

HKEx REJECTION LETTER
Cite as HKEx-RL21-07 (February 2007)

[Withdrawn in March 2019; Superseded by HKEX-GL68-13]

Summary	
Listing Rule	Listing Rule 8.04
Reason for rejection and the subsequent disposal of the case on review	The Listing Committee rejected the listing application of the Company for the reason that the Group was not able to demonstrate that it is capable of carrying on its business independently of its controlling shareholders and therefore the Listing Committee considered the Group not suitable for listing as required by Listing Rule 8.04. The Listing Committee noted that in view of the importance of the Group's relationship with its controlling shareholders, there were inadequate arrangements and no sufficient and tested corporate governance measures to manage actual and potential conflicts of interest between the Group and its controlling shareholders.
Contents	Extracts of the decision letter of the Secretary to the Listing Committee

[Date]

[Name and Address of Sponsor]

Dear Sirs

Re: Application for new listing of a Main Board listing applicant
(the "Company" together with its subsidiary, the "Group")

We refer to your application Form A1 dated [*day*month*year] made on behalf of the Company (the "Application") and the hearing proof of the Company's prospectus dated [*day*month*year] (the "Prospectus") and your submission dated [*day*month*year] (the "Submission"), which was also tabled at the Listing Committee hearing of [*day*month*year]. Capitalised terms used herein shall have the same meanings as defined in the Prospectus, unless the context otherwise requires.

At the Listing Committee meeting held on [*day*month*year], [names of members purposely omitted] attended to consider the Application. Having considered all relevant facts and circumstances in totality, which include, inter alia, the Group's relationship with its controlling shareholders and the corporate governance measures adopted by the Company, the Listing Committee resolved that the Group is not suitable for listing as required by Listing Rule 8.04. Accordingly, the Company's listing application is rejected. The analysis and conclusion are set out below.

A. Relevant Facts

Relationship with the Controlling Shareholders

1. The Company is currently listed on the GEM. The Group is engaged principally in the business of *[production and distribution of Product X]*, which accounted for *[approximately 95%]* of the Group's total income for each of the three years during the Track Record Period (comprising *[Year 1, Year 2 and Year 3]*). During the Track Record Period, *[approximately 90%]* of the Group's total turnover was derived *[through referrals made by Company X]*.
2. *[Company X]* also conducts promotional activities for and provides copyright licensing services to the Group under the Master Royalty Agreements. The *[referrals made]* and the provision of other services by *[Company X]* to the Group under the Master Royalty Agreements form a crucial part of the Group's operation.
3. *[For Year 3]*, the distribution business of the Group's *[Product Y]* represented approximately 1% of the Group's total revenue. The distribution revenue through the distribution network of *[Company Y]* under the Master Distribution Agreement represented *[over 20%]* of the Group's total distribution revenue.
4. In addition to the Master Royalty Agreements and the Master Distribution Agreement, *[Company X and Company Y]* (collectively the "Controlling Shareholders") will continue to provide various services to the Group which constitute continuing connected transactions including sub-lease of office premises, production and consignment sales of merchandise, promotional services and updating and maintenance of websites. Full details are set out in the Prospectus.

Overlap of Board of Directors

5. There are a total of nine members on the Board of the Company, comprising six executive directors and three independent non-executive directors ("INEDs"). Five of the six executive directors are also directors of *[Company X]* and/ or *[Company Y]*. It is also noted from the Submission that the Company proposed the following resignations, re-designations and appointments of directors to avoid any actual or potential conflicts of interest:
 - (a) *[Four of the above five overlapping directors including Mr. A]* will resign from the board of the Company and/ or the principal operating subsidiary of the Company;
 - (b) *[Mr. A]* will remain as a senior manager of the principal operating subsidiary of the Company;
 - (c) *[Mr. B, one of the above five overlapping directors,]* will be re-designated as a non-executive director and chairman of the Company;
 - (d) *[Mr. C]* will be nominated and appointed as a director of the Company; and
 - (e) the company secretary and financial controller of the Company will be nominated and appointed as directors of the Company.

Following such resignations, re-designations and appointments, *[Mr. B]*, the chairman and a non-executive director of the Company, would remain as a director of *[Company*

Y]. In addition, three directors of the principal operating subsidiary of the Company would remain as directors of [Company X or Company Y].

Corporate governance measures

6. The Company is of the view that the three existing INEDs possess sufficient knowledge, experience and expertise to provide advice to the Group and the shareholders and make contributions to the development of the Group's strategies and policies. All of the three INEDs are practicing accountants and have qualifications in order to effectively be able to understand and advise on financial matters and matters such as connected transactions.
7. The decision-making mechanism of the Board is set out in the Company's Articles of Association which include provisions that the Directors and the Sponsor considered are sufficient corporate governance measures in place for the purpose of minority shareholders protection. It was submitted that additional executive directors who will be independent of each of [Company X and Company Y] may be appointed. The Sponsor has submitted that it considered that the Company has more than sufficient corporate governance arrangements in place to manage any potential conflicts of interest and competition which may arise between the Company and its Controlling Shareholders.

