modern and easily understandable language.

The new CO has also introduced various changes, but it contains deeming provisions to ensure a smooth migration to the new regime for existing companies. These effectively deem that some existing regulations and provisions were deleted or modified when the new CO came into effect.

The new CO also introduces initiatives that Hong Kong companies may choose to follow if they wish. These are mainly intended to enable their management to operate in a more efficient and modern way. Existing Hong Kong companies may elect to continue to be managed in their current way under the provisions of their articles of association. However, to enjoy the benefits of new initiatives, companies will need to amend their articles of association.

Besides provisions affecting the corporate constitutional document, there are changes to the structure, reporting and record-keeping of Hong Kong companies. These must be followed by all companies.

A summary of the major changes is as follows:

Enhancing corporate governance

- Every private company is required to have at least one natural person to act as a director;
- The directors' duty of care, skill and diligence was codified;
- A comprehensive set of rules for proposing and passing a written resolution has been introduced;
- The threshold requirement for members to demand a poll is reduced from 10% to 5% of total voting rights;
- Public companies, larger private companies and guarantee companies are obliged to prepare more-comprehensive directors' reports that include an analytical and forward-looking "Business Review", whereas private companies are allowed to opt out of this provision by special resolution;
- More-effective rules have been established to deal with directors' conflicts of interests, including an expanded requirement for shareholders' approval concerning the employment contracts of directors that exceed three years; and
- The disinterested shareholders' approval is required to ratify director misconduct.

Ensuring better regulation

- The Registrar is empowered to compound specified offences in order to optimise the use of judicial resources;
- Through a new definition of "responsible person", the enforcement regime in relation to the liabilities of officers of companies that contravene the provisions of the new CO has been strengthened by a lower threshold for prosecuting a breach or contravention of these, and it has been extended to cover reckless acts;
- All guarantee companies are required to file annual returns with financial statements, and an escalating scale of annual registration fees for the annual returns of guarantee companies has been introduced to encourage timely compliance with statutory filing requirements; and
- A certified copy of the charge instrument must be registered and available for public inspection, in order to provide more-detailed information to those searching the register.

Facilitating business operations

- Companies are allowed to dispense with annual general meetings by unanimous shareholders' consent;
- An alternative court-free procedure based on a solvency test has been introduced for reducing capital;
- All types of companies are allowed to purchase their own shares out of capital, subject to a solvency test;
- All types of companies may provide financial assistance to another party for the purpose of acquiring the company's own shares or the shares of its holding company, subject to a solvency test;
- Eligible small private companies may prepare simplified financial and directors' reports;
- The use of a common seal has become optional, and the requirement for a company to have an official seal for use abroad has been relaxed; and
- A general meeting may be held at more than one location, using electronic technology.

Modernising the law

- A mandatory system of no-par for all companies with a share capital has been adopted;
- The requirement for companies to have a memorandum of association has been abolished, and current provisions in the memorandum of association, except those that have been abandoned or abolished under the new CO, will be deemed as provisions in the articles of association; and
- The power of companies to issue share warrants to bearers has been removed.

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RECENT AMENDMENT TO LISTING RULES RELATING TO CONNECTED TRANSACTIONS

Disclosure of connected transactions is one of the key obligations of Hong Kong listed companies under the Hong Kong Stock Exchange Listing Rules (the Listing Rules). In the first quarter of 2014, The Stock Exchange of Hong Kong Limited (the Exchange) concluded two consultations and released amendments to the connected transaction requirements and rules. The amendments became effective on 1 July 2014.

In this article we outline the key elements contained in the amendments and recent publications of the Exchange.

OVERVIEW OF AMENDMENTS

The purpose of the 2014 amendments to Main Board Listing Rules Chapter 14A related to connected transactions is to simplify and improve the clarity of the Listing Rules while maintaining the same level of investor protection. The amendments, which became effective from 1 July 2014, include:

- Changes to the existing rules on connected transactions set out in Chapter 14A;
- Changes to the definitions of "connected person" and "associate" in Chapter 1 to distinguish them from those used in Chapter 14A and alignment of the definitions of "connected person" and "associate" in other parts of the Listing rules with those used in Chapter 14A.

HIGHLIGHTS OF THE AMENDMENTS

1. Plainer language

Chapter 14A is revised in plainer language with diagrams and examples. Basically, it replaces the Guide on Connected Transaction Rules published by the Exchange in April 2012.

2. Relaxed requirements for persons connected at subsidiary level

a. Transactions between the issuer's group and connected persons at subsidiary level will be exempt from the circular and shareholders' approval requirements if the transaction is on normal commercial terms, approved by the board and include the independent non-executive directors' (INEDs) view that the terms of the transaction are fair and reasonable and they are in the interests of the issuer and its shareholders as a whole.

PRIMARY REGULATION

*Main Board Listing Rules Chapter 14A** contains the rules governing connected transactions. It sets out the disclosure and shareholders' approval requirements for connected transactions, being transactions between the issuer (or its subsidiaries) and any connected persons. The purpose of the rules is to ensure that the interests of minority shareholders are protected.

