

## The SFC's Guidance on Valuations in Corporate Transactions: What Financial Advisers Should Know

May 2017

The Securities and Futures Commission (SFC) recently issued: (i) a [guidance note on directors' duties \(Guidance Note\)](#); (ii) a [circular to financial advisers \(Circular\)](#); and (iii) a [statement on the liability of valuers, in the context of valuations in listed companies' corporate transactions](#).

The SFC is concerned by instances where listed companies have acquired assets or target companies at unreasonably high prices or sold them at a substantial undervalue, and valuations were either not obtained in these transactions (when circumstances suggest it would have been appropriate to do so) or were relied upon to justify the transaction when such reliance was imprudent.

This note highlights the key implications of the Circular and the Guidance Note from the perspective of Financial Advisers (FAs) appointed to assist with acquisitions or disposals of assets or target companies by Hong Kong listed companies (Corporate Transactions).

### The Circular and the Guidance Note will impact on an FA's scope of work

Both the Guidance Note (which is aimed at directors of listed companies) and the Circular (which is aimed at FAs) contain requirements on the scope of work of an FA who has been appointed to assist with a Corporate Transaction.

The key pressure point for FAs is where they are instructed to assist the listed client on a

Corporate Transaction in circumstances where there is no obligation on the listed client under the Hong Kong Listing Rules (the Listing Rules) to engage an FA. Generally in those circumstances, unless it has been specifically agreed at the time with the listed client that the FA will review the valuation process and methodology, the FA will not accept a duty of care to the listed client in relation to valuation on the basis that this is a matter for the directors to determine. It appears the SFC is of the view that when an FA advises a listed company on any transaction involving the sale or purchase of shares, assets or business, the FA is within the scope of the Corporate Finance Adviser Code (CFA Code) for that engagement and should have more enhanced duties in relation to valuation issues as described below.

The Guidance Note requires directors to draft the scope of an FA's mandate (in consultation with the FA) appropriately for the matter in question, which should include assessing the reasonableness of any valuation assumptions. The Circular expands on this and states (in broad terms) an FA's mandate should be drafted to comply with an FA's obligations under the CFA Code as appropriate and, where a valuer is appointed, this should specifically include discharging its obligations under paragraph 5.3(a) of the CFA Code (assessing the experience and expertise of the valuer)<sup>i</sup> and paragraph 5.3(b) of the CFA Code (assessing the reasonableness of the valuation assumptions)<sup>ii</sup>.

Where a valuer has been appointed, the Circular also expects FAs to be satisfied that the directors have: (i) considered the valuer's independence, reputation, experience and available resources; (ii) set an appropriate scope of mandate for the valuer; and (iii) critically reviewed the reasonableness of the financial forecasts,

valuation assumptions and methodologies and when any of these have appeared unreasonable, asked follow-up questions to resolve the issues.

Even if no external valuer is appointed, the Circular requires the FA to be satisfied that both the decision not to appoint a valuer and the valuation prepared (by the listed company or a non-valuer third party) have been made on a reasonable basis. In particular, when assessing the reasonableness of not appointing a valuer, FAs should have regard to: (i) whether the directors possess sufficient experience or expertise in the field of the proposed investment and in valuation; (ii) whether the proposed investment requires professional advice in order to properly assess its merits; and (iii) the materiality of the deal to the listed company, the risks involved and the complexity or nature of the investment.

As noted above, this is a move away from existing market practice where an FA's mandate is typically much narrower in respect of valuations. Despite language in the Guidance Note that the scope of the mandate should be drafted "appropriately for the matter at hand", we expect it would be difficult to argue it is appropriate to exclude the valuation aspects mentioned above on any Corporate Transaction on which an FA is appointed (irrespective of the size, nature or significance of the transaction, or whether the valuation constitutes a "profit forecast" under the Listing Rules). The overall effect of the Circular and the Guidance Note is to make any FA appointed on a Corporate Transaction a key part of the valuation "verification" exercise.

