HKEx LISTING DECISION
HKEx-LD77-2014 (published in January 2014)

Summary	
Party	**Company A – a Main Board listing applicant**
Issue	**Whether Company A's level of internal controls on its hedging activities was appropriate for a listed company**
Listing Rules	**Main Board Rules 2.13(2) and 11.07**
Decision	**The Exchange was satisfied with Company A's internal controls on hedging and the disclosure in the listing document relating to hedging**

FACTS

1. A type of commodities was used by Company A as major raw materials in its production process. For hedging purposes, Company A entered into forward purchase contracts with its suppliers which were settled by physical delivery within the next 12 months. The forward purchase contracts covered a majority of its production requirement while the remaining portion was covered by spot purchases. Mr. X, (Company A's controlling shareholder and executive director) was responsible for making decisions relating to forward purchase of the commodities based on his industry experience.

2. Company A entered into forward purchase contracts with its suppliers directly and not through an organised and regulated exchange.

3. As a matter of internal control on the hedging activities, Company A's finance department had to report details of all forward purchase contracts entered into on a monthly basis to Mr. Y (a non-executive Director ("**NED**")) and all three independent non-executive Directors ("**INEDs**"). However, neither the NED nor the INEDs had experience in hedging/trading of commodities.

APPLICABLE RULES

4. Rule 2.13(2) states that the information contained in the listing document must be accurate and complete in all material respects and not be misleading or deceptive. In complying with this requirement, an applicant must not, among other things, omit material facts of an unfavourable nature or fail to accord them with appropriate significance.

5. Rule 11.07 states that as an overriding principle, all listing documents must contain such particulars and information as, according to the particular nature of the issuer and the securities for which listing is sought, is necessary to enable an investor to

make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer and of its profits and losses and of the rights attaching to such activities.

ANALYSIS

6. The Exchange considered that Company A's internal controls on hedging lacked the level of dynamic risk management that was customary for listed companies engaging in hedging activities which exposed them to the risks of price movement.

7. There was also insufficient disclosure on the credit risk of the counterparties to the hedging activities, namely the suppliers of Company A.

DECISION

8. Company A was asked to consider, in addition to the existing internal control measures as described in paragraph 3 above, :

   – establishing a formal risk management committee;
   – setting position limits for the forward purchases;
   – establishing formal procedures to approve positions exceeding limits;
   – establishing formal procedures to set and vary counterparty limits, and to authorize any excesses over those limits;
   – monitoring value at risk.

9. The Exchange expected that appropriate disclosure be made in the prospectus as to which of the measures mentioned in paragraph 8 above were adopted by Company A, and if any of those measures were not adopted, the reason for not doing so.

DISCLOSURE

10. Company A subsequently implemented and disclosed in the prospectus the following measures:

    *Established a risk management committee (the "**Risk Management Committee**")*

    (i) Company A appointed an additional INED who had over six years of experience in trading of commodities. It established the Risk Management Committee which comprised the additional INED, two of the remaining INEDs and the NED. The finance department would provide relevant information on the hedging activities (e.g. amount of forward purchases, actual amount of commodities consumed, confirmed orders on hand, production schedule, inventory level, amount of expected export sales) to the Risk Management Committee which would hold monthly meetings to review whether the hedging policy has been complied with. Company A would disclose in its annual report the Risk Management Committee's confirmation on whether Company A has complied with its hedging policy;

(ii) all the forward purchases would be handled by the hedging team (the "**Hedging Team**") which was led by Mr. X and other members comprising the chief financial officer and heads of relevant departments (e.g. production department, sales and marketing department);

Setting/approving position limits and counterparty limits

(iii) the Hedging Team was allowed to forward purchase up to 50% of the monthly production requirement based on sales forecast up to a rolling 12-month period (the "**Aggregate Position Limit**"). However, if Company A secured confirmed orders, the Hedging Team was allowed to forward purchase the unhedged portion of the commodities required for the production of such confirmed orders in excess of the Aggregate Position Limit. Details of the corresponding confirmed orders had to be recorded and reviewed by the Risk Management Committee. In addition, the Hedging Team can make application to the Risk Management Committee to change the Aggregate Position Limit in view of any changes in the relevant markets such as the supply and demand situation of the commodity market. Such application has to be supported by relevant reasons and analyses on market figures and trends;

(iv) the chief financial officer would calculate the position limit for each counterparty based on the counterparty's paid-up capital or net worth. The position limit for each counterparty had to be reviewed and approved by the Risk Management Committee annually and the position limit should not be changed unless it was approved by the Risk Management Committee;

Monitoring value at risks

(v) on a weekly basis, the finance department would prepare a mark-to-market calculation over the outstanding position of all forward purchases for review by the Hedging Team. The Risk Management Committee would comment on the performance of the Hedging Team in its monthly review meeting and make recommendation on the hedging activities (where necessary); and

Monitoring counterparty risks

(vi) Company A's finance department would conduct company searches and internet searches and its sales and marketing department would conduct market searches on the approved suppliers on a regular basis to find out if there is any adverse market news on the creditworthiness of Company A's counterparties. The procurement manager would also pay regular visits to the approved suppliers to understand their latest business development, financial and market position, and request for their latest financial statements and business registration certificates to keep track of their financial position.

CONCLUSION

11. Based on the above, the Exchange was satisfied with Company A's disclosure on its internal controls measures relating to hedging activities.

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