**HKEx LISTING DECISION**
**HKEx-LD92-1 (May 2010)**

***[Withdrawn in March 2019; Superseded by HKEX-GL68-13]***

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| **Parties** | Company A – a Main Board listing applicant and its subsidiaries |
| **Subject** | Whether Company A was suitable for listing where it derived a significant portion of its turnover and net profit from transactions with closely related parties |
| **Listing Rules and Other Reference Materials** | Rule 8.04; HKEx-LD8-2 |
| **Decision** | The Exchange doubted Company A's suitability for listing because of its heavy reliance on transactions with closely related persons during the track record period and after listing. This issue could not be addressed by corporate governance measures and disclosure alone |

## SUMMARY OF FACTS

1. Company A provided securities trading brokerage and margin financing services. It derived its income mainly from brokerage commission and margin financing interest.

2. During the track record period (Year 1 to Year 3), a significant portion of turnover and net profit were derived from transactions with the group's directors and employees. Transactions with these directors would constitute connected transactions after listing.

   Table – *transactions with directors and employees expressed as approximate percentages of Company A's turnover, net profit and net profit margin:*

| | **Turnover (%)** | **Net profit (%)** | **Net profit margin (%)** |
|---|---|---|---|
| Year 1 | 90% | 90% | 50% |
| Year 2 | 45% | 40% | 60% |
| Year 3 | 60% | 40% | 35% |

3. If profits from transactions with directors were excluded, Company A would barely meet the profit requirement. If profits from transactions with directors and employees were excluded, it would not meet the minimum profit threshold of HK$20 million for the latest financial year.

4. Company A proposed to have substantial continuing connected transactions after listing:-

a. brokerage services to directors would have an aggregated annual cap for each of the three years after listing representing approximately 50% of Company A's total brokerage commission income in Year 3; and

b. margin financing to directors would have an aggregated annual cap for each of the three years after listing representing over 50% of Company A's total assets as at the end of Year 3.

## THE ISSUE RAISED FOR CONSIDERATION

5. Whether Company A was suitable for listing where it derived a significant portion of its turnover and net profit from transactions with closely related parties?

## APPLICABLE LISTING RULES OR PRINCIPLE

6. Rule 8.04 requires both the issuer and its business, in the opinion of the Exchange, to be suitable for listing.

7. Listing Decision HKEx-LD8-2 recorded a case where a substantial portion of the issuer's profits was derived from connected transactions without which it could not meet the profit requirement. It was decided that the issuer's application should be postponed until it was able to fulfil the profit requirement without including the profits from those connected transactions.

## THE ANALYSIS

### *Reliance on Transactions with Connected Persons and Related Parties*

8. There is no rule that profits from transactions with connected persons or closely related parties must be disregarded in assessing whether the profit requirement under the Listing Rules is met. The Exchange normally considers that this issue can be addressed by disclosure in the listing document.

9. However, where these transactions are excessive during the track record period, this may raise a concern whether the issuer is suitable for listing. First, it will be uncertain whether the issuer can carry on business without these transactions given that the risks of connected transactions could be substantially different from those with independent third parties. Second, where the issuer marginally meets the profits requirement, there is concern whether the connected transactions are designed to enable it to meet the profit requirement. The issue was discussed in Listing Decision HKEx-LD8-2.

10. Based on the following findings, the Exchange had serious concerns on Company A's suitability for listing:

    a. Company A did not have a proven track record of carrying on its business independently of the transactions with connected persons and employees. It would not meet the profit requirement if transactions with connected persons and employees were excluded. The Exchange considered that the principle underlying HKEx-LD8-2 extended to situations where an issuer derived its profits from transactions with closely related parties, e.g. employees in Company A's case;

    b. Its ability to obtain finance from independent financial institutions for its margin financing business was dependent on its historical revenue profile generated from transactions with connected persons and employees. But it had not shown its ability to carry on business without these transactions, and hence its ability to raise independent finance was uncertain; and

    c. reliance on connected persons was expected to continue after listing. Transactions with employees had made up 20% to 30% of its turnover during the track record period and were expected to continueafter listing. There was no objective information to substantiate that income would be generated from new clients.

***Conflicts of Interest Dealings Raised Further Doubts***

11. Heavy reliance on transactions with the issuer's officers, may give rise to higher risk of them overriding internal control procedures and breaching their fiduciary duties to further their own interests. In reviewing these cases, the Exchange will adopt a risk-based approach. The Exchange will examine the issuer's corporate governance measures to handle conflicts of interest and may apply a higher standard of review to ensure the issuer's eligibility for listing. The Exchange may not accept that disclosure is sufficient to address the conflicts of interest issue.

12. Because conflicted dealings occurred frequently in this case, the Exchange considered that a high level of assurance would be appropriate. However, the Exchange did not consider that the conflicts of interest issue had been addressed because:

    a. the SFC had discovered internal control weaknesses in five years before the track record period. Company A proposed to deal with these internal weaknesses by disclosure in the prospectus. It provided no information on how the corporate governance measures it introduced would be able to address the conflicts of interest. There was no information on whether internal guidelines and policies had been adhered to and whether conflicts of interest had been avoided during the track record period; and

    b. the proposed independent non-executive directors were not shown to have sufficient industry experience to advise on conflicted dealings.

## THE DECISION

13. The Exchange doubted Company A's suitability for listing because of its heavy reliance on transactions with closely related persons during the track record period and after listing. This issue could not be addressed by corporate governance measures and disclosure alone.