FAs should therefore review their standard engagement letters on Corporate Transactions to ensure their scope of work complies with the Circular.

### **The Circular is likely to impact on an FA's existing business processes**

The Circular requires FAs to conduct their own assessment and reasonable checks on the forecasts, assumptions and methodologies of the valuation.

FAs will already have in their existing processes steps to test the reasonableness of a valuation (although these steps may only have been applied where the FA agreed with the client that their engagement extended to the valuation of the assets concerned). These processes should now be applied on all Corporate Transactions, and be reviewed against the detailed requirements in the Circular and the CFA Code to see whether they need to be broadened to encompass the required aspects or enhanced to meet the required standards summarised above.

In particular, where the board has not appointed a valuer, looking into the reasonableness of not appointing one is an aspect that may well be absent from some FAs' existing processes. Conducting due diligence on any valuer that is appointed and reviewing their scope of mandate for the transaction may also be aspects that are missing from existing protocols.

The FA should document its investigation and results. Any question marks about the reasonableness of the valuation should be flagged to, and any implications discussed with, the listed company's directors, and in extreme circumstances, lead to the FA stepping down from its role.

### **The Circular and the Guidance Note represent an opportunity and a potential risk for FAs**

As mentioned above, the appointment of an FA is not required under the Listing Rules for all Corporate Transactions. The Listing Rules only require listed companies to appoint an independent FA on certain transactions. Technically speaking, neither the Guidance Note nor the Circular changes this position. However, the Guidance Note requires directors to seek assistance from professional valuers *or other advisers* if appropriate. Given the potential consequences of a director being held to have breached the Guidance Note<sup>iii</sup> and the enhanced responsibilities of an FA under the Circular, some listed companies are now likely to be more

inclined to appoint FAs on their M&A transactions even if the appointment is not required under the Listing Rules - although any reliance placed by directors on external advice must still be reasonable in the circumstances. This is particularly the case where certain “risk factors” exist which the Guidance Note states should lead to directors paying closer attention to the transaction (for example, where the target has a limited track record, is generating very little profit or has minimal net assets).

An FA should be aware that if appointed, it would ultimately need to be satisfied that the valuation is reasonable (or risk having to step down from its role). If the listed company ends up announcing the value of the acquired assets or target has substantially declined within a short time after the transaction, this will increase the chance of the SFC investigating the relevant parties (including the FA). If an FA is found to have breached the Circular or the CFA Code, this may attract disciplinary sanctions and adversely reflect on its “fitness and properness”.

- 
- <sup>i</sup> The wording of this requirement is: “a Corporate Finance Adviser...should...undertake reasonableness checks to assess the relevant experience and expertise of the firm of experts or other professionals and to satisfy itself that reliance could fairly be placed on their work”.
- <sup>ii</sup> The wording of this requirement is: “a Corporate Finance Adviser...should...review and discuss with its clients and the experts or other professionals the qualifications, bases and assumptions adopted by the experts or the other professionals in the course of their work and satisfy itself that the qualifications, bases and assumptions have been made with due care and objectivity, and on a reasonable basis”. Note this requirement does not apply to (i) valuations of real property if the property valuer is a member of a relevant regulatory or professional body (ii) legal advice from legal advisers and (iii) audit results / accountants’ reports of accountants, but the FA would still need to assess the experience and expertise of the relevant expert.
- <sup>iii</sup> The Guidance Note states the SFC will take into account whether directors have adhered to the Guidance Note in assessing a breach of directors’ duties and will be more likely to investigate and seek orders (such as disqualification or compensation orders) under section 214 of the Securities and Futures Ordinance against directors who do not act in accordance with the Guidance Note.



**Peter Brien**  
**T +852 2901 7206**  
**E [peter.brien@slaughterandmay.com](mailto:peter.brien@slaughterandmay.com)**

© Slaughter and May 2017

This material is for general information only and is not intended to provide legal advice.  
For further information, please speak to your usual Slaughter and May contact.