

## HKEx GUIDANCE LETTER

HKEx-GL68-13 (December 2013) **(Updated in June 2015)**

<b>Subject</b>	<b>Guidance on suitability for listing</b>
<b>Listing Rules and Regulations</b>	Main Board Rules 8.04, 2.06 GEM Rules 11.06, 2.09
<b>Related Publications</b>	<b><u>HKEx-LD8-2</u></b> ; HKEx-LD43-3; HKEx-LD46-1; HKEx-LD46-2; HKEx-LD50-5; HKEx-LD51-1; HKEx-LD51-3; HKEx-LD69-1; HKEx-LD92-1; HKEx-LD96-1; HKEx-LD97-1; HKEx-LD107-1; HKEx-LD19-2011; HKEx-LD30-2012; HKEx-LD37-2012; HKEx-LD73-2013; <b><u>HKEx-LD92-2015</u></b> ; HKEx-RL12-06; HKEx-RL19-07; HKEx-RL20-07; HKEx-RL21-07; and HKEx-RL25-09.
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**Important note:** *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing ~~Division~~ Department on a confidential basis for an interpretation of the Listing Rules or this letter.*

### 1. Purpose

1.1 This letter provides guidance on the factors that the Exchange would take into consideration when assessing whether an applicant and its business are suitable for listing under Main Board Rule 8.04 (GEM Rule 11.06).

1.2 ~~Over the years, the Exchange has considered~~ considers a ~~wide variety~~ number of factors ~~which are considered to be relevant for the purposes of~~ when assessing an applicant's suitability for listing. ~~We have published various listing decisions and rejection letters for the market in this regard, as referred to above, to provide transparency to the market.~~ This letter is intended to assist applicants and their advisers by consolidating the factors included in these listing decisions and rejection letters. **(Updated in June 2015)**

1.3 This letter sets out examples of factors that have been considered by the Exchange in the past and published as guidance on the Exchange's website, and they are not exhaustive. (Added in June 2015)

### 2. Relevant Listing Rules

2.1 Main Board Rule 8.04 (GEM Rule 11.06) states that both the applicant and its business must, in the opinion of the Exchange, be suitable for listing.

2.2 Main Board Rule 2.06 (GEM Rule 2.09) states that suitability for listing depends on many factors. Applicants for listing should appreciate that compliance with Listing Rules may

not itself ensure an applicant's suitability for listing.

- 2.3 GEM Rule 11.06 also states, by way of example, that an applicant whose assets consists wholly or substantially of cash or short-dated securities (i.e. securities such as bonds, bills or notes which have less than one year to maturity) would not normally be regarded as suitable for listing, except where the applicant or group is solely or mainly engaged in the securities brokerage business.

### 3. **Guidance on suitability**

- 3.1 When vetting a listing application, the Listing ~~Division~~ ~~Department~~ will focuses on an whether the applicant's is eligible eligibility for listing as set out in the Listing Rules (e.g. whether the financial requirements are met; compliance with law, rules and regulations), suitability for listing (e.g. whether matters on sustainability of the business; reliance on a parent company; suitability of directors, including potential ~~shadow directors~~ persons of substantial influence are satisfactorily addressed), and whether there are any material disclosure deficiencies. (Updated in June 2015)
- 3.2 There is no hard and fast rule in determining what would render an applicant and its business not suitable for listing. Each case is determined on its own individual factual circumstances.

#### **(1) suitability of director and controlling shareholders**

Having a past non-compliance or conviction record does not necessarily mean that a person cannot be accepted as a director of a listed company.

However, in the case where the past record or conviction raises serious concern on an the individual's integrity, and the individual is likely to exert substantial influence on the applicant after listing (e.g. a controlling shareholder and director), there may be concern as to the applicant's suitability for listing and ~~the director's~~ suitability of the individual to act as a director under Main Board Rules 3.08, 3.09 and 8.15 (GEM Rules 5.01, 5.02 and 11.07(1)). (Updated in June 2015)

Where a person is a controlling shareholder, his majority vote as a controlling shareholder is likely to be decisive in the appointment of the directors of the applicant. It will accordingly be highly likely that he will be able to exert substantial influence over the operation and management of the applicant ~~and may be a "shadow director"~~ even if he is not formally appointed as a director, or has previously resigned as a director. The issue of the applicant's suitability therefore may not be solved by that person refraining from acting as the applicant's director. (Updated in June 2015)