In general terms, the spirit of Chapter 14A is that all transactions with connected persons require an announcement, a circular and independent shareholders' approval (together with an annual review by independent non-executive directors (INEDs) and auditors and reporting if the transactions constitute continuing connected transactions (CCTs)), unless one of the de minimis or other exemptions apply. The shareholders who can vote on the transaction exclude connected persons, any person falling within the extended definition of a connected transaction and their associates, and any other shareholder, to the extent that such person has a material interest in the transaction.

** The equivalent GEM Listing Rules are in Chapter 20.*

b. Persons connected with "insignificant subsidiaries" of the issuer will be exempt from definition of connected person, rather than exempting transactions with these persons.

3. Exemption for trustee interest

A trustee of an employees' share scheme or occupational pension scheme established for a wide scope of participants will no longer be considered an "associate" if the connected persons' total interests in the scheme are less than 30%.

4. Modified exemption for interest in an associate held via the issuer

The definition of "associate" excludes a 30%-controlled company if the connected person's interest in the company is only held via the issuer. This exemption is modified such that a 30%-controlled company will not be considered an "associate" only if the connected person and his associates together hold interests of less than 10%, other than those held via the issuer.

5. Acquisition/disposal of interests in a target company of which the controller is a substantial shareholder

The acquisition/disposal of interest in a target company between the issuer and a third party involving a controller, who is a director, controlling shareholder or chief executive of the issuer and any of its subsidiaries, are connected transactions under the existing rules. The new rules simplify this situation and exclude the following transactions from the scope of connected transaction:

a. Disposal of interests in a target company to a third party; or
b. Acquisition/disposal transactions involving a controller at the subsidiary level.

6. Broadened monetary limits for de minimis exemption

The monetary threshold, below which connected transactions are fully exempt from all connected transaction requirements, is increased to HK$3 million, provided that transactions are on normal commercial terms and do not involve issue of new securities by the issuer to connected persons.

7. Relaxed condition on consumer goods/ services exemption

The provision of consumer goods or services such as meals and medical services to or receipt from connected persons is fully exempt from all connected transaction requirements, with the removal of the 1% cap on the transaction value.

8. Directors' indemnity/insurance

The provision of directors' indemnity and directors' liabilities insurance is exempt from all connected transaction requirements, provided that the liabilities are incurred in the course of performing their duties and the indemnity/ insurance is allowable under the laws of Hong Kong and the place of incorporation of the company providing the indemnity or insurance.

9. Independent directors' view on transactions

For connected transactions subject to shareholders' approval, the INED's opinion on the connected transaction should also cover whether the transaction is on normal commercial terms and within the issuer's ordinary and usual course of business.

10. Auditors' annual confirmation of CCTs

The requirement regarding auditors' confirmation of continuing connected transactions (CCTs) is aligned with HKICPA Practice Note 740 such that the current practice is codified to accept negative confirmation.

OTHER RECENT PUBLICATIONS

Coupled with the rule amendments, the Exchange has published guidance on the pricing policies for continuing connected transactions (CCT) and their disclosure, as per *HKEx Guidance Letter HKEx-GL73-14 (March 2014)*. The purpose is to ensure that the terms of framework agreements of CCT are specific and measurable, and that there are adequate internal controls in place to ensure that individual transactions are indeed conducted within the framework agreement. It provides guidance on:

- Pricing policies
- Disclosure of information
- Internal controls
- INED's role
- Annual review by auditors

Also, the Exchange has published *Frequently Asked Questions Series 28* to further explain:

- The transitional arrangement relating to the application of the new exemptions available under the revised rules, both for one-off transactions and CCTs; and
- The application of the connected transaction rules in various scenarios involving the provision of financial assistance by or for the benefit of listing issuers.

USEFUL REFERENCES

Details of the regulation updates are available from the following links:

- Summary of proposals in HKEx press release of 21 March 2014: http://www.hkex.com.hk/eng/newsconsul/hkexnews/2014/140321news.htm
- Amendments to the Main Board Listing Rules: http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_contxn_index.htm
- Amendments to the GEM Listing Rules: http://www.hkex.com.hk/eng/rulesreg/listrules/gemrulesup/gem_contxn_index.htm
- Guidance letter on pricing policies for continuing connected transactions and their disclosure (HKEx Guidance Letter HKEx-GL73-14 (March 2014): http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl73-14.pdf
- FAQ Series 28: Requirements on the connected transaction Rules: http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/FAQ_28.pdf

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ALBERT AU AWARDED THE BBS

Chairman **Albert Au** was awarded the Bronze Bauhinia Star (BBS) medal by the Chief Executive of HKSAR Government on 1 July 2014 under the 2014 Honours List.

Albert is awarded the BBS in recognition of his dedicated and invaluable contributions to the Hong Kong accounting profession and the corruption prevention regime as well as for enhancing the governance of the Hong Kong Productivity Council.

BDO ASIA PACIFIC REGIONAL CONFERENCE 2014

Bringing together 130 delegates from over 30 countries, the Asia Pacific Regional Conference 2014 was hosted in Hong Kong on 10-11 July 2014 at Hyatt Regency, Shatin. The theme of this year's Conference is "Strategic execution – achieving our ambition" and focused on key initiatives to realise BDO's ambitious Strategic 2014-19 plans, which is underpinned by our vision, "To be the leader of exceptional client service".