Non-competition Undertakings

8. [Prior to the Track Record Period, i.e. Year -2], [Company X] and each of the Company and the principal operating subsidiary of the Company entered into a deed of non-competition undertakings (the "Original Deeds of Non-competition Undertakings") respectively in relation to the production of certain products. [In Year 3], [Company X and Company Y] entered into a non-competition agreement (the "Non-competition Agreement"), pursuant to which the business scopes of [Company X and Company Y] are restricted to their respective business activities defined in the Non-competition Agreement. For activities not covered in the Non-competition Agreement, [Company X and Company Y] will decide by mutual consultation. Details of the Original Deeds of Non-Competition Undertakings, forming part of the proposed acquisition of 80% equity interests in the principal operating subsidiary of the Company from [Company X], were set out in the Company's circular dated July [Year -2] and considered, among other things, by shareholders of the Company in its extraordinary general meeting held in September [Year -2].

B. Applicable Listing Rules

9. Listing Rule 8.04 states that "[B]oth the issuer and its business must, in the opinion of the Exchange, be suitable for listing".
10. Listing Rule 8.10(1)(a) requires that where a new applicant has a controlling shareholder with an interest in a business apart from the applicant's business which competes or is likely to compete, either directly or indirectly, with the applicant's business, the applicant's listing document must prominently disclose further information in relation to the excluded business.

11. Paragraph 27A of Appendix 1A to the Listing Rules provides that the listing document should include a statement explaining how the issuer is satisfied that it is capable of carrying on its business independently of the controlling shareholder (including any associate thereof) after listing, and particulars of the matters that it relied on in making such statement.
12. It is stated in Listing Decision HKEx-LD51-2 that, when interpreting the requirements under paragraph 27A of Appendix 1A to the Listing Rules and Listing Rule 8.10(1)(a), the Exchange normally requires an applicant to take into account factors relating to the conduct of the applicant's business independently from its controlling shareholder, in areas including financial independence, operational independence and management independence. An applicant may be dependent on its controlling shareholders in one or more of these areas. Where the degree of independence is excessive, this may translate into a concern about the suitability of an applicant for listing for purposes of Listing Rule 8.04. Similarly, competition is normally regarded by the Exchange as a disclosure issue and the requirement of Listing Rule 8.10 applies. However, in extreme cases where, in the view of the Exchange, there are inadequate arrangements to manage actual or potential conflicts of interest between the listing applicant and other businesses under the control of a common controlling shareholder, the Exchange would consider the impact on the applicant's suitability for listing. Where suitability of listing is an issue of our concern, the Exchange may rely on its discretion to reject the application for listing.
13. In its meeting on 23 January 2006, the Listing Policy Committee recognized that in circumstances where conflicts of interest arising from the competing business of the controlling shareholder existed, it is the ordinary practice of the Listing Division to focus on the new applicant's corporate governance mechanisms such as board structures and policies. Contractual terms such as terms underlying the non-competition undertakings and options are one aspect of this review but the non-competition undertaking is not required as a necessary condition to comply with the Listing Rules. As an agreement between the controlling shareholder and the applicant memorializing certain aspects of how they intend to manage their affairs in the future, a non-competition agreement may be one relevant factor among many considered by the Exchange when reaching a conclusion on suitability for listing in an individual case. This position was endorsed by the Listing Policy Committee and is reflected in Paragraphs 21 to 23 of the Listing Committee Annual Report 2006.

C. The Issue

14. Given the nature of the businesses carried out by the Group and the Controlling Shareholders and the extent of their relationship, the Listing Committee has reviewed whether the state of affairs that exists between the Group and its Controlling Shareholders including the existing/ potential competition and the potential conflicts of interest of certain common directors would render the Company unsuitable for listing on the Main Board.

D. The Analysis

No significant independent access to customers

15. Given that *[approximately 90%]* of the Group's total turnover were derived *[through referrals made by Company X]* during the Track Record Period, the Listing Committee considered it to be clear from the record that the Group heavily relies on *[Company X]* for the procurement of *[customers to the Group]* and has not demonstrated that during the Track Record Period it was able to procure *[customers]* for its business to a significant level. In reaching this conclusion, the Listing Committee accepted the submission of the Sponsor that *[not all business may necessarily be introduced by Company X to the Group]* but determined that the level of financial reliance was not materially mitigated by this factual detail.
16. The Listing Committee also considered that the listing application materials clearly established that the *[referrals made]* and other services provided by *[Company X]* under the Master Royalty Agreements form a crucial part of the Group's operation. This view is supported by the information contained in the Prospectus which states that in the event the Master Royalty Agreements entered into between the Group and the Controlling Shareholders have to be terminated or cannot be renewed upon expiry, the Group's profitability and financial results could be adversely affected. The estimated amount of royalties payable to *[Company X]* for *[the year immediately after Year 3]* will be *[nearly doubled that of Year 3]*. The level of reliance of the Group on the Controlling Shareholders can be seen to be increasing in line with the increasing amount of royalties paid/payable to the Controlling Shareholders.

Increasing reliance on distribution through Company Y

17. Although the Group's turnover from distribution *[of Product Y]* is presently small, the Listing Committee noted that the Group intends to develop distribution channels in Japan and explore expansion opportunities elsewhere in Asia, including the PRC. This development is in line with the Company's anticipation *[of the prosperity of distribution business in Japan]* as disclosed in the "Risk Factors" section and the shift in market demand for *[Product Y]* in Japan as seen in the "Industry Overview" section of the Prospectus. It can therefore be envisaged that the Group's reliance on its Controlling Shareholders will increase.

Problematic composition of the Board of Directors

18. The Listing Committee considered that the present composition of the Company's Board of Directors and that of its principal operating subsidiary created a significant possibility that actual or potential conflicts of interest could be encountered regularly by the Company following listing on the Main Board. While GEM Listing Rule 11.03 explicitly contemplates that a GEM listed company may have a close relationship with a controlling shareholder in certain circumstances, the Listing Rules for the Main Board are substantially different in this respect. Recent precedents established clearly that the Exchange expected there to be a greater separation of the board of directors of a Main Board listed company from that of its controlling shareholder than was currently exhibited by the Company, and the Listing Committee did not consider it

appropriate for different standards to apply to a GEM listed company applying to list on the Main Board.

19. The Listing Committee noted the Company's proposal to revise the structure of its Board of Directors to address concerns of this kind. However, the Listing Committee did not consider the proposed changes would fully address its concerns, and would themselves raise possible concerns regarding management continuity under Listing Rule 8.05(1)(b). As such, the proposals of the Company currently on the record were not considered to be adequate.

Arrangement to manage conflicts of interest

20. It is noted that the corporate governance measures in place (such as review and approval of connected transactions by the INEDs and independent shareholders) only meet the basic requirements under the Listing Rules and are not different from cases where actual and potential conflicts of interest are not a significant concern. Save for the proposed changes to the Board of Directors described above, there are no further corporate governance measures adopted by the Company to manage actual and potential conflicts of interest.

E. The Conclusion

21. Having considered all relevant facts and circumstances in totality, which include, inter alia, the Group's relationship with its Controlling Shareholders and the corporate governance measures adopted by the Company, and on the basis that:
 - (a) the Group's relationship with its Controlling Shareholders is fundamental to its business operations for the reasons set forth above and the Group has not been able to demonstrate that it is capable of carrying on its business independently of its Controlling Shareholders;
 - (b) the Company's proposal to revise the structure of its Board of Directors were not considered adequate and would themselves raise possible concerns regarding management continuity under Listing Rule 8.05(1)(b); and
 - (c) there are inadequate arrangements and no sufficient and tested corporate governance measures to manage conflicts of interest between the Group and its Controlling Shareholders,

the Listing Committee resolved that the Group is not suitable for listing as required by Listing Rule 8.04. Accordingly, the Company's listing application is rejected

F. Other Considerations

22. During the course of the vetting of the Company's listing application, it was apparent that the structure of the Company's Board of Directors and related corporate governance practices were not consistent with the standards the Listing Committee currently expects of Main Board listed companies. In considering the Company's

listing application the Listing Committee acknowledged that the GEM Listing Rules, notably Rule 11.03, contemplated that GEM listed companies may have closer relationships with their parent companies in some circumstances. It was also apparent from the record that the Company had complied with applicable GEM Listing Rules concerning necessary approvals by independent shareholders in all respects. Therefore, absent the Company's application to list on the Main Board, the Exchange and the Listing Committee would not have had occasion to intervene to seek changes to the composition of the Board of Directors of the Company or the principal operating subsidiary of the Company, or to seek other modifications of their relationship with the controlling shareholders and their affiliated companies.

23. It is the ordinary practice of the Listing Committee, through the Listing Division, to work with listing applicants during the vetting process to revise their application materials to improve the level of disclosure for prospective investors and to ensure compliance with the Listing Rules. That practice has been followed in this case. In certain instances the Listing Committee may also establish conditions that must be met in order for an individual applicant to be eligible for listing, so that its expectations on particular matters may be more easily satisfied. In this case the Listing Committee, following due consideration, declined to establish specific conditions for the Company to meet with respect to the composition of its Board of Directors and other corporate governance matters in order to be eligible for a listing on the Main Board.
24. The Listing Committee considered that in the case of an existing GEM listed company, absent an identifiable Listing Rule compliance concern, such matters were more properly left to be decided through the normal operations of a company's Board of Directors and consultation with shareholders as required by the GEM Listing Rules. Any revisions to past practices that may be required to meet the standards of the Main Board were best adopted well in advance of an application for listing, so that the effects of such changes could be reviewed during the application process.

Pursuant to Rule 2B.07(1) of the Listing Rules, the Company has the right to have this decision reviewed by the Listing (Review) Committee.

[Portion of Letter Purposely Omitted]

Yours faithfully,
For and on behalf of
The Stock Exchange of Hong Kong Limited

[Signed]

Secretary to the Listing Committee