

HKEX GUIDANCE LETTER

HKEX-GL68-13A (June 2016) (Updated in April 2018 and October 2019)

Subject	Guidance on IPO vetting and suitability for listing
Listing Rules and Regulations	Main Board Rules 8.04, 2.06 GEM Rules 11.06, 2.09
Related Publications	HKEX-GL68-13 - Guidance on suitability for listing HKEX-GL56-13 – Guidance on (i) disclosure requirements for substantially complete Application Proofs; and (ii) publication of Application Proofs and Post Hearing Information Packs on the Exchange's website
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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 shall prevail. You may consult the Listing Department on a confidential basis for an interpretation of the Listing Rules or specific issues raised in this guidance letter.*

1. Background

- 1.1 The Exchange notes that there have been a number of listed issuers where their controlling shareholders either changed or have gradually sold down their interests shortly after the regulatory lock-up period following listing. One explanation for this phenomenon is the perceived premium attached to the listing status of such issuers rather than the development of the underlying business or assets.
- 1.2 The Exchange believes that such companies (often referred to as “shell companies”) will invite speculative trading activities when identified by potential buyers. This can lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market post-listing, none of which is in the interest of the investing public. Furthermore, activities by such companies may be structured so that they are not subject to regulatory scrutiny under Rules 14.06B to 14.06E, our Guidance Letters HKEX-GL78-14104-19 on reverse takeovers, and HKEX-GL84-15105-19 on cash companies large scale issues of securities. (updated in October 2019)
- 1.3 The Exchange has concerns in respect of listing applicants whose size and prospects do not appear to justify the costs or purpose associated with a public listing. This raises questions regarding the reasons and justification for their listing, and therefore raises concerns regarding the suitability for such listings.

Review of Past Listings and Observations

1.4 The Exchange's concerns have led to a review of all new listings on the Main Board and GEM between 2012 and 2014 together with selected companies in 2015. We focused on companies in which the initial controlling shareholder had sold down to below 30% or appeared to be in the process of selling down its controlling stake of the company and identified characteristics shared by such companies ("**Target Companies**"). Based on the empirical data, it is observed that Target Companies have one or more of the following characteristics:-

- (i) small market capitalisation;
- (ii) only marginally meet the listing eligibility requirements;
- (iii) involve fund raising disproportionate to listing expenses (i.e. a high proportion of the listing proceeds were used to pay listing expenses);
- (iv) involve a pure trading business with a high concentration of customers;
- (v) are asset-light businesses where a majority of the assets are liquid and/or current assets;
- (vi) involve a superficial delineation of business from the parent whereby the applicant's business is artificially delineated from the parent by geographical area, product mix or different stages of development; and/or
- (vii) have little or no external funding at the pre-listing stage.

This brings into question the suitability for listing of such Target Companies and whether they should be subject to a more focused review by the Exchange.

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 the Listing Rules may not itself ensure an applicant's suitability for listing.
- 2.3 Guidance Letter HKEX-GL68-13 provides guidance on the factors which may be relevant 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).

3. Guidance

- 3.1 The Exchange considers that suitability is a fundamental listing requirement and conducts appropriate review of all applications to maintain the quality and reputation of the Hong Kong market. Applicants should note that there is no prescribed bright-line

test in determining suitability and the Exchange will take into account facts and circumstances of each case.

3.2 In this regard, the Exchange expects that the applicant and sponsors should provide a robust analysis in the listing document to substantiate that the applicant is suitable for listing including, among other things, in the following areas:-

- (i) **Use of proceeds** – we would expect that the applicant to disclose specific uses for proceeds commensurate with the applicant’s past and future business strategy and observed industry trends and explain the commercial rationale for listing. We would not be satisfied with generic descriptions such as (a) using listing proceeds to increase reputation and brand awareness, (b) for potential acquisitions without identified target and specific selection criteria, and/or (c) for expansion through increase in headcount;
- (ii) **Future objectives and strategies** – we would expect a comprehensive analysis to be provided to demonstrate that the applicant has a detailed strategic plan for its business operations and growth;
- (iii) **Profit and revenue growth** – where an applicant (a) has experienced decreasing or low profit and revenue growth; and/or (b) is expected to record decreasing or low profit and revenue growth after listing, a comprehensive analysis is required to substantiate that the applicant’s business is sustainable;
- (iv) **Potential sunset industries** – where an applicant is in a potential sunset industry or in an industry that has declining market prospects, the applicant must be able to demonstrate that it is feasible and it has both the ability and resources to modify its business to respond to the changing demands of the market; and
- (v) **Cost of listing** – if a significant portion of the listing proceeds will be applied to listing expenses, the applicant should explain how the advantages of listing outweigh the cost of listing.

3.3 Sponsors are therefore reminded that before submitting an application to the Exchange for listing on behalf of an applicant, they should ensure they are aware of all material issues which, in their reasonable opinion, are necessary for consideration of whether the applicant is suitable for listing.

3.4 The Exchange may impose additional requirements or conditions on applicants or exercise its discretion to reject the applicant’s listing on the grounds of suitability. We would like to emphasize that this Guidance Letter is only part of the suitability assessment by the Exchange, and there may be other issues which could render an applicant not suitable or eligible for listing. Please refer to our Guidance Letter HKEX-GL-68-13 “Guidance on Suitability for Listing”.

3.5 You may consult the Listing Department on a confidential basis for an interpretation of the Listing Rules or specific issues raised in this Guidance Letter. However, the Exchange will not give specific guidance on the suitability of an applicant as a whole for the purpose of this Guidance Letter as an assessment of suitability can only be made when a substantially complete application proof is provided.

4. Recent Development (Updated in April 2018)

- 4.1 Since the publication of this guidance letter, we have observed that certain listing applicants and their sponsors have treated the characteristics we listed in paragraph 1.4 as a checklist. We emphasise that our focus is a qualitative review on the applicant's suitability such as whether a listing of the applicant is consistent with its business strategy, including the proposed use of proceeds and whether the applicant has genuine funding needs (please refer to paragraph 3.2).
- 4.2 The Exchange will continue to use its broad discretion in determining suitability. If the applicant is unable to demonstrate the commercial rationale for listing, we may find that the applicant is not suitable for listing irrespective of the nature and financial standing of the business operated by the applicant. In addition, if we are aware of specific facts and circumstances which give us a reasonable basis to believe that an applicant is likely to invite speculative trading upon listing or to be acquired for its listing status, we may find the applicant to be not suitable for listing.
- 4.3 Some controlling shareholders or major shareholders have voluntarily provided lock-up undertakings to the applicant that extend beyond the requirements under the Listing Rules to demonstrate their commitment to develop the businesses after listing. These longer lock-up undertakings do not in and of themselves address our concerns.
- 4.4 Once listed, an issuer must ensure that it and its business continues to be suitable for listing. Failing to meet this requirement may lead to the Exchange canceling the issuer's listing under Main Board Rule 6.01(4) (GEM Rule 9.04(4)). The Exchange closely monitors the developments of listed issuers. It may have a concern about the suitability of an issuer or its business for continued listing if, for example, the issuer's activities are found to deviate significantly from its original business model or strategy or the commercial rationale for its listing set out in its listing application.