The Conference provided the ideal arena to reflect on new drivers and avenues for growth in the region. Over 20 delegates, mostly from the Asia Pacific region, presented their ideas and best practices in applying our vision in different and motivating ways. Participants discussed key strategic initiatives, shared their ambitions and the challenges and opportunities we faced in the ever evolving landscape for professional accountants.


BDO International CEO Martin van Roekel


BDO International CEO of Asia Pacific Steven Darley


Chairman of BDO Policy Board and BDO USA CEO Wayne Berson


BDO Hong Kong Chairman Albert Au


BDO International Global Head of Clients & Marketing Allan Evans


BDO Hong Kong CEO Johnson Kong


Clement Chan, BDO Hong Kong Managing Director - Assurance (right)

FANNY HSIANG WAS APPOINTED AS A MEMBER OF THE SMALL AND MEDIUM-SIZED ENTITIES IMPLEMENTATION GROUP

Director and Head of Technical and Training Fanny Hsiang was appointed by IFRS Foundation as a member of the Small and Medium-sized Entities Implementation Group (SMEIG) for three years from 1 July 2014 to 30 June 2017.

The SMEIG is an advisory body to the IASB. Its mission is to support the international adoption of the IFRS for Small and Medium-sized Entities (IFRS for SMEs) and to monitor its implementation. One of the key responsibilities of the SMEIG is to provide recommendations to the IASB through comprehensive review of the IFRS for SMEs.

The appointments were made based both on the qualifications of the individuals and the need to achieve a professional and geographical balance in the membership of the SMEIG.

BDO NEW APPOINTMENTS

RITA LEUNG
Director
Assurance Services

Rita Leung was appointed as Director of Assurance with effect from 1 May 2014.

Rita has extensive experience in handling audit assignments of listed companies operating mainly in Hong Kong and mainland China over a wide variety of industries including manufacturing, mining, online game, real estate development and garment. Rita has also been involved in various transaction support assignments including initial public offerings and acquisitions of companies.

Rita is a Certified Public Accountant in Hong Kong.

FRANKI LUI
Director
Assurance Services

Franki Lui was appointed as Director of Assurance Services with effect from 1 May 2014.

Franki has extensive experience in handling listed company audit assignments over a wide variety of industries including retailing, luxury products, manufacturing, property development and natural resources. He also specialises in transaction support assignments, such as initial public offerings, capital market transactions and financial due diligence in acquisitions of companies.

Franki is a Certified Public Accountant in Hong Kong and a Fellow of the Association of Chartered Certified Accountants.

PETER PAK
Director
Assurance Services

Peter Pak was appointed as Director of Assurance with effect from 1 May 2014.

Peter has extensive experience in handling assignments of listed companies and private companies operating mainly in Hong Kong, mainland China and various overseas countries over a wide variety of industries including natural resources, trading and manufacturing, mass media, hospitality, infrastructure, financial and investment advisory services etc.

Peter has been involved in various transaction support assignments including financial due diligence as well as corporate mergers and acquisitions.

Peter is a Certified Public Accountant in Hong Kong and a Fellow of the Association of Chartered Certified Accountants.

RECENT BDO PUBLICATIONS

HKFRS/IFRS UPDATES

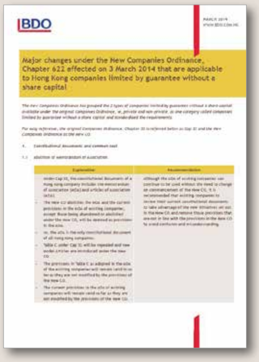
HKFRS/IFRS UPDATE 2014/07
Regulatory deferral accounts

HKFRS/IFRS UPDATE 2014/08
Clarification of acceptable methods of depreciation and amortisation

HKFRS/IFRS UPDATE 2014/09
Revenue from contracts with customers

HKFRS/IFRS UPDATE 2014/10
Accounting for acquisitions of interests in joint operations (amendments to HKFRS/IFRS 11)

NEW COMPANIES ORDINANCE PUBLICATIONS



Major changes applicable to Hong Kong companies limited by guarantee without a share capital

Major changes applicable to private limited companies incorporated in HK

Financial Reporting-related Matters and Preparation of Directors' Reports under the new Companies Ordinance, Chapter 622 – an Overview - July 2014

MPF UPDATES April 2014

BDO ANNUAL STATEMENT

The BDO Annual Statement for year 2013 has been released.

As well as giving an overview of the global performance of the international BDO network, this year's Annual Statement includes a CEO Report from Martin van Roekel, who took over the post of CEO of BDO International Limited in October 2011.

As of 30 September 2013, BDO provided services in 144 countries. BDO have completed 20 mergers in the past 12 months and there were corresponding increases in the numbers of BDO's partners and staff members, as well as the number of BDO offices. These rose to 56,389 people and 1,264 offices.

Please visit the "**International**" of "**Publications**" section under "**Resources**" at www.bdo.com.hk

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