

## Hong Kong Listed Companies to Fully Strengthen Internal Systems as the First Line of Defense Against Compliance Risks: Insights from Enforcement Cases

Enforcement cases show that Hong Kong's listed companies and their management should avoid non-compliances by tightening internal controls over funds management, investments, disclosure and subsidiary oversight.



For Hong Kong listed companies, enforcement trends make clear that compliance turns on whether the issuer has created and maintained the right conditions for compliance – effective internal controls, meaningful supervision, and information flows that allow issues to be identified and addressed in time.

### *Essentials of internal controls*

The SFC and AFRC adopt the same lens, particularly in cases where listed issuers channel corporate funds to third parties through loans, prepayments or similar arrangements without a clear commercial rationale, adequate due diligence or proper approval discipline. HKEX's own guidance on internal controls reinforces this risk-based, systems-driven approach. The Exchange describes internal controls as processes and policies designed to provide reasonable assurance regarding achievement of the issuer's objectives, and organises them into five interlocking components. These are: (i) the control environment or corporate culture, which requires a board-led "tone from the top" and a commitment to integrity, compliance and ethical behaviour across the organisation; (ii) risk assessment, involving ongoing analysis of business and fraud risks and significant changes that may affect control effectiveness; (iii) internal control systems and activities responding to identified risks; (iv) information and communication, ensuring internal control systems are supported by appropriate, up-to-date information that is properly communicated internally and externally; and (v) monitoring, through continuous review and timely remediation of deficiencies.

HKEX also expects detailed disclosure in the corporate governance report on the risk management and internal control systems and the at least annual review of their effectiveness, which underscores that internal controls are an active, board-level responsibility rather than a static manual. The HKEX reiterates that internal controls should be embedded in day-to-day operations and structured around five components – control environment, risk assessment, control activities, information and communication, and monitoring – and that boards must regularly evaluate whether these elements are functioning effectively across the group.

HKEX's corporate governance materials emphasise that the board is responsible for ensuring appropriate and effective internal controls, monitoring their effectiveness, and maintaining reporting and compliance systems that support accurate disclosure and regulatory compliance. Listing Rules rule 3.08 reinforces that directors must exercise skill, care and diligence, and HKEX enforcement consistently shows that directors who fail to follow up, or who place excessive reliance on management or delegates, remain exposed to disciplinary action.

A listed issuer should adopt written policies and procedures that translate these duties into concrete steps in terms of review, escalation protocols, matters to be put before the board, identification of connected parties or notifiable transactions and subsidiary reporting to the listed parent, to name a few examples. In enforcement, internal policies are the first line of defense because they are the mechanism by which the board demonstrates that governance has been intentionally designed, implemented and supervised rather than left to assumption or custom.

#### *Governance policies*

A suite of specific governance policies should be maintained and disclosed publicly. These include a dividend policy, a written board diversity policy and a separate workforce-wide diversity policy covering all employees including senior management, as well as a written director nomination policy addressing nomination procedures and selection criteria. Issuers should also maintain clear internal guidelines for notifiable and connected transactions under Chapters 14 and 14A of the Main Board Listing Rules, a whistleblowing policy allowing employees to raise concerns confidentially about financial reporting, internal control or other misconduct, and an anti-corruption policy and systems to promote compliance with applicable anti-bribery laws. These are complemented by internal escalation and reporting arrangements under the Corporate Governance Code and section 307G of the Securities and Futures Ordinance, and a formal inside information disclosure policy and procedures to ensure compliance with statutory and Listing Rule disclosure obligations.

#### *Funds management and investment controls*

The recent SFC–AFRC joint statement responds to a marked increase in suspected misconduct where listed issuers divert corporate funds to third parties through loans, advances, prepayments and similar arrangements in dubious circumstances. It sets out the regulators' observations that these arrangements often lack genuine commercial rationale, involve inadequate due diligence and weak documentation, and are supported by poor internal controls and monitoring, leading to heightened risks of asset misappropriation, misstatements and audit failures.