Relevant listing decision: HKEx-LD96-1

#### **(2) non-compliances**

The Exchange considers that systematic, intentional, and/or repeated breaches of laws and regulations by an applicant may affect its suitability for listing. The Exchange will take into account the following factors in determining the impact of non-compliance on an

applicant's listing:

- (i) the nature, the extent and the seriousness of the breaches;
- (ii) the reasons for the breaches, whether they were intentional, fraudulent, due to negligence or recklessness;
- (iii) impact of the breaches on the applicant's operation and financial performance;
- (iv) rectification measures adopted; and
- (v) precautionary measures put in place to avoid future breaches.

In cases such as non-compliant bill financing arrangements, the Exchange will expect the applicant to have demonstrated for a reasonable period (normally 12 months) that (a) it would be financially sound and could operate without reliance on the non-compliant bill financing arrangements; and (b) it has effective internal control to avoid future non-compliance of a similar nature.

In other cases where the non-compliances do not have a direct impact on the financial position of the applicant (e.g. failure to obtain the necessary licence, approval or complete the necessary registration required by law), where the non-compliances had been serious, listing was only approved after the applicants had demonstrated continued compliance for a reasonable period of time.

Where it is determined that the material non-compliance incidents can be resolved by way of disclosure, the Exchange expects the applicant to follow Guidance Letter HKEx-GL63-13.

Relevant listing decisions: HKEx-LD50-5; HKEx-LD97-1; and HKEx-LD19-2011

### **(3) deteriorating financial performance**

The Exchange is of the view that the assessment of suitability is a continuous process and that the applicant must remain suitable for listing at the time of listing, taking into account the actual performance after the latest audited period, profit forecast and such other projected information submitted by the applicant in relation to its business and financial position after listing.

Examples of deteriorating financial performance that may give rise to a concern as to suitability include:

#### **(i) deteriorating financial performance subsequent to the track record period**

Even if the applicant can meet the relevant requirements of Main Board Rule 8.05 during the track record period, any deteriorating financial performance subsequent to the track record period may be a strong indicator of a fundamental deterioration of commercial or operational viability, which goes to the heart of sustainability and

suitability for listing.

Relevant listing decision : HKEx-LD73-2013

(ii) track record results are not indicative of future performance in light of significant profit drop in its profit forecast

A significant decline in the applicant group's forecast profit together with an engagement in new business through acquisition may also render the applicant not suitable for listing, as the track record results may not be indicative of the applicant's business going forward.

Relevant rejection letter : HKEx-RL19-07

~~While no profit requirement is imposed on companies seeking to list on GEM, uncertainty over a company's future financial performance may cast doubt on its sustainability, e.g. deteriorating financial performance during the track record period and no sign of improvement in the forecast period. Where a company's business model is believed to be unsustainable, the Exchange will consider it unsuitable for listing.~~

~~Relevant listing decision : —HKEx-LD37-2012~~

~~(Updated in June 2015)~~

**(4) reliance on parent group / connected persons / major customer**

When reviewing a reliance issue, the Exchange will take into account the degree of dependence. Where the degree of dependence is excessive, this would translate into a concern on suitability for listing.

Examples of reliance that may give rise to a concern as to suitability include:

- (i) reliance on a parent group for certain important functions such as sales and procurement functions; or financial and operational reliance on the applicant's parent.

Paragraph 27A of Appendix 1A to the Main Board Rules (Paragraph 27A of Appendix 1A to the GEM Rules) provides that the listing document should include a statement explaining how the applicant is satisfied that it is capable of carrying on its business independently of the controlling shareholder after listing, and particulars of the matters that it relied on in making such statement.

When reviewing whether an applicant can carry on its business independently of its controlling shareholder, the Exchange ordinarily considers the applicant's specific circumstances, including financial independence, operational independence and management independence;

Relevant listing decisions / rejection letter : HKEx-LD46-1; HKEx-LD46-2; HKEx-LD51-1; HKEx-LD69-1; HKEx-LD30-2012; and HKEx-RL12-06

- (ii) dependence on the parent when there are overlapping directors, the applicant and its parent are in the same industry sector, and there are inadequate arrangements to manage conflicts of interest and delineation of businesses.