The statement emphasises the importance of proper conduct in issuers' financial activities and of auditors' work in identifying and reporting irregularities, and then outlines expected standards of conduct for boards and management in approving, monitoring and disclosing such arrangements.

HKEX's action in the case of FingerTango Inc. (Stock Code: 6860) illustrates the same point at exchange-enforcement level. The Exchange found that the money-lending business lacked adequate and effective internal controls over its lending activities and that the board failed to provide proper oversight until most loans were already in default, and further that the company failed to announce a

number of loans that constituted discloseable transactions under the Listing Rules. Issuers must ensure that appropriate and effective internal controls and procedures are in place, including due diligence, risk assessment, credit evaluation and proper approval arrangements. This applies to other material deployment of funds, for example by way of loan, prepayment, subscription, investment or guarantee, whereby they are governed by a policy requiring a documented business rationale, counterparty due diligence, valuation or pricing review where relevant, approval at the correct level, and post-completion monitoring.

Approval routes must also be designed to prevent system bypass. In the case of Datang Group Holdings Limited (Delisted, Previous Stock Code: 2117), HKEX found that substantial financial assistance of RMB 1.03 billion was provided to the controlling shareholder's group without going through the issuer's established approval and reporting systems and without compliance with connected transaction requirements under Chapter 14 and 14A. The then chairman and executive director was also found to have allowed the group to execute these transactions without following the Listing Rules or the group's own internal controls and without informing the board, thereby breaching his fiduciary duties and duties of skill, care and diligence. Issuers should not rely solely on a connected-persons register or a treasury manual, instead should embed connected-party screening and escalation directly into transaction initiation and approval workflows so that business teams cannot process high-risk transactions outside the formal system.

#### *Disclosure and shareholder approval controls*

HKEX's internal control guidance stresses that an issuer's systems should be supported by appropriate, up-to-date information and effective internal and external communication. In practice, this means compliance cannot start only after a deal is signed. A listed issuer needs a pre-signing protocol under which finance, legal, company secretarial and business teams consider whether a proposed matter may trigger notifiable transaction, connected transaction, inside information, annual reporting or shareholder approval requirements.

The case of KWG Group Holdings Limited (Stock Code: 1813) is a strong illustration of the need to maintain appropriate and effective internal controls to monitor compliance with the Listing Rules or to ensure that HKEX correspondence and enquiries were escalated to the board in a timely manner. The Exchange's disciplinary action concerned, among other things, a prolonged delay in despatching a circular for two major transactions, and the criticism went well beyond the missed deadline: HKEX highlighted the absence of effective internal controls and the failure to escalate Exchange enquiries and compliance issues to the board in a timely manner. The broader lesson is that a disclosure policy must clearly allocate ownership for drafting, verification, timetable monitoring and liaison with the Exchange, and must specify which matters must be escalated to the board and when. The directors should also actively monitor and follow up matters without placing full reliance on the company secretary only.

The cases of Sterling Group Holdings Limited (Stock Code: 1825) and Universal Star (Holdings) Limited (Delisted, Previous Stock Code: 2346) further demonstrate that connected transaction-related disclosure failures often arise from familiar business relationships or informal dealings that were never viewed through a proper compliance lens. In Sterling, the issuer failed to comply with connected transaction requirements in relation to dealings with a connected person. In Universal Star, undisclosed liabilities, a pledge and other arrangements were not escalated to the sponsor, the board or shareholders, and required approvals were not obtained prior to the time of listing. Connected-transaction compliance must be embedded upstream, through systematic assessment of "connectedness", mandatory legal or compliance clearance procedures, and board minutes that record that related-party checks were actually carried out.

Annual reporting also warrants focused attention. HKEX's governance materials now require greater board-level articulation of risk management, internal controls, board performance and other governance topics. Issuers should therefore consider a formal annual report verification process, supported by checklists and clear accountability for each disclosure stream, or even a disclosure-error accountability policy. This is particularly important where operations are decentralised or reporting inputs are sourced from multiple Mainland subsidiaries.

### *Subsidiary oversight*

One of the most significant recent enforcement developments is the clearer extension of responsibility from the listed parent to its subsidiaries. In Enterprise Development Holdings Limited (Stock Code: 1808), HKEX censured the issuer, six directors and a subsidiary director after repeated Listing Rule breaches arising from the subsidiary's securities investment business. The Exchange attributed the misconduct to the listed issuer directors' failure to monitor or supervise the subsidiary's business and to procure adequate and effective controls and procedures, as well as the subsidiary director's failure to report transactions and keep track of them systematically.

That case has two important implications. First, the listed issuer's compliance perimeter clearly extends beyond the parent boardroom into group-level systems, especially where a subsidiary's activities are material to the listed group. Second, HKEX has made clear that enforcement can reach not only the issuer and its directors, but also subsidiary directors or senior management whose acts or omissions caused or knowingly participated in the breach.

For companies with Mainland Chinese operating subsidiaries, this is particularly significant. A Hong Kong listed holding company may have commercially capable local management in the PRC, but HKEX expects a formal reporting and control architecture that ensures those subsidiaries identify potentially notifiable or connected matters, escalate them to the listed parent in time, and maintain adequate transaction records. A subsidiary governance policy should therefore define reserved matters for parent approval, set expectations for monthly compliance reporting, establish event-driven escalation triggers and transaction logs, and assign clear accountability for local management where reporting failures occur.

The cases of Fantasia Holdings Group Co., Limited (Stock Code: 1777) and Colour Life Services Group Co., Limited (Stock Code: 1778) add a critical controller-risk dimension. In those matters, HKEX found failures to put in place adequate and effective internal controls, resulting in inaccurate disclosures and non-compliance linked to group-level liquidity arrangements, and later pursued further disciplinary action over attempts to circumvent Listing Rules requirements in relation to a very substantial disposal. Where a controlling shareholder, founder or central group team drives a disposal, restructuring, financing or security arrangement, internal policy should require immediate escalation to each affected listed board as well as a separate analysis of the obligations, risks and approvals relevant to each listed vehicle.

### *Annual policy review and the broader policy suite*

HKEX's materials emphasise annual review of risk management and internal controls, ongoing board oversight, and continuous learning by directors. Cases such as Enterprise Development and Sterling have also concluded with mandatory training directions, underscoring that regulators expect active maintenance of competence rather than passive reliance on legacy practices.

Boards should therefore treat policy review as a standing agenda item. At least annually, the board or a designated committee should assess whether key policies remain aligned with current Listing Rules and regulatory guidance, whether approval thresholds still reflect the group's business model and risk

appetite, whether subsidiaries are complying in practice, whether incident reports reveal systemic weaknesses, and whether directors and staff need targeted training on new or emerging requirements.

Boards should make explicit use of internal audit and board evaluation as feedback loops: internal audit plans should cover the high-risk areas highlighted in recent enforcement – funds flows, related-party dealings, disclosure controls, subsidiary oversight and controller-driven transactions – and board and committee evaluations should feed into targeted training, policy updates and disclosure enhancements.

#### *Need for a practical suite of internal policies*

Issuers should also consider a broader policy suite than the Listing Rules expressly prescribe. Depending on the group's profile and ownership structure, useful additional policies may include board secretary work procedures, investor relations management, subsidiary governance and oversight, internal material information escalation, annual report disclosure-error accountability, prevention of controlling shareholder or connected-party fund occupation, external guarantee approval, independent director work procedures, external investment governance, policies on fund dealings with related parties, and frameworks addressing ESG, privacy, data security and AI governance. These instruments help clarify who decides, who checks, who escalates, who records and who reports, which is precisely where recent enforcement has focused.

ESG and emerging regulatory themes such as privacy, cybersecurity and data governance should be brought within the same risk management and internal control architecture, rather than dealt with in isolation.

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