Main Board Rule 8.10(a)(iii) requires that where the controlling shareholder has a business which is likely to compete with the applicant's business, the listing document must disclose the facts demonstrating that the applicant is capable of carrying on its business independently of, and at arm's length from the competing business of the controlling shareholder.

In contrast, GEM Rule 11.03 provides that an applicant would not be rendered unsuitable for listing on the grounds that any director or shareholder has an interest in a competing business;

Relevant listing decision / rejection letter : HKEx-LD51-3 and HKEx-RL21-07

- (iii) the applicant derives a significant portion of its turnover and net profit from transactions with closely related parties and connected persons.

Although profits from transactions with connected persons or closely related parties do not necessarily have to be disregarded in assessing whether the requirements of Main Board Rule 8.05 are met, when these transactions are excessive, this may raise a concern as to whether the applicant is suitable for listing.

Firstly, the risk involved in connected transactions is substantially different from transactions with independent third parties, and hence it will be uncertain whether the applicant's business is relying on the connected person and is sustainable without these connected transactions.

Secondly, significant connected transactions will also give rise to a concern as to whether they are designed to enable the applicant to meet the requirements of Main Board Rule 8.05;

Relevant listing decision : [HKEx-LD8-2](#) and [HKEx-LD92-1](#)

- (iv) heavy reliance on a major customer.

When the applicant's reliance on a single major customer is extreme, the applicant may suffer a material and adverse financial impact if it loses that customer or there is a change in the business relationship.

In assessing whether a case of reliance on single customer is an extreme case which impacts on suitability for listing for an applicant, the Exchange will take into account the applicant's ability to find substitute customers, the likelihood for the level of reliance to decrease in the future, the industry landscape, whether reliance is mutual and complimentary, the existence of any long-term contractual arrangements and whether the applicant is capable of maintaining its revenue and profitability in the future in light of the reliance;

Relevant listing decision: HKEx-LD107-1

- (v) a captive business model, i.e. the sourcing of the applicant's principal raw materials and its principal customer channel are dominated by the same party.

When the applicant's supply and sales are dominated by the same party, the applicant's relationship with this party will be fundamental to its business. If the applicant is unable to demonstrate that it is capable of carrying on its business independently of this party, it will translate into a concern about the suitability of the applicant for listing.

Relevant rejection letter: HKEx-RL20-07

**(5) gambling**

Applicants which engage in gambling business will be considered not suitable for listing unless they satisfy the requirements in the Exchange's announcement on "Gambling Activities Undertaken by Listing Applicants and/or Listed Issuers" and Listing Committee Report 2006.

Relevant rejection letter: HKEx-RL25-09

**(6) contractual arrangements (VIEs)**

Applicants adopting contractual arrangements of the nature described in Listing Decision HKEx-LD43-3 may be considered not suitable for listing unless they satisfy the conditions set out in that Listing Decision, including closely tailoring the use of such arrangement to the applicant's needs.

Relevant listing decision: HKEx-LD43-3.

**(7) reliance on unrealised fair value gains to meet profit requirement**

The Exchange is of the view that even if an applicant is able to satisfy the profit test under Main Board Rule 8.05(1)(a) by relying on the unrealized fair value gains of its investment properties, if the applicant is loss making after such gains are excluded and it did not have a substantive business during its track record period, the applicant would have to demonstrate that it has a sustainable business before the Exchange considers it suitable for listing.

The demonstration of a sustainable business can include the existence of property projects under development as at the date of the listing document, or significant recurring income (e.g. rental income) generated in the applicant's ordinary and usual course of business during the track record period which is expected to continue after listing.

**(8) Unsustainable business model**

Where a company's business model is believed to be unsustainable, the Exchange will consider it unsuitable for listing. A business model may be considered unsustainable due to a combination of factors, e.g. significant and recent changes in the revenue model such that its trade record is not representative of its past performance; changing regulatory environment and industry outlook; deteriorating financial performance during the track record period and no sign of improvement in the forecast period and beyond; one-off windfall profits unlikely to be recurring. While none of the factors alone may necessarily be detrimental, the Exchange will consider the combined impact of such factors on the applicant's business.

Relevant listing decisions: HKEx-LD37-2012, Company D, Company L, Company N, Company O and Company P of HKEx-LD92-2015

*(Added in June 2015)*

- 3.5 ~~The above are only examples of factors that have been considered by the Exchange in the past and published as guidance on the Exchange's website, and they are not exhaustive.~~  
*(Deleted in June 2015)*